Criteria for approaching a venture capitalist

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VC-backed firms have more leverage to innovate and create more employment and growth than their peers. What are the criteria for investing in such funds?

Venture capital funds are not the first element in the capital supply chain for young, start-up corporations. Institutional investors such as pension funds, insurance, funds of funds and endowments all fall under the umbrella of supplying the money that eventually leads to venture capital (VC).

The criteria used by an institution when allocating capital to venture funds are of primary interest to IESE Prof. Heinrich von Liechtenstein and visiting professor Alexander P. Groh. The two economists surveyed more than 1,000 institutional investors to determine the importance of several criteria when selecting VC funds. The results are presented in their paper, "The First Step of the Capital Flow from Institutions to Entrepreneurs: The Criteria for Sorting Venture Capital Funds."

Investors were asked to consider: the expected deal flow and access to transactions; a VC fund's track record; local market experience; team member's experience matched with the proposed investment strategy; general reputation; and the proposed mechanism to align interests between institutional investors and the VC funds.

As one might expect, the criteria used by investors when choosing a VC fund are fundamentally similar to the criteria used by the venture capitalists themselves. The professors do note that fees payable to funds are an added criterion in sealing the deal for investors, but that these fees are not considered "important" when initially selecting the fund. For the most part, when reviewing thousands of possible VC funds, institutions seek to

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diminish the same types of agency conflicts that venture capitalists face when searching for possible entrepreneurs.

Between the institutional investors and VC funds lies an entire chain of intermediaries - agents such as general partners and limited partners who are all in competition for the funds being raised, not unlike the reality of entrepreneurs vying for capital to get a business idea off the ground. To that end, the authors say, understanding the level of importance of each of the criteria can serve the purposes of both investors and VC managers alike.

Results vary by geography, type and size

The professors surveyed 1,079 institutional investors around the world. The vast majority (77 percent) came from North America, with the rest from Europe (17 percent), Asia (5 percent) and other regions (1 percent). The participating limited partners were segmented as follows: corporate investors, government agencies, banks, pension funds, insurance companies, funds of funds, endowments and others.

According to the general survey results, the top criteria were deal flow/access to transactions, track record, local market experience, match of team background and strategy, and the reputation of the team or individuals involved.

To test for sample selection bias, the response behavior of different sub-groups of respondents was also analyzed. In doing so, the authors gain more detailed insights for geographical investors. For example, reputation was found to be a more important criterion for European limited partners than for North American ones.

The authors also divide the respondents into sub-groups based on types of funds. Notably, they find that the limited partners in charge of funds of funds pay more attention to interest alignment than other institutional investors. The reason for this, they figure, is that "funds of funds are on a higher level of the intermediary relationship and cannot directly invest in any assets but have to diversify among other funds."

The least important criteria appear to be general fee levels and commitments from other reputed limited partners. Again, these vary according to geographic region, as well as different types and sizes of institutions.

"The findings confirm the importance for general partners to operate close to their investments, to build a strong operational network that secures deal flow, and to focus on long-term quality to establish a successful track record," state the authors.

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Business domino effect

Institutional investors' selection of VC funds is driven by three main elements: investment strategy and expected implementation; local expertise and incentive structure; and prestige/standing versus cost.

In a business domino effect, institutional investors rely on the same strategy when selecting the general partner as the venture capitalist does when choosing the entrepreneur.

These results contribute to a better understanding of institutional entrepreneurial finance. The VC allocation process can be convoluted by fees and agents vying for capital. However, understanding what institutional investors hold most dear allows venture capitalists to adapt strategies and create more efficient incentive structures while mitigating agency cost.

Institutional entrepreneurial finance is all about people, their expected ability to implement a certain strategy and, of course, the incentive structures. Venture capitalists approach an entrepreneur the same way an institutional investor approaches a general partner. All have the same goal. Thus, entrepreneurs, too, can glean insights from the findings of this paper, since they essentially share the same goals as the venture capitalists: to secure funding.

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