Venture capitalists can improve success by considering prior funding

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Investors benefit from considering prior funding sources when selecting entrepreneurial start-ups, reveals new research from Nyenrode Business University. This insight is also of societal importance as particularly entrepreneurial start-ups have proven to benefit society at large, in innovation and employment, even more so than established corporates.

Dr. Job Andreoli, Assistant Professor of Finance at Nyenrode, found that while practice and academia point to only two investment considerations (i.e. the entrepreneur and the venture, or 'the jockey' and 'the horse'), a third consideration deserves attention too: prior funding sources.

Dr. Andreoli studied ventures early stage, actually before these ventures have a product or service to evaluate, and need funding to do so. This is when the information asymmetry between investor and entrepreneur is largest as is their mutual benefit. Despite this large information asymmetry, entrepreneurs and investors alike seek to close virtually irrevocable agreements.

Entrepreneurs and investors need one another to grow the venture, yet are typically perfect strangers with their own goals and priorities. Both thus need to find ways to bridge the unknowns and find common ground. While this challenge applies to all financing and investment decisions, it is particularly pronounced in early-stage ventures as they are riskier, resulting from their developing proposition, limited market proof and lack of collateral.

The investment selection appears to be the most important determinant for investment success, even more so than for instance the treatment effect (i.e. the coaching and networking activities after having selected the venture). Yet selecting the right ventures to invest in, is a challenge and good understanding of its determinants has been lacking in practice and in academia. Whether causal or not, persisting low rates of successful investments are apparent as well.

Both the practice and the science of investment selection rely on only two candidates to address the information challenge: the jockey and the horse. The jockey is the entrepreneur and their traits. Examples are entrepreneur level of education, work experience, whether they set-up a venture before, and so forth… Likewise, the horse is the venture and its traits. Examples may include the business model, competition, industry, and so forth… The literature thus recognizes the inability of investors and entrepreneurs to have the same level of information. It merely suggests two candidates for investors to assess potential and select investments.

Dr. Andreoli reveals that attention for prior funding sources enriches the art and science of investment selection, on top of the extant two categories. He does so by creating a 'pecking order' of new early-stage funding sources and by providing evidence of the value that crowdfunding has for VCs with a more social orientation. The research seems promising to improve funding success and create more societal wealth.

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