# Analyzing the business model of early stage venture capital firms and identifying the factors for success.

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## Abstract

**Research Title:** Analyzing the business model of early stage venture capital firms and identifying the factors for success.

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The research aims to investigate the challenges that early stage venture capital (VC) firms are facing and will identify the factors that give an edge to well-established venture capital firms. With more venture capitals firms being formed as the outlook of the venture capital industry has been optimistic, the research will study the landscape and elements that a venture capital firm requires in order to thrive. This research will also explain the business model of early stage venture capital firms and how venture capital firms cover their operationalcosts.

Looking into how the policy makers in Singapore have managed to quickly learn from the international best practices and developed policies for the local market will help us better understand how the country has managed to draw a big pool of venture capital firms and entrepreneurs. This research will deep dive into some of the essential factors that venture capital firms and entrepreneurs should build up and maintain in order to succeed, and will focus on elements which were key to building an attractive venture capital market, and will highlight the significance of establishing or relocating a venture capital firm into a market with robust policies and regulations in the venture capital industry.

**Key words:** Venture Capital (VC), early stage investment, Factors of success for venture capital firms and entrepreneurs.

**Approved by**

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## Introduction:

Venture capital firms have been playing a big role in driving the success of the early stage firms that they invest in. not only with capital injection but as well with providing those early stage firms with a bundle of value-adding activities to de-risk and increase the success rate of their investments. “Many new ventures, which receive fund and services from venture capital, such as Microsoft, Apple, Yahoo, and Amazon, grow up faster and steadier than those without investment from venture capital”. **(Jin, Zhang, Shan & Li, 2015).**

There are two main factors that can be used to define how strong a VC fund will perform.

1. VCs raise funds from a set of limited partners, typically, corporate entities, family offices and UHNI. Hence, knowledge, operational expertise and network access that can help early stage firms to scale in other countries, which a VC can offer is dependent on the experience and the network of its GPs and LPs. A venture capital firm with international ties will help with the transmission of knowledge from other international innovation hubs. “Due to the distance constraints associated with the transmission of knowledge, it is unlikely that new knowledge created elsewhere finds its way to the cluster in a timely manner, if it were not for directly established contacts with those distant innovative hubs”. **(Bringmann, Vanoutrive & Verhetsel, 2018).**

2. Scale of the fund is a major factor that dictates how the fund will support its investments on the following rounds of funding and the level of operational support that the fund managers can provide to those investments.

In order to understand the VCs investments strategies. It is important to explain the business model of the VCs by understanding how do venture capital firms cover their operational cost and make money on their successful investments.

VCs firms covers their operational cost by taking a management fee which varies from 2 to 3% of the fund’s total investment capital. therefor a VC with a bigger fund size will be able to afford hiring bigger and more experienced team compared to VC with a smaller fund size. More significant financial gains will be from an exit, an exit can take place through an initial public offering (IPO) or by being acquired by another company (M&A). At that point, the VCs will be retaining 20% of the profits from the financial gains remaining after returning the original fund size to the LPs. Afterwards the rest of the financial gains will be distributed between the LPs.

Finding and evaluating early stage firms with a good potential for a successful exit depends on the personal experience and network of the VC firms. **(Zhong, Liu, Zhong & Xiong, 2018)** With that

being said, having a strong experienced team will have a huge impact on the type of investments opportunities that each VC firm is able to source. Subsequently, this indicates that the stronger and bigger the VC firm is, the more successful the firm can be.

The scale of the fund plays a big role with how many investments a fund can do, which subsequently boils down to how many successful exits can take place during the lifetime of the fund. **(Gregson, Bock & Harrison, 2017)** highlighted during his research that increasing portfolio size reduces risk and provides more stable returns.

The rule of thumb being followed by the majority of the VCs known as "one in ten." Under this rule, a venture capital firm needs at least one in ten of its investments to be a "home run", an investment that generates not only enough profits to cover the other nine but also enough to ensure an ROI to the LPs high enough to justify follow-up investment in the next fund". **(Breznitz, Forman & Wen, 2018).**

To ensure the continuity of their business the VC firms will need to justify to their current and potential LPs, the value of investing in their funds. This is something which bigger and more established VC funds are able to do due to their track record. That track record is built on successful investments and exits which the VC firms have executed in the past and how strong is their core management team and investment committee. Which have led the fund to perform well and generate favourable ROI to its LPS despite its losses. "The VC business model specifically seeks "big-ticket" financial exits that will not only cover the losses of their other investments but also generate enough pay-out to offer high rates of return to their own investors". **(Breznitz, Forman & Wen, 2018).** The edge of a bigger venture capital firm in that case would be the track record of their previous funds, which backs up the fund-raising process for their following funds. this allows their LPS to use statistical analysis to evaluate the VC performance based the historical data provided by the VC. "In order for the VCs to be able to secure investment for their next fund, they need to show current and prospective LPs that, after taking all costs and risks into account, their fund's rate of return on investment (ROI) is more attractive than that of other investments". **(Breznitz, Forman & Wen, 2018).**

## A problem to be investigated:

VC firms with minimal global ties and comparably weaker track record to more established VC firms, are unable to execute the four phases of risk cycle as efficiently as compared to more established VC firms. Starting with raising funds from LPs, in which the VC track record, experience of the management team will be an advantage. The fund-raising phase will be followed by the investment

phase which requires strong pipeline of deal flow plus a well-defined and executed deal analysis process. The deal flow pipeline is the output of the how the VC firm is distinguished of being able to provide high level of support to each of their portfolio companies with operational expertise, knowledge, network and follow up funding. Hence, more experienced founders of early stage startups will tend to select a more established VC firm to invest in their firms. The investment phase will be followed by monitoring phase to make sure that the expected results are being achieved by the investees. The cycle ends when VC funds are able to return capital to shareholders by exit mechanisms in which a more established VC firms are able to create by leveraging their global ties and network. Based on that, more established VC firms are outperforming the VC market. **(Sincerre, Sampaio, Famá & Flores, 2019).**

The biggest challenge which is most evidently seen on the popular TV show Shark Tank is that the entrepreneur wants to get the most money from the investor while giving up the smallest share of the company but the investor wants the opposite. More established VC firm with a team of analysts and wide experience in valuing companies will have an edge over a newly established VC firm. **(Krumm, 2017).**

## Objective:

The research will explain some of the similarities and differences between small and large early stage venture capital firms and the factors which can give an edge to a firm. The research will also explain the business model of those firms and how they cover their operational cost and make money from their successful investments. as a starting point it's important to understand that the main focus of early stage venture capital is to invest in early stage companies.

The research will investigate how setting up or relocating and operating a venture capital firm or a startup in a country with more attractive economical and legal structure can impact its performance. This will also highlight some of the policies and regulations that the Singapore government has managed to develop in order build an attractive and strong ecosystem.

## Scope of the study

A deep dive into the factors that can directly impact the success or failure of early stage venture capital firms and entrepreneurs who are building their ventures in the booming era of venture capital and entrepreneurship. By understanding those factors and applying this knowledge, the early stage venture capital professionals and entrepreneurs can increase their success chances and mitigate the risk of failure.

## Research significance:

Understanding the challenges that early stage venture capital firms and entrepreneurs will possibly encounter and the factors that can help with the success will subsequently influence the overall business strategy and the decision-making process. Therefore, it is highly beneficial for early stage venture capital firms and entrepreneurs to have a good understanding of the ecosystem landscape in their respective markets, the competition, local rules and regulations as well as government support.

## Literature review:

Earlier researches on venture capital have presented that venture capital firms have been playing a crucial role in supporting early stage companies which is also referred as startups for a long time, especially in new high-tech startups, many successful high-tech enterprises, such as Microsoft and Netscape, once received support during their development by venture capitals. Venture capital is risky simultaneously, even though it is vital to the economic development in general. As presented by **(Zhang, Xiang, Ding & Chen, 2017)** that it could be very difficult or almost impossible to receive finance service support from traditional channels such as banks and securities agencies for entrepreneurs due to the shaky nature of innovative projects, incompleteness of accounting certificates, or insufficiency of fixed assets.

Venture capital has become a significant source of financing for entrepreneurs under capital constraint. VCs provide not only capital venture funds to the entrepreneurs, but also assistance with strategic and operational planning, management recruitment, marketing, and obtaining additional capital, for the purpose of promoting the level of profitableness by acquisition or IPO.
The most important task in the management of venture capital is maintaining and increasing the value of venture capital. The management team of the VC spends time and effort in selecting the venture projects which potentially have a good prospect in the future. However, at a very early stage of a venture project, the VCs usually do not clearly know the entrepreneur's management ability, the effort level, and the return and risk condition of the project. **(Ding, Chen, Liu & Zheng, 2015).**

According to current literatures on venture capital, staged financing could mitigate financial risk, the VC invests in stages to control risks and makes refinancing decisions according to the project condition. In order to mitigate the risk venture capital firms prefers multi stage investment to venture projects **(Ding, Chen, Liu & Zheng, 2015)** This will help the VC with deciding to continue investment if the venture project is of good quality or to withdraw from the project if the project fails.

In essence, the VC management team will rely on their experience and the experience of their network to assist with the selection process which in some cases can hinder the decision-making process. An example of VCs with both low and high levels of IT knowledge will be more likely to overestimate their ability to overcome the adversities of the business environment of an IT start-up due to their overly positive and unrealistic view of how much they know about the IT domain. As highlighted by **(Singh, Aggarwal & Cojuharenco, 2015)** that VCs' misplaced confidence ultimately hurts everyone in the system—VCs lose reputation, limited partners lose money, and the society fails to grow jobs.

In examining the early stage investment (**Kim & Wagman, 2016)** found that VC firms have put in place dedicated funds to make small, seed investments, viewing them as sources for potential follow-on investments.

Moreover, start-ups may belong to any sector, manufacturing or services or both. The start-up may be using technology extensively or trying to promote technologically based products or services. A start-up may explore an inventive business model which may churn existing organizations or markets. The startup entrepreneur would have gained the knowledge about his main product/ service through a high level of self-motivation, creativity, learning capabilities and desire to succeed.

Securing financing from a venture capital firm is not an easy task and the ability of the entrepreneurs to present and communicate their investment case in a manner that corresponds with the investment process of the particular financing source is an important skill. **(Rasmussen & Sørheim, 2012).** On top of that, the higher quality management teams increase the likelihood that technology ventures will raise early-stage capital **(Townsend, & Busenitz, 2015),** this can be demonstrated through the ability of the entrepreneurs and their business plans through the acquisition of new customers for their newly developed products and services. This early-proven execution ability enables the firms to gain credibility from new potential customers. More importantly, the executives' track record of past performance. Such credible information empowers the entrepreneurs to approach new potential investors for the next stage of financing requirements. This observation suggests the significance of founding executives in leveraging their external networks and social communities to enhance the process of entrepreneurial finance. (**Ng, Macbeth & Southern, 2014).**

Building and maintaining relationships with a sizeable network of entrepreneurs and venture capital professionals is instrumental, a recent study by **(Parida, Pesämaa, Wincent & Westerberg, 2016)** have indicated that small firms and new ventures can largely mitigate market uncertainty and dynamism when they effectively use their network capability to benefit from external relationships. A network capability is fundamental construct that secures relationships with partners in networks or alliances. Moreover, VCs rely heavily on their network to source start-ups A start-up thus has better

chances of finding its next investor if its existing ones are well connected as stated by **(Gompers, Gornall, Kaplan, & Strebulaev, 2020)** that few VC investments come from entrepreneurs who beat a path to the VC's door without any connection.

With a specific focus on the factors of success for venture capital, several previous literatures emphasized the importance of the network as **(Sorenson, 2018)** have highlighted in his research that Venture capitalists rarely fund entrepreneurs with whom they do not have a prior direct or indirect relationship. In part, this probably reflects the fact that venture capitalists can gather information — do due diligence — more effectively on entrepreneurs with whom they share a connection. Although it has been concluded by **(Checkley, Steglich, Angwin, & Endersby, 2014)** during their research of how interfirm networks improve performance outcomes in the UK venture capital market that more interfirm connectedness causes higher performance outcomes.

Equally important is the support that of the VC post the investment process or portfolio management as **(Bernstein, Giroud, & Townsend, 2016)** research results indicated that VCs' on-site involvement with their portfolio companies is an important determinant of innovation and success not only but also the increase of VC involvement improves portfolio company outcomes. An effective involvement and support require the venture capital firms to utilize the specific knowledge of its management team and network. **(Wu, Yang, Lee, & Mcmurtrey, 2019)** research result shows that the private knowledge transferred from venture capitalists can improve the technological innovation ability of VC-backed firms. That level of support that each VC firm is able to grant to its ventures is entirely driven from the VC management team which is required to handle flow of information and resources from the VC network to support the ventures seamlessly. **(Milosevic, 2018)** research conclusion is that companies which are backed by VC firms with a higher proportion of managers with prior R&D, entrepreneurship, VC and investment banking experience have a higher probability of a successful exit.

In spite of the support that VCs are offering to their venture and in order to mitigate the risk of financing those ventures, VCs exercise staged financing which is a common practice and vital activity to reduce uncertainty by limiting negative financial exposure in subsequent staging round instead of investing a lump sum, VC investors split finance into multiple rounds, where the next round disbursement depends on whether the startup company meets the current round's performance target set by the VC. results suggest that early-stage investors may benefit from using a real options investment strategy and investing smaller tranches of capital in ventures beset by high levels of uncertainty, regardless of the quality of the management team. as presented on the findings of (**Sharma, & Tripathi, 2016**) that startups will decrease their chances of the next round of funding for

one possible reason, which is not being able to meet their milestones. research results have shown that the investment decreases sharply with subsequent rounds for that possible reason.

All of the highlighted factors can be controlled internally on an individual organizational level however the regulations and role of the government is a fundamental factor that can greatly impact the overall all performance of the VC industry as the government plays a crucial role to support it. This can be in the form of setting up government VC funds and co-investing in start-ups which is the case in Singapore as highlighted on **(Wonglimpiyarat, 2013)** research that Singapore has a thriving VC industry where its success can be attributed to the government acting as a catalyst to promote the VC industry.

Looking into the factors of success for early stage ventures, several previous literatures highlighted the importance of the founder's connections and network. **(Spiegel, Abbassi, Zylka, Schlagwein, Fischbach, & Schoder, 2015)** found that start-ups with better-connected founders are more successful because the founders' professional social networks provide the required means to develop the business model in the early stage of the start-up. Although it has been suggested by **(Banerji, & Reimer, 2019)** that start-up companies with well-connected founders have access to more resources and found that there is a positive correlation between founder LinkedIn number of followers and funds raised per year by companies. Additionally, **(Bellavitis, Filatotchev, & Kamuriwo, 2013)** have posited that, in order to thrive, a new firm needs to have a richer set of ties that provides access to different types of resources and opportunities.

Furthermore, early traction has been proven to be vital for success. Successful founders do not consider product-market fit as traction, they understood that it takes considerably more effort to gain traction which requires branding, promotions, enterprise sales, and marketing to increase conversion rates, reduce the costs of acquiring customers, and to improve growth in users and revenue. **(Zaheer, Breyer, Dumay, & Enjeti, 2019).**

The regulations and role of the government plays an important role in the startup growth. The state can play a lead role in strengthening the relationships among various actors of the big data ecosystem and prioritize and sequence steps to manage big data analytics for public policy and program management. An example of how governments can support the startups with creating success and positive results can be Singapore. (**Hanna, 2018)** research included Singapore among other leading examples in promoting and diffusing digital transformation highlighting that Singapore continues to improve its services, innovate new ones, and provide a test bed for new waves of digital technologies.

**Findings and Conclusion:**

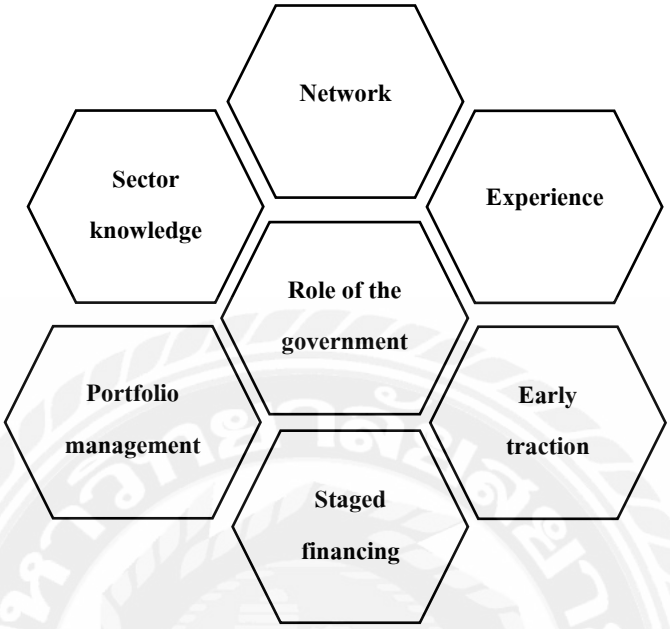


**Fig. 1. Internal and external factors of success for early stage VC firms and entrepreneurs**

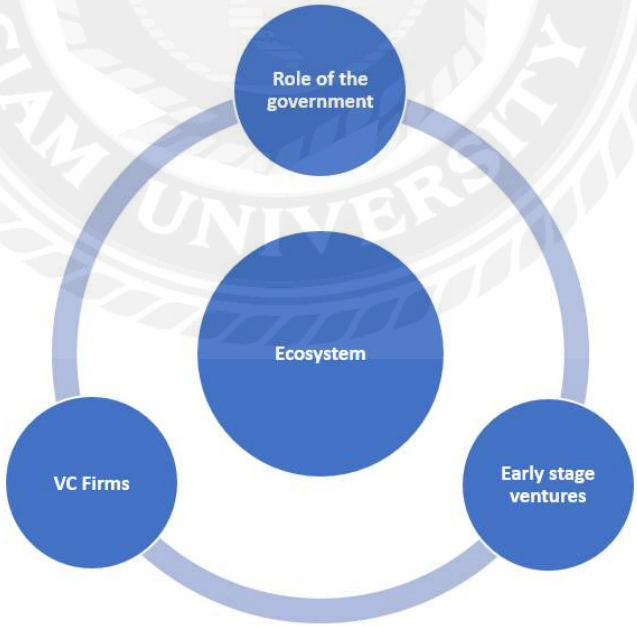


**Fig. 2. Players in the ecosystem**

Fig.2. Points out the key players in the startup ecosystem and as shown that the main players are required to be correlated in order to develop and maintain a successful startup ecosystem.

Fig.1. points out the factors of success related to early stage venture capital firms and ventures that have been researched during the study.

Based on all the factors that have been examined and used for the development of this research, the role of the government have been identified as a paramount factor in view of the fact that role of the government is an external factor that goes beyond the control level of the VC firms and/or the early stage ventures. In addition, the research found that there is a significant importance for the role of the government in the success of early stage ventures and attracting venture capital firms by promoting innovation and implementing favorable policies for the VC market.

Through studying several success cases on how governments can stimulate their local ecosystem, we have identified success cases from Singapore and China which supplements our finding as **(Klingler-Vidra, 2016)** pointed out that Singapore government adopted the LP structure in 2002, but departed significantly from the neoliberal model as its policy-makers deployed an internationally focused USD 1 billion fund, offered permanent residency for VC fund investors and gave a tax credit for start-up investment losses. furthermore, Singapore deployed the USD 1 billion Technopreneurship Investment Fund (TIF). The TIF was a fund of VC fund in which the Singaporean state invested in VC managers (in exchange for) their operating in Singapore. As for China, the country managed to create the second largest VC market in the world despite its immature legal infrastructure. The lesson to be learned from the Chinese experience is that the optimal role of a government in engineering a VC market should be to provide the necessary enablers, while playing only a limited role in the capital allocation process by simply providing seed funding and leaving specific capital allocation decisions such as selection of portfolio companies and designing investment strategies to private VC firms with the right incentives. **(Lin, 2017).**

Empirical studies into the policies which every government is implementing to support the startup ecosystem and how those policies impact the success of the startups found that these policies vary significantly between different startup ecosystems as every startup ecosystem have different levels of support measures and different levels of success in creating, growing and retaining local startups and attracting foreign promising startups. **(Pustovrh, JakliČ, Bole, & Zupan, 2019)** research highlighted that a growing ecosystem also makes it attractive for entrepreneurs and companies from nearby environments, who see the advantage in moving from their own environment to an ecosystem that enables them faster growth and development. Due to the mobility of startups, successful ecosystems thus quickly become globally attractive ecosystems.

## Recommendations:

In this research paper we set out to examine the success factors that can significantly impact the performance of the VC firms and new ventures. The research has identified the role of the government as crucial in promoting and developing an attractive local VC market and a startup ecosystem that can attract promising foreign VC firms and startups which can contribute immensely into the success of those VC firms and early stage ventures.

The research sheds light on the investment decision process of early-stage VC investors, the fund-raising process of the VC firms from their LPs and how VC firms make money and cover their operational cost. Unlike investments in the public market and the publicly traded firms, little is known about the selection process of these VC firms, despite their important role in promoting innovation and economic growth. Based on the findings of our research study that there are some factors that can increase the probability or the chances of the entrepreneurs in getting funded from an early stage VC firm. Our research findings are in line with **(Ismail, & Medhat, 2019)** study which concluded that the decision to fund a new startup is mainly shaped by the entrepreneur's industry experience, product stage, revenues, time of applying to the VC fund, and the size of the entrepreneur's social network.

The research finds that VC investors react most strongly to the information about start-ups that have been referred to the VC firm through its network. We further find suggestive evidence that VC investors care about a founding team with prior experience in working or founding an earlier startup, this is because teams matter for operational reasons. The most experienced VC investors reacts only to the experience of the founding team, which suggests that the selection process based on the founding team information can be a successful and viable investment strategy. The research also revealed that startups with a product which is fully developed and tested in the market or what we can call early traction had higher chances of getting funded than startups with partially developed products and no traction. Which is in line with **(Ismail, & Medhat, 2019)** research stating that with a ready or commercialized product, VC firms uncertainty is decreased and the informational gaps are reduced and venture capitalists have a preliminary idea on what the business is worth, furthermore, **(Falik, Lahti, & Keinonen, 2016)** study highlighted that entrepreneurs with previous startup experience, and in particular success stories, provide an indication that the entrepreneur in question is capable of turning an invention into a successful and viable business. A convincing track record can help entrepreneurs attain a target valuation for the investment.

Additionally, the research has identified that the similarity in a VC firm and a venture technical experience can lead to positive assessment bias and higher likelihood of the venture being funded by that specific VC firm. This is due to the increased level of the technical complexity of the product or the service that have been developed by the venture. Hence, that specific technical expertise will allow the two parties to communicate more easily and efficiently with one another, which is in line with the research results of **(Aggarwal, Kryscynski, & Singh, 2015)** stating that VC technical competence strongly correlates with assessment accuracy, and that similarity in technical competence strongly predicts positive assessment bias.

However, the research did not study the impact of corporate venture capital (CVC) on early stage ventures which is as important but relatively understudied element in the early stage venture capital research. The CVCs are typically stand-alone subsidiaries of non-financial corporations and they invest in new ventures on behalf of their corporate parents. **(Chemmanur, Loutskina, & Tian, 2014)** research concluded that CVC-backed firms achieve a higher degree of innovation output, as measured by their patenting, although these firms are younger, riskier, and less profitable. Which also indicates that CVCs are able to better nurture innovation and having a greater failure tolerance**.** This can be an interesting topic for future research studies.

Overall, the results in this paper present consistent and strong evidence suggesting that the role of the government is one of the key elements needed in the local market in order to promote and maintain a promising and attractive entrepreneurship ecosystem and VC market which can contribute to the success of early-stage VC firms and ventures.

The results of this study are useful for governments interested in building a successful startup ecosystem as well as institutions interested in financing and backing early stage start-ups. The study contributes to the technology entrepreneurship literature by exploring the factors that can influence the performance of VC investors as well as new ventures.

Finally, our research study is also beneficial for entrepreneurs who are running their early stage venture and interested in raising funds from VCs. They can use the research study to understand how they will be evaluated by the VC firms, what kind of information they are expected to present, and what they can expect VCs to do post-investment.

Alike to other studies, this research study contains limitations, which presents opportunities for further study. The research study is formed on the method of testing the success factors of VC firms and early stage ventures. Other significant success factors may exist among other firms which was not involved, for example, CVC-backed firms can achieve a higher degree of innovation output. The understanding

of the support and technical expertise that CVCs are able to provide to early stage ventures can be improved with further study.

**Limitations:**

The findings of this paper may be useful for future research. The gaps emerged from the literature review underline that despite in the past few years there is a growing number of articles published on this topic, the factors of success of VC firms or new ventures is still fragmented and many topics and research directions are still considerably unexplored. Nevertheless, the findings have produced meaningful implications on venture capital, new ventures and government support. However, a specific limitation needs to be mentioned. While the study examined the effect of venture capital and government funds on the performance of ventures, we could not identify the effect of investment and support from a corporate venture capital. It is expected that the performance effect of a new venture may differ according to the level of support that the VC investors and local government can offer to those new ventures however, our sample did not include information in regards to the success factors of corporate venture capital. If this information is included, future work would show the effect of each VC and CVC on the performance of venture firms.

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