A Systematic Literature Review of the Assessment Criteria Applied by Equity Investors

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Abstract: What assessment criteria are most widely used by equity investors during their funding decisions? In the context of the so-called picking winner's problem, which aspect do they consider most? Is it the jockey (entrepreneurial team), the horse (product/service), the race-track (market) or the odds (financials) to make the difference? Despite the investment evaluation funnel being very selective, about 35% of the venture-backed firms actually fail and, considering a conservative estimate, an additional 20% doesn't provide the expected return on investment. The data therefore indicate that the investment process has large room for improvement. This paper is a systematic literature review of the research about the assessment criteria used by equity investors (venture capital and angel investors) during their investment decision making process. The research is designed around three research questions. RQ.1: what are the criteria used by equity investors to support their decision-making process in venture funding? RQ.2: what are the investment criteria that have been most discussed in the literature? RQ.3: which aspects of the company are mostly assessed by investors? After screening the abstract of 894 unique journal publications, 53 articles were selected for a detailed analysis. The criteria mentioned in every study were registered and 208 distinct drivers were identified. The criteria were classified into 35 specific categories, 11 generic classes and 4 main domains of analysis (respectively related to the venture, the investor, the risks factors and the environment). The high detail and granularity of the analysis is one of the added values of this work compared with previous literature. The authors propose a new approach to research, based on the use of large databases on ventures funding (e.g. Crunchbase). By analysing data on thousands of actual investments, researchers could introduce a radical change of perspective in this field of research.

Keywords: startup; investment decision; evaluation criteria; venture capital; business angel; crunchbase

1. Introduction

Technology-driven ventures generally operate in close relationship with equity investors, such as Business Angels (BAs) and Venture Capitalists (VCs). The survival rate for VC-backed venture is higher than for non-VC-backed ones (Kunkel and Hofer, 1991; Sandberg, 1986; Timmons, 1994). However, the statistics on the financial success of equity-investments show that the failure rate is still quite high. The numbers vary depending on the definition given for failure. According to the National Venture Capital Association (NVCA) 25% to 30% of the venture-backed companies in the U.S. fail, which might suggest that 70% to 75% succeed. This percentage is generally calculated only on the number of companies that definitely close their business.

Other studies provide very different numbers. According to Shikhar Ghosh, of Harvard Business School, about 35% of the venture-backed firms in the U.S. liquidate all assets, with investors losing most or all their money; another 40% don't liquidate all their assets but they don't even return investors' original capital; 20% do return investors' original capital but fail to provide the projected Return on Investment (ROI) and only 5% succeed in providing the projected ROI or more (Gage, 2012). Whatever the statistics we consider, the data indicates that the equity investors decision-making process has wide room for improvement.

In order to maximize the probability of getting the projected ROI, an investor can work to improve the different stages of the funding process. i.e. deal sourcing, scope-specific screening, generic screening, first-phase evaluation, second-phase evaluation, deal closing, post-investment activities and exit strategy (Wells, 1974; Tyebjee and Bruno, 1984; Hall, 1989; Fried and Hisrich, 1994; Boocock and Woods, 1997; Bliss, 1999; Silva, 2004). According to various studies (Dorsey, 1979; Tyebjee and Bruno, 1984; Bygrave and Timmons, 1992; Zacharakis and Meyer, 1999), a greater chance of success for the investor can be obtained by improving the investment decision making strategy. The use of more effective criteria during the assessment process could therefore increase the probability of success in the so-called *picking winner's* problem. The analysis of investment criteria has therefore been over time a very interesting topic for many researchers in entrepreneurship.