

**SCREENING PHASE REJECTIONS OF
VENTURE CAPITAL SEEKERS
IN SOUTH AFRICA**

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Summary and key terms

A lack of capital is one of the factors that inhibit business development in the developing world, including South Africa. This is especially true for a prospective business where the owner does not have security to secure a bank loan.

A financing option that is available to entrepreneurs is venture capital. However, venture capitalists reject 88 percent of all new applications for venture capital in the initial screening phase. This study examined the reasons for the high rejection rate of applications for venture capital in South Africa. Non-compliance with the internal fund preferences of venture capitalist firms was identified as one of the biggest reasons for the rejection of applications for venture capital.

Other factors were also investigated with specific reference to the Timmons Model of the entrepreneurial process. It was determined that factors relating to team, opportunity, and resources are also important in the initial screening phase, but they are not as important as internal fund preferences.

Uniquely South African factors were also investigated and it was determined that factors relating to black economic empowerment and corporate citizenship play a relatively unimportant role in the approval of new ventures by venture capitalists.

Based on the above-mentioned study, a Framework for venture capital seekers was developed. This framework is aimed at increasing the probability of applications for venture capital passing the initial screening phase.

Opsomming en sleuteltermes

'n Gebrek aan kapitaal is een van die faktore wat 'n inhiberende uitwerking op besigheidsontwikkeling in die ontwikkelende wêreld, insluitend Suid-Afrika, het. Dit geld veral ten opsigte van voornemende besighede waar die eienaars nie die nodige sekuriteit het om 'n banklening te bekom nie.

'n Vorm van finansiering wat tot entrepreneurs se beskikking is, is waagkapitaal. Verskaffers van waagkapitaal keur 88 persent van alle nuwe aansoeke om waagkapitaal af gedurende die aanvanklike keuringsfase. Die redes vir die hoë persentasie aansoeke wat in Suid-Afrika afgekeur word, is in hierdie studie ondersoek. Een van die vernaamste faktore wat daartoe bydra dat aansoeke om waagkapitaal tydens die keuringsfase afgekeur word, is geïdentifiseer: dit is bevind dat voorgestelde ondernemings nie aan die interne fondsvoorkeure van waagkapitaalfirmas voldoen nie.

Ander faktore is ook ondersoek met spesifieke verwysing na die Timmons-model van die entrepreneursproses. Dit is bevind dat faktore met betrekking tot span, geleentheid en hulpbronne ook 'n belangrike rol tydens die keuringsfase speel, alhoewel dit nie so belangrik soos interne fondsvoorkeure is nie.

Faktore wat uniek is aan die Suid-Afrikaanse konteks is ook ondersoek. So is bevind dat faktore wat verband hou met swart bemagtiging en korporatiewe burgerskap 'n relatief klein rol in die goedkeuring van nuwe ondernemings deur waagkapitaliste speel.

'n Raamwerk vir Waagkapitaalsoekers is op grond van die genoemde studie opgestel. Hierdie raamwerk is daarop gemik om die kans te verhoog dat 'n aansoek om waagkapitaal die aanvanklike keuringsfase slaag.

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Chapter 1

Introduction

1.1 Background to the study

South Africa is a country of extreme contrasts. The contrast between wealth and poverty is evident in our landscape. Sandton and Alexandra, for example, which lie adjacent to each other, are a testimony to the gap between economic prosperity and poverty. Following the recent political liberation in South Africa, one might assume that there is a very bright future ahead for everyone. However, the reality is that South Africa faces many problems, specifically poverty and crime. To add to South Africa's woes there is also a large skills shortage.

Given South Africa's many problems, the question can rightly be asked whether the country can become a winning nation. This is also the question foremost in the minds of many development studies scholars. Many people believe that some negative trends can, indeed, be reversed. In terms of the unemployment situation, the current government have introduced many initiatives to solve the problem. They have instated various Sector Education and Training Authorities (SETAs) to address the skills shortage in different industries. The South African government has also pledged to create one million jobs in the next five years (Manning, 2004).

Job creation is closely linked with small and medium enterprises (SMEs). Some scholars believe that SMEs are the engine of an economy and that they provide the primary impetus for economic growth. One of the results of economic growth is job creation. Given the South African government's focus on job creation, SMEs should get their support. But SMEs face many obstacles in South Africa. Firstly, the government has imposed strict regulations on SMEs. Secondly, SMEs get limited support from the government. Thirdly, SMEs are generally cash-strapped and do not have access to capital. According to De Soto (2000:5), limited access to capital is why the Third World is economically underdeveloped and the First World is economically advanced. In a study conducted on a number of third world countries, financial support was stated by experts as one of the three national weaknesses in Brazil, India, Mexico, and South Africa. In South Africa, this factor

was listed second after education and training (the most mentioned factor) (Orford, *et al.* 2003:17).

In a study conducted by Pretorius and Shaw (2004:239) they concluded that when business owners apply for bank loans in South Africa, the creditworthiness of an applicant is the primary criterion in terms of which an application is considered. Even if an entrepreneur has a good business idea, his chances of obtaining debt capital are very slim. Fortunately, there are other sources of business capital. One of them is venture capital. This study will focus on the key factors that contribute to successful applications for venture capital, with specific reference to SMEs.

1.2 Reason for the study

In a preliminary investigation of the venture capital industry the following trend was observed: Venture capitalists are very selective in choosing venture opportunities and reject most of the investment opportunities that are proposed to them. It is estimated that only between two and four percent of all entrepreneurs who contact venture capitalist firms receive financing from them. (Timmons & Spinelli, 2003:480). The question can rightly be asked whether 96 percent of all business opportunities proposed to venture capitalists is unsound. When the venture capital process is investigated further, it becomes evident that most of these rejections occur in the screening phase. Given the fact that venture capitalists publish their minimum investment criteria on their websites, it is unclear why the rejection rate is so high. Is it the result of poor communication by venture capitalists (insufficient information on their websites), or do entrepreneurs fail to comply with the criteria that venture capitalists lay down? There are various other possibilities, one of which is that venture capitalists are not completely open and forthright about their requirements. Another possibility is that venture capitalists are not sure about their own investment requirements. Studies indicate that venture capitalists are, indeed, unreliable when they are asked about their selection criteria. In fact, venture capitalists tend to overstate unimportant factors and understate more important criteria (Shepard, 1997:8).

In light of this, the selection criteria of venture capitalists require further study. An attempt will be made through this research to identify the key factors that ensure success for venture capital seekers in the venture capital process.

1.3 Problem statement

With reference to the initial venture capital screening process, the following statements can be made:

- On the one hand, venture capitalist seekers are not knowledgeable about the key factors that play a role in the procurement of venture capital and, on the other hand, venture capitalists do not communicate these key factors to venture capitalist seekers.
- There is a great deal of uncertainty about the screening phase in the venture capital process.

1.4 Objectives of the study

The main objective of this study is to identify the critical factors that play a role in the screening phase of the venture capital process. This endeavour will make a significant contribution to the venture capital process by providing clarity for both venture capital seekers and venture capitalists.

The second objective of this study is to gain an understanding of the reasons for the high rejection rate of applications for venture capital in the initial screening phase.

The third objective of this study is to identify what information venture capitalists should publish to discourage non-qualifying venture capital seekers from applying. If the screening process is communicated upfront much time will be saved in the screening process. The venture capitalist will have more time to analyse good opportunities and the entrepreneur will be guided to create better business proposals.

1.5 Research methodology

To achieve the above-mentioned objectives, the following research methodology will be followed:

A literature study will be conducted on venture capital and various aspects relating to it. The purpose of this study is not to create a complete overview of all aspects of venture

capital; rather, it is an attempt to highlight important aspects and issues regarding venture capital and the venture capital process. Once a basic understanding has been achieved of the issues surrounding the industry, it will be possible to focus on specific issues. After this general overview, the focus of the study will shift towards critical factors in the venture capital screening process. An attempt will be made to identify and categorize critical factors.

After the critical factors have been identified, a field study will be conducted among venture capital companies in South Africa. A questionnaire will be distributed to study the relative importance of each factor identified in the preceding study. The responses obtained in the questionnaire will be captured in a database/spreadsheet. Thereafter conclusions will be drawn from these responses in order to identify the critical success factors in the initial screening phase of the venture capital process.

1.6 Boundaries of the study

This study will be limited to SMEs in South Africa that seek venture capital. Therefore, only those venture capitalists who offer a minimum investment amount of less than R10 million will be studied. The empirical study will be limited to full members of the South African Venture Capital and Private Equity Association. The study will also focus on the initial screening process in the venture capital process.

1.7 Breakdown of the study

Chapter 2: Venture capital: theoretical concepts

Chapter 3: Venture capital screening: critical factors

Chapter 4: Empirical study of venture capitalist
companies in South Africa

Chapter 5: Survey results

Chapter 2

Venture capital: theoretical concepts

2.1 Introduction

In the world of venture capital, the name that is mentioned time and again is John Doerr. John Doerr is to the venture capitalist industry what Warren Buffet is to the stock investor industry. Both have an extraordinary ability to choose winners. John Doerr made an investment of \$12,5 million for a stake in Google in 1999. When Google goes public later in 2004, it is expected to reach more than \$3 billion. With one deal John Doerr has earned a return 240 times the original investment for his firm Kleiner Perkins Caufield & Byers. This represents a return of 2 400 percent in five years.

Other successes that John Doerr have secured for his firm were an \$8 million investment in Amazon Books that turned into \$60 million, and a \$5 million investment in Netscape Communicator that reaped \$400 million. "John Doerr throws big darts at distant targets. Most miss, but when they hit, it's spectacular," says Jerry Kaplan, a Silicon Valley entrepreneur whose start-ups in the early 1990s, Go Corporation and Onsale.com, were flops backed by Kleiner through Mr Doerr. (Rich, 2004). From this example the venture capital industry in the United States can be described as vibrant and potentially very rewarding for a venture capitalist.

Venture capital will now be examined from a theoretical perspective. The best place to start this examination is to explore the various definitions of venture capital.

2.2 Venture capital defined

There are numerous definitions of venture capital.

Definition 1: According to the ECED (2001:1605), venture capital is money used for investment in projects that involve a **high risk**, but offer the **possibility of large profits**.

Definition 2: Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for start-up companies (National Venture Capital Association, 2004).

Definition 3: Money used to support new or unusual commercial undertakings; equity, risk or speculative capital. This funding is provided to new or existing firms that exhibit above-average growth rates, a significant potential for market expansion and the need for additional financing for business maintenance or expansion (The Online Financial Dictionary for Investors, 2004).

Definition 4: A fund-raising technique for companies who are willing to exchange equity in the company in return for money to grow or expand the business. Venture capital firms often want a high rate of return (20%+) and will finance the business with \$500,000 to millions. A venture capitalist differs from an angel investor in terms of wanting greater control of company and quicker return on investment (About.Com, 2004).

The following elements of the above definitions are important:

- **There is an exchange of equity.** The venture capitalist buys a portion of the entrepreneur's business. The venture capitalist becomes a co-business owner along with the entrepreneur. If the business fails, the venture capitalist loses his money, but he has no claim against the entrepreneur. If the business is successful the venture capitalist shares in the spoils of the business.
- **There is an exchange of money.** There is a capital injection in the venture that is funded. This implies that the venture will have more money available to assist in its development.
- **There is a high-potential opportunity.** The venture that is financed is typically a high-potential opportunity. This implies that if the venture is successful it will have big returns.

- **There is an element of risk.** The ECED (2001:1605) defines “venture” as a risky project; a new business enterprise; and money risked. The venture capitalist takes the risk to lose his money in return for higher potential gains. The entrepreneur’s risk is lowered, because a capital injection in the business will increase the odds of survival of the firm. The capital is risk free to the entrepreneur, because it will not have to be paid back if something goes wrong, as is the case with debt.

2.3 Venture capital vs. debt

The main differences between debt and equity are summarized in Table 2-1.

Table 2-1
Venture capital vs. debt

	Debt financing	Equity financing
Provider	Usually banks	Venture capitalists (VCs) and angels
Risk	Generally low	High
Claims against entrepreneur if something goes wrong	None, but banks usually ask for security on loans.	None
What if the business -		
Barely survives?	The bank will still get its money back and the bank manager will be happy.	The VC will not be satisfied with its investment.
is very successful?	The bank will only get back the borrowed amount plus interest.	The VC will be entitled to a portion of the business and will realize a high return on his investment. The VC can choose to sell his stake in the business or continue his ownership in the business and share in its profits.
fails?	The bank will stand first in the line together with other creditors and should get back a portion of the loan.	The VC will stand last in the queue and will only get money after all the debtors have been paid.

Own table

From the above table the following conclusions can be drawn: Whilst a venture capitalist is highly involved with the future growth prospects of a business the same cannot be said about banks. Banks have nothing to gain if a venture is highly successful. The findings of Pretorius and Shaw (2004:237) on the role of business plans in bank decision making, confirm this - they conclude that banks sometimes even finance poor potential ventures if they are supported by credit guarantees. The entrepreneur might lose everything, but the bank will get its money back, because it did not take any risks.

In another study it was confirmed that banks place a high premium on security in the granting of finance and that this is not only a South African phenomenon. Manove *et al.* (2001:728) state that in the United States, approximately 40 percent of small business loans and almost 60 percent of their value are guaranteed and/or secured with personal assets. There is a general complaint that banks do too little screening and tend to rely excessively on collateral. One of the only financing avenues that might be open to the entrepreneur without security is a venture capitalist firm. The classification of venture capitalists will be discussed next.

2.4 The 'typical' venture capitalist

Venture capitalists are very diverse and cannot be classified according to the business type they finance, the amount of money they invest, or the life cycle of a business they prefer to finance. This will be discussed below.

Venture capitalists cannot be classified according to the business type that they choose to finance. Some venture capitalists specialize in certain businesses, whilst others stay away from those businesses owing to moral reasons. Aquila Growth Ltd, for example, favours gambling ventures, whilst gambling is specifically excluded from the portfolio of Kagiso Enterprises.

Venture capitalists cannot be classified in terms of the amount of money that they invest. Some invest a maximum of R100 million, whilst others are only prepared to invest a maximum of R1 million. The minimum investment ranges between R100 000 and R30 million.

Venture capitalists cannot be classified according to the life cycle of the business they choose to finance. Some venture capitalists prefer to finance start-up ventures and other exclude start-ups from their portfolio (SA Waagkapitaal-en Privaataandeelvereniging 2004 Jaarboek (SAVVJ), 2004:20-23).

Although venture capitalists are a very diverse group, a number of common factors set them apart from other finance providers. Referring back to the definitions of venture capital discussed earlier, venture capitalists purchase equity in businesses in an attempt to gain above-average returns. In order to gain a better understanding of venture capitalists the differences between them and angels will be investigated.

2.5 Venture capitalists and angels

Angels are wealthy investors who mostly provide start-up capital for businesses. Although angels are classified as wealthy, their capital investments do not match the capital resources of venture capitalists. Venture capitalists obtain the money they invest from various investors. This is also one of the main reasons why angels are mainly involved in start-up businesses and venture capitalists are involved in later round financing.

One might assume that there is a good relationship between angels and venture capitalists in view of their co-dependency. Sources indicate that it is actually the other way around. Some venture capitalists would not come near ventures where angels are involved (Stein, 2004:28) (Ravi, 2004:29-30). Venture capitalists view angels as unsophisticated, because angels sometimes impose exorbitant terms and conditions on entrepreneurs. Some of these are non-dilution clauses that inhibit further financing rounds (Bushrod, 2003:47-52).

The capital sources of venture capitalists will be investigated further.

2.6 Capital sources of venture capitalists

From the preceding discussion two important points must be stressed: Venture capitalists use money obtained from various sources and have large amounts to invest. This can be seen from the minimum amount invested in ventures. In South Africa, the minimum

amount ranges from R100 000 to R30 million. A venture capitalist typically gets investors to invest in a fund. Once this fund is strong enough, the fund managers will start to invest in big opportunities. Hence the definition of venture capitalists as individuals who **join together** in formal, organized firms to provide equity funds to high-risk, high-potential-return ventures (Leach & Melicher, 2003:25). This type of investment is called independent funds (SAWVJ, 2004:11).

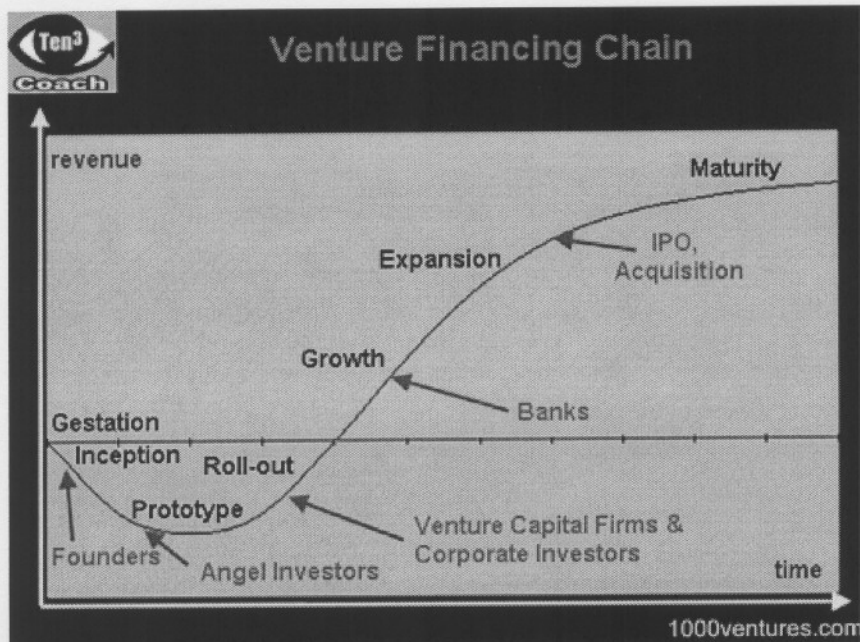
There is another source of capital for venture capitalist companies. Some investment companies use their own balance sheet or the balance sheet of their holding company to invest in ventures. This type of investment is called private equity funds.

The financial cycles in venture capital will be investigated further.

2.7 Financial cycles and venture capital

Theory suggests that there are many financing rounds in the lifetime of a business. The participants of each round try to maximize its terms to their advantage and to protect their investment from unfavourable conditions in future rounds. This is one of the major areas of conflict between angels and venture capitalists (as discussed earlier). Kotelnikov (2004) suggests that venture capitalists generally get involved in the roll-out phase of a business (Figure 2-1).

Figure 2-1
Venture financing chain

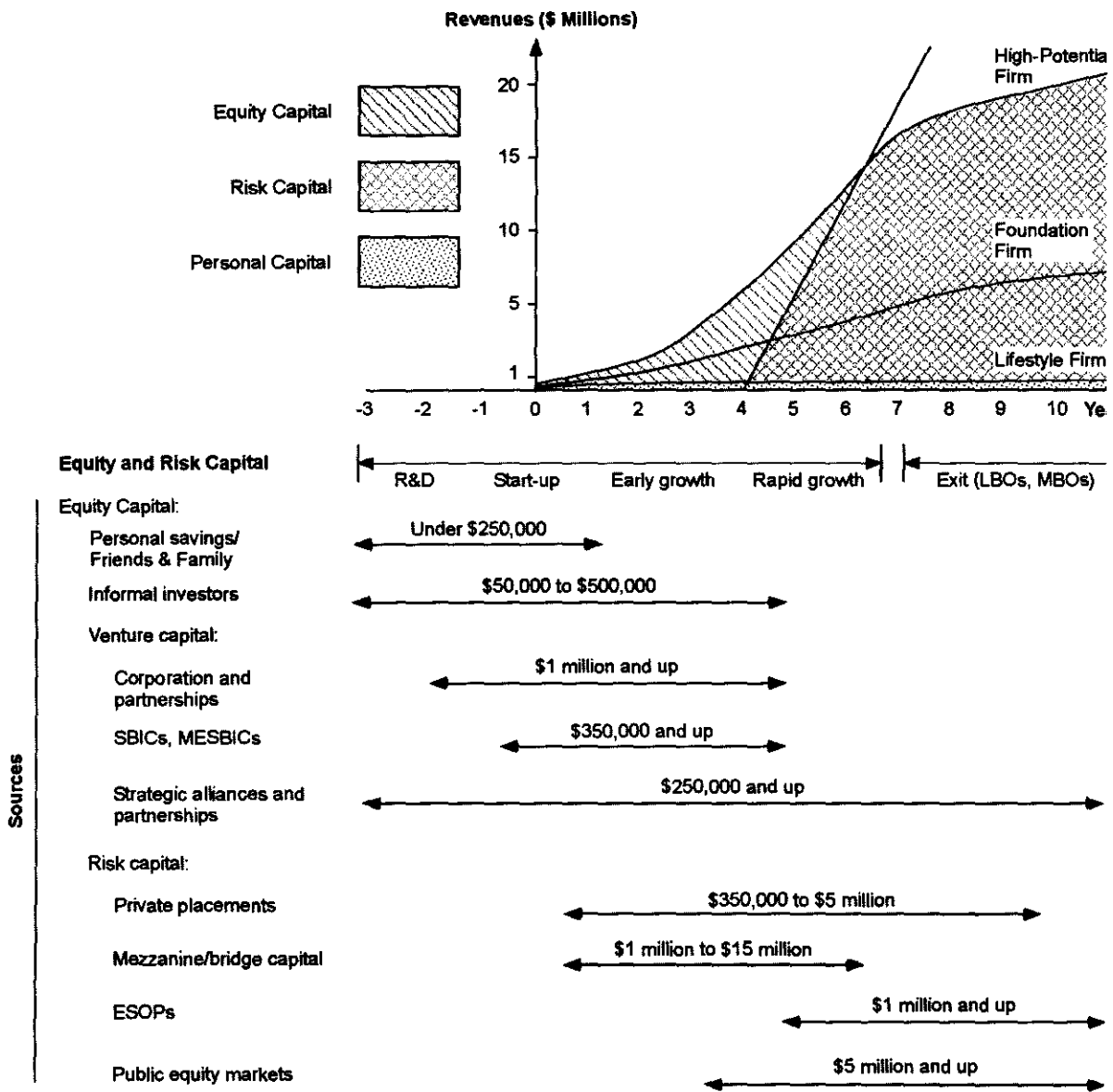


Kotelnikov (2004)

According to the SAWVJ (2004:11), equity investment is only classified as venture capital if it is seed capital or if it is invested in the early stages of the business cycle. Development capital (used for the expansion of an existing business) and buy-out capital (used by management to buy into a business) are not classified as venture capital.

Figure 2-2 gives a detailed overview of the financial cycle of a business and the typical financing used in each stage of the development of a business.

**Figure 2-2
Financing life cycles**



Timmons & Spinelli (2003:453)

Venture capital is generally only an option for a company from more or less the start-up stage until year five of the rapid growth phase. After year five of the rapid growth phase, the company must search for other financing avenues like private placements, bridge capital, employment stock ownership plans (ESOPs) or listing on public equity markets. If a company is still in the research and development stage of development, venture capital is not an option and the entrepreneur must seek other options of financing.

Another aspect that must be noted regarding the financing cycle is that a firm might need the same kind of financing more than once during its move towards maturity. For this reason financing rounds are usually numbered incrementally.

2.8 Classification of venture capitalist firms in South Africa

Of the members of the South African Venture Capital and Private Equity Association listed in the SAWVJ (2004:20-45), only full members that invested R10 million or less were investigated. Each company was measured against its financial cycle investment stage preferences. On the basis of this, each firm was examined to determine whether or not it can be classified as a venture capitalist firm.

Table 2-2
Financial cycle investment stage preferences by South African VC companies

Company	Financial cycle investment stage preferences	VC firm?
Aquila Growth Ltd	All	Yes
Agil Venture Capital (Pty) Ltd	Early phase investments	Yes
Aureos Capital	Late stage investments	?
Brait Private Equity	Late stage investments	?
Business Partners Ltd	All	Yes
Cycad Financial Holdings Ltd	All	Yes
Enterprise Equity Partners (Pty) Ltd	Early	Yes
Equity Africa Trust	Early / expansion	Yes
Export Venture Capital Corporation (Pty) Ltd	N/a	-
HBD Venture Capital	Start-up and early stage investments	Yes
Horizon Equity Partners	All, except start-up	Yes
i capital Fund Managers	All, except sow capital, start-up	Yes
Industrial Development Corporation of SA Limited	N/a	-
International Finance Corporations	N/a	-
Investec	Usually start-up or sow capital	Yes
Kagiso Enterprises	All, except start-up	Yes

Company	Financial cycle investment stage preferences	VC firm?
Kagiso Ventures	All, except sow, start-up and early stage	Yes
Khula Equity Fund	All	Yes
Lireas Holdings (Pty) Ltd	Start-up	Yes
MCI Fund Managers (Pty) Ltd	All, except start-up	Yes
National Empowerment Fund	All, except sow capital	Yes
Nedbank Corporate Private Equity	All, except start-up	Yes
NewFarmers Development Company Ltd	All	Yes
NIB-MDM Fund Managers (Pty) Ltd	All, except sow and start-up	Yes
Sabvest Ltd	All, except start-up	Yes
Southern Africa Enterprise Development Fund	N/a	-
Triumph Venture Capital (Pty) Ltd	All, with a preference for early stage investments	Yes
Vantage Capital Fund Managers (Pty) Ltd	All	Yes
Wipprivate Equity (Pty) Ltd	All, except start-up and growth	Yes

Own from SAWFJ (2004:20-45)

From the above the following is important: Most of the companies investigated finance at least one financial stage that is usually financed by venture capitalists. Therefore, they can be classified as VC firms. In the case of Aureos Capital and Brait Private Equity, it is only stated that they favour later stage investments. The context and exact meaning of this term cannot be determined and both companies will be disregarded from this study. The same will be done regarding companies whose preferences are unknown.

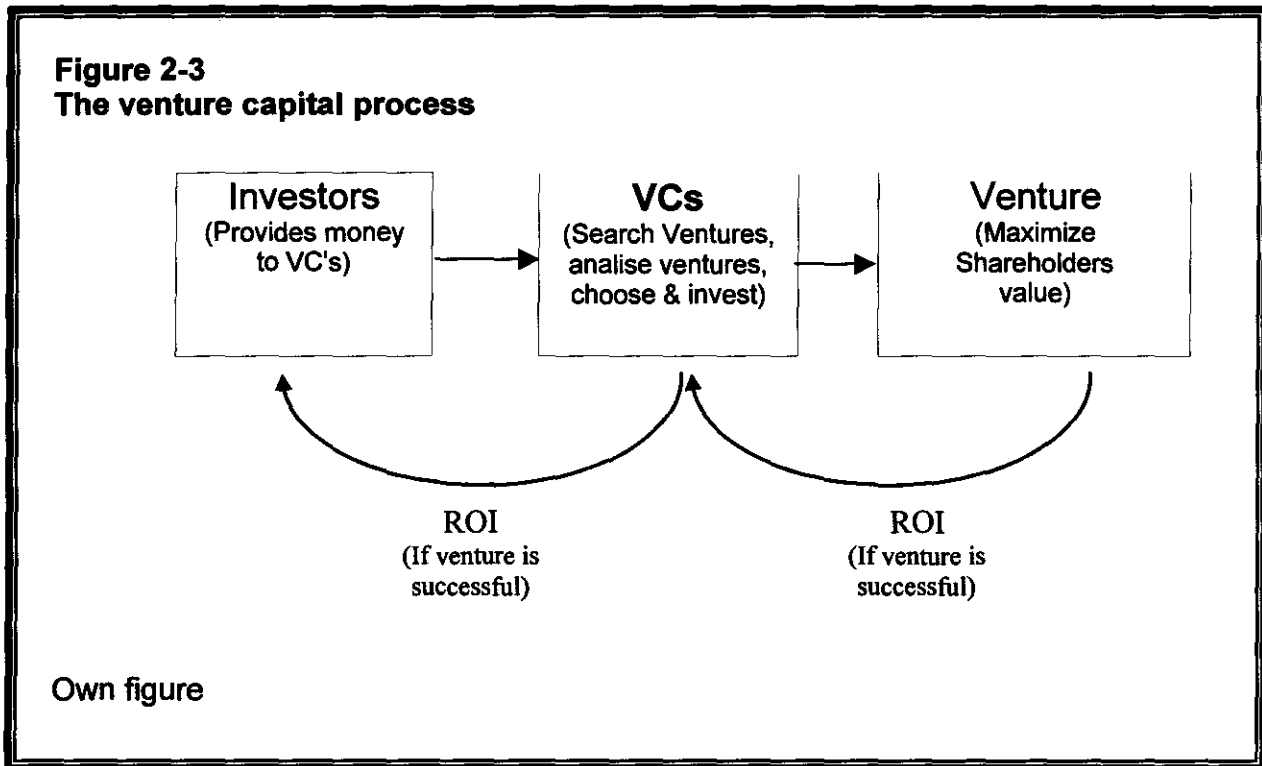
2.9 The venture capital process

As seen from the above-stated definitions, venture capitalists buy stakes in promising businesses. However, there is much more to the 'job description' of a venture capitalist. A venture capitalist must -

- find money to invest;
- find ventures to invest in;

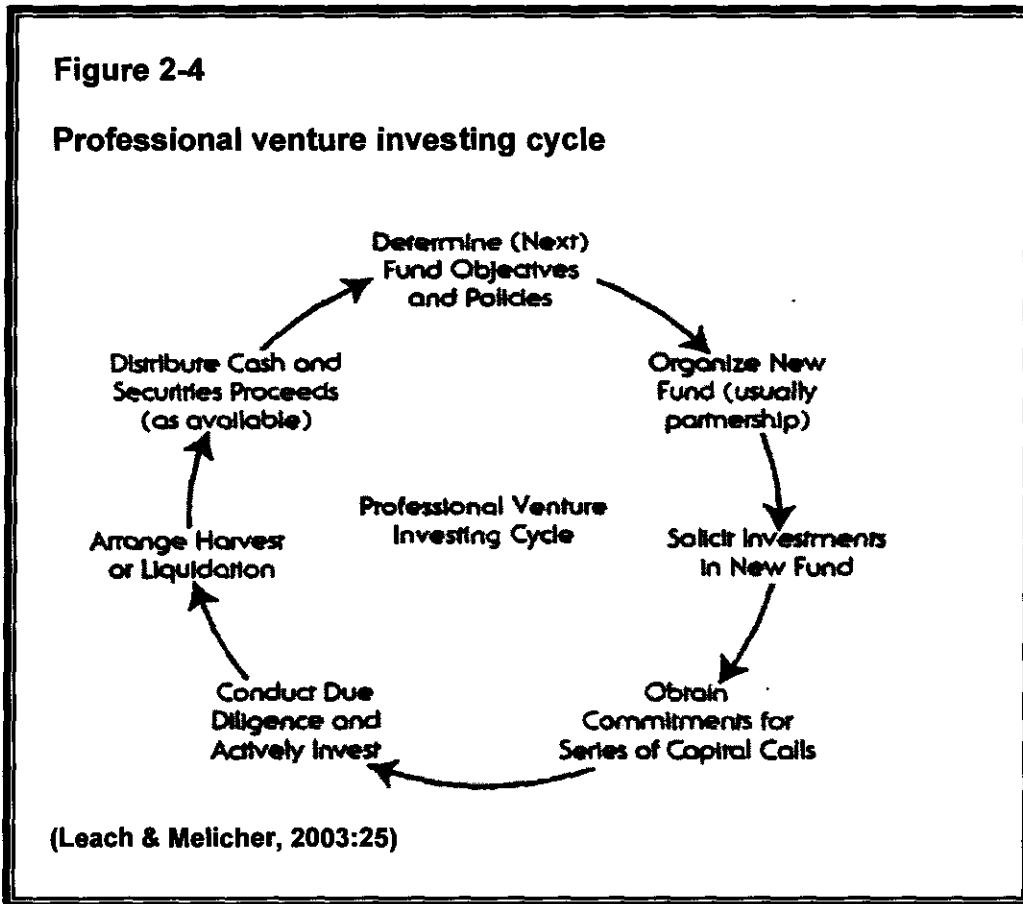
- analyse ventures to determine the risk profile of each venture;
- identify the best possible investment; and
- realize a return on investment for his investors.

Figure 2-3 is a graphical representation of the above process.



Every element in the above process is important. Should any element be lacking the venture will not be successful. If, for example, the VC constantly fails to choose successful ventures it will not obtain funding from investors. The decision-making process is, therefore, of critical importance to the venture capitalist.

Another way of looking at the VC process is to investigate the Professional Venture Investing Cycle as illustrated in Figure 2-4.



In Figure 2-4 the venture capital process is depicted as a continuous cycle of the following steps;

1. Determining fund objectives and policies.
2. Organizing the new fund (usually a partnership).
3. Soliciting investments in the new fund.
4. Obtaining commitments for a series of capital calls.
5. Conducting due diligence and investing actively.
6. Arranging harvest or liquidation.
7. Distributing cash and securities proceeds if available.

The rest of this study will focus on step 5 of the above list, that is, the conducting of due diligence. Due diligence will be narrowed down and the focus will be on the screening phase of the decision-making process.

2.10 The venture capitalist decision-making process

Venture capitalists will say that they make rational decisions based on certain criteria and standards that are taken into consideration. However, when the decision-making process is researched, various loopholes are exposed in the 'rational' decision-making processes of venture capitalists. There are indications that venture capitalists are unreliable when they are questioned on their decision-making processes. Their **actual** decision-making process has been found to differ significantly from their **believed** decision-making process (Zacharakis, 1995:21).

Closely related to the above is the role of subjective evaluation when analysing business opportunities. One venture capitalist compares the portfolio management process with art appreciation: "You look at a lot of art, some is good, some is OK and some is bad. At some point, after seeing enough art, something inside clicks and you start to appreciate why certain art is good and more importantly why certain art is bad." (Waldeck, 2003:6.)

One important aspect of the VC decision-making process is that it consists of different stages. Authors differ on the exact steps in the decision-making cycle, but most agree that it involves a screening stage.

Table 2-3 is a representation of the stages in the venture capital investment cycle.

Table 2-3
Stages of venture capitalist investment cycle

Tyebjee and Bruno (1984)	Hall (1989)	Fried and Hirsch (1994)	Boocock and Woods (1997)
Deal origination	Generating a deal flow	Deal origination	Generating a deal flow
Screening	Proposal screening	Firm-specific screen	Initial screening
n/a	Proposal assessment	Generic screen	First meeting
Evaluation	Project evaluation	First phase evaluation	Second meeting
n/a	n/a	n/a	Board Presentation
n/a	Due Diligence	Second phase evaluation	Due Diligence
Deal structuring	Deal structuring	Closing	Deal structuring
Post investment activities	Venture operations	n/a	On-going monitoring of investments
n/a	Cashing out	n/a	Cashing out

Birrer (2002:6)

It takes between four and eight steps before money is paid out to an entrepreneur. All authors agree that there is a screening phase. The screening phase will be investigated further.

2.11 The venture capital screening phase

A detailed analysis of a venture does not take place in the screening phase. Screening is rather a generic evaluation based on a checklist. If a venture passes the first phase it warrants further investigation. According to Wu (2001:1), a managing director in Alameda Capital, a VC firm, the process works as follows: "Since a VC has to process a very large number of new prospects, sometimes thousands each year, his highest priority is his own time management. This means that his work is mostly focused on eliminating 99% to 99.8% of the opportunities he is presented. As quickly as he can. The game becomes one of looking for reasons **NOT** to invest. Due diligence proceeds only when a VC feels strongly that an investment might make sense, so is usually a late step in the process."

Wu's estimation of 99 percent might be overstated for with respect to VC industry. According to an estimate from Singapore, one in 20 proposals will pass the initial screening (Koh & Koh, 2002:6). In another estimate, 80 percent of all venture capital applications are rejected in the initial screening process in the USA (Paap, 1992:2). The bottom line is that a high percentage of business proposals are only screened and are rejected on the basis of that screening.

When one investigates venture capitalists in South Africa, it is evident that every VC company has minimum requirements for investment. Almost all of them lay down fixed criteria for their target investments. These criteria include minimum investment size, maximum investment size, industry preference, industry exclusions, economic cycle of business, and geographic preference. These criteria are usually published on a VC firm's website to discourage VC seekers to apply for funds for which they do not qualify. HBD Venture Capital, for example, has published the following information on its website. "How to Apply - Got a concept or start-up business that requires funding? Firstly, you need to -

- a) determine if you qualify;
- b) if you do, the next step would be to apply." (<http://www.hbdvc.com>)

Detailed information on the investment criteria of HBD Venture Capital is available on this website. Similar information can be obtained from the other VC companies in South Africa.

It appears that venture capitalists publish all their minimum criteria for investment. In light of this, the question can be asked why there is still such a high rejection rate in the screening phase. There are various possible answers to this question. A few of the most obvious answers are the following:

- a) Venture capitalist seekers do not familiarize themselves with the basic criteria.
- b) Venture capitalist seekers (as most entrepreneurs) ignore the criteria and believe that their idea is so good that it will be funded.
- c) Venture capitalist firms do not publish all the information regarding the initial screening process and their selection criteria.
- d) Venture capitalist firms are not sure about their own investment criteria.

Consequently, the venture capital screening criteria require further examination. This will be done in the next chapter.

Chapter 3

Venture capital screening: critical factors

3.1 Introduction

As indicated in the previous chapter, the screening of ventures is the phase where most business proposals are rejected. Studies indicate that the average venture capitalist firm spends 10 to 15 minutes on the initial screening phase. One study indicates that as little as six minutes is spent on screening a business proposal (Mason & Stark, 2002:8). In an extreme example, Wu (2001:1) puts the attention span of a venture capitalist at two minutes.

These findings suggest the following: The basic screening criteria used by a venture capitalist are not overly complicated, because little time is spent evaluating ventures. The criteria that venture capitalists use in order to identify critical factors used in the screening process will be investigated next from the following perspectives:

- Internal fund preferences
- Venture analysis
- The South African context

3.2 Internal fund preferences

Research indicates that one of the main reasons why venture capitalists reject proposals in the initial screening phase is that proposals do not fit investors' internal fund preferences (Mason & Stark, 2002:7). As discussed earlier, venture capitalists can be differentiated from each other in terms of internal fund preferences. Venture capitalists usually have preferences with respect to the following:

- Minimum investment amount
 - Maximum investment amount
 - Industry preferences
 - Industry exclusion preferences
-

- Investment stage
- Minimum and maximum percentage equity taken up
- Geographic preference

Various other factors can be included in internal fund preferences. Leach and Melicher (2003:11) also include the following: Cash-out potential; familiarity with technology, product, and market; financial provisions for investors; investor control; rate of return; and risk.

The internal fund preferences are of vital importance. The empirical study will measure how tolerant investors are in the initial screening phase towards ventures that fall outside the scope of the internal fund preferences. But there is much more to the screening phase than internal fund preferences. Factors that fall outside the internal fund preferences will be examined next.

3.3 Venture analysis

As stated earlier, successful venture analysis is crucial to the success of a venture capitalist firm. Venture capitalists cannot use the traditional methods that banks use. Banks have no interest in the success of a venture, whilst venture capitalists are very interested in this aspect and only invest in the best opportunities. Venture capitalists are like diamond miners and will go through tons of rock to find a diamond. For this reason, venture capitalists cannot use the bankruptcy prediction models that banks sometimes use.

3.3.1 Predicting venture success

This following question is at the core of venture analysis: How can it be predicted that a given venture will be **very** successful?

MacMillan *et al.* (1995:126) concluded in a study of 150 ventures that there are only two necessary and sufficient predictors of venture success. They are -

- the extent to which a venture is initially isolated from competition; and
- the degree to which there is a demonstrated market acceptance of the product.

In the study, all other factors were disregarded as unreliable predictors.

This finding is in stark contrast with the views of John Doer who believes that the team is one of the best predicting factors of venture success. Doer states: "In the world today, there's plenty of technology, plenty of entrepreneurs, plenty of money, plenty of venture capital. What's in short supply is great teams. Your biggest challenge will be building a great team....But to take full advantage of those opportunities, focus on the team. Teams win." (Malone: 1997)

Other authors believe that success can be predicted by taking a combination of factors into account. Table 3-1 presents a number of predictors of success.

Table 3-1
Characteristics of successful ventures and relevant predictors of success

Predictors of success	Characteristics
Entrepreneurial team characteristics	<ul style="list-style-type: none"> ● Capacity for sustained effort ● Evaluates and reacts to risk well ● Articulate when discussing venture ● Attention to detail ● Personal compatibility with me ● Familiarity with the market ● Leadership ability demonstrated ● Relevant track record ● Familiarity with team's reputation ● Referred by a trustworthy source
Product/service characteristics	<ul style="list-style-type: none"> ● Protection of product ● Demonstrated market acceptance ● Functioning prototype ● High-tech product
Market characteristics	<ul style="list-style-type: none"> ● Established distribution channel ● Target market has high growth rate ● Existing market would be stimulated ● Familiar with industry ● Competition anticipated in two years ● Change competitive structure of industry ● Venture could create a new market

Predictors of success	Characteristics
Financial characteristics	<ul style="list-style-type: none"> • Investment easily made liquid • Opportunity to double value in three years • No subsequent investments • First round of investment

(Gresham: 2004)

Two factors mentioned in the preceding discussion, namely team and demonstrated market acceptance, are listed in Table 3-1. The factor isolation from competition is not mentioned directly in this table and it can be accepted that there is not agreement on whether it is a relevant predictor of venture success.

3.3.2 Venture capital screening criteria

The findings of five different academic studies regarding venture capital screening criteria are summarized in Table 3-2.

Table 3-2
VC screening criteria by Hall and Hofer

Factor	Criteria
Venture capital firm requirements (This is discussed under 3.2.)	<ul style="list-style-type: none"> • Cash-out potential • Equity share • Familiarity with technology, product, and market • Financial provision for investors • Geographic location • Investor control • Rate of return • Risk • Size of investments • Stage of development
Characteristics of the proposal	<ul style="list-style-type: none"> • Requirement for additional material • Stage of plan

Factor	Criteria
Characteristics of the entrepreneur/team	<ul style="list-style-type: none"> • Ability to evaluate risk • Articulate regarding the venture • Background/experience • Capable of a sustained effort • Managerial capabilities • Management commitment • References • Stake in firm
Nature of the proposed industry	<ul style="list-style-type: none"> • Market attractiveness • Potential size • Technology • Threat resistance

Leach & Melicher (2003:411)

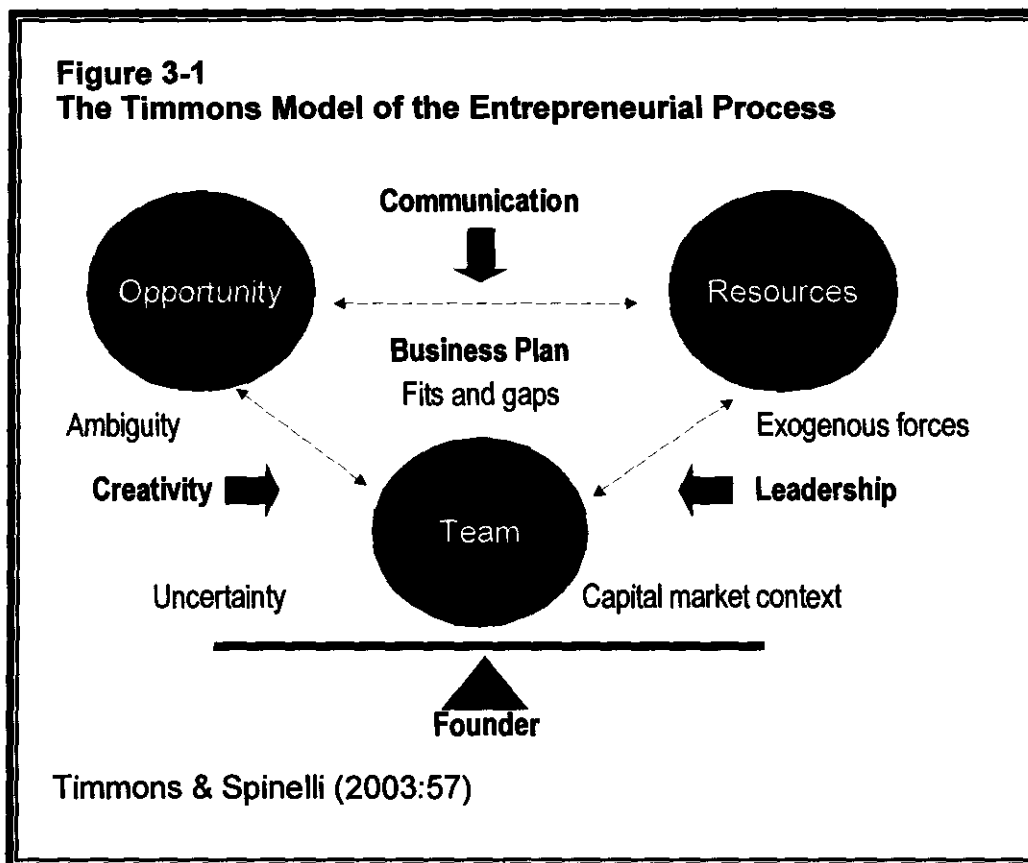
In Table 3-2 there is a strong emphasis on team and industry factors.

3.4 Summary

From the above discussion the following is clear: There is general consensus on the main characteristics that make a venture successful. If one investigates the sub-characteristics, authors and venture capitalists differ significantly on what should be important. This conclusion is confirmed by Table 3-1 and Table 3-2. The following must also be taken into account: If the average time that an entrepreneur spends on screening proposals is between six and 15 minutes, both the screening criteria outlined in Table 3-2 and the venture success prediction factors in Table 3-1 appear to be too complicated to be used in the initial screening process. The Timmons Model will now be investigated to determine if it is suitable to be used in the initial screening of new ventures.

3.5 The Timmons Model

According to Timmons (1975:50), a successful new venture requires the right combination of people, a good idea, and money. Timmons refined this concept in his later publications and he created the Timmons Model of Entrepreneurial Success (Figure 3-1).



According to this model, three aspects are crucial to the entrepreneurial process, namely, the opportunity, the team, and resources. All aspects that are included in the model are equally important and must be present for a venture to succeed. All these aspects must also be in equilibrium for a venture to have the best chance of success. A high-potential opportunity cannot be taken on with a weak team or insufficient resources. Likewise, a low-potential opportunity cannot be pursued with a very strong team. Resources are also important. A good team with a good opportunity will not guarantee success without financial resources.

The advantage of this model is that it is a simple and powerful framework for analysing ventures. The three main elements of the model will now be investigated.

3.5.1 Resources

Resources include the following:

- People (everybody, including outside personnel, involved in the venture)
- Financial resources
- Assets
- A business plan

Timmons (1980:28) places a high premium on a business plan. When one seeks venture capital, the submission of a business plan is usually the point of departure. An entrepreneur wants to extract financial resources (an investment) from a venture capitalist in order to give his venture a bigger chance of survival.

3.5.2 The team

Timmons and Spinelli (2003:59) draw a distinction between the entrepreneurial leader and the rest of the team. One of the tasks of the entrepreneurial leader is to build a good team. The team is, therefore, a very important component in the entrepreneurial process.

3.5.3 The opportunity

An opportunity has the qualities of being attractive, durable, and timely. Furthermore, an opportunity is anchored in a product or service which creates or adds value for its buyer or end user. The opportunity should be the starting point for screening opportunities, because the most successful entrepreneurs, venture capitalists, and private investors are opportunity focused - they start with what the customer or the marketplace wants.

According to Timmons and Spinelli (2003:92-93), the following aspects are important when evaluating an opportunity: Industry and market, economics, harvest issues, competitive advantage issues, management team, fatal-flaw issue, and strategic fit differentiation. The factors that are associated with each of these aspects are reflected in Table 3-3.

Table 3-3
Criteria for evaluating venture opportunities

Criteria/ (Main factors)	Factors
Industry and market	Market (customers, user benefits, value added, product life) Market structure Market size Growth rate Market capacity Market share attainable (year five) Cost structure
Economics	Time to break even/positive cash flow ROI potential Capital requirements Internal rate of return potential Free cash flow characteristics: Sales growth, asset intensity, spontaneous working capital, R&D/capital expenditure, gross margins, after-tax profits Time to break even, profit and loss
Harvest issues	Value-added potential Valuation multiples and comparables Exit mechanism and strategy Capital market context
Competitive advantage issues	Fixed and variable costs Control over costs, prices and distribution Barriers to entry (proprietary protection, response/lead time, legal/contractual advantage, contacts and other networks, and key people)
Management team	Entrepreneurial team Industry and technical experience Integrity Intellectual honesty
Fatal-flaw issue	
Personal criteria	Goals and fit Upside/downside issues Opportunity costs Desirability Risk/reward tolerance Stress tolerance

Criteria/ (Main factors)	Factors
Strategic differentiation	Degree of fit Team Service management Timing Technology Flexibility Opportunity orientation Pricing Distribution channels Room for error

Own adapted from Timmons and Spinelli (2003:92-93)

3.5.4 Summary

Although the Timmons Model is extremely simple, the same cannot be said about the criteria for evaluating business opportunities. What is also important is that some of the same factors previously mentioned are mentioned again.

The real preferences of venture capitalist firms will be tested in a questionnaire. The above criteria will be included in this test. Before this is done it would be worthwhile to ask the following question: Should venture capitalist firms have additional screening criteria in the light of the socio-economic problems facing South Africa?

3.6 Corporate citizenship, legislation and venture capital screening

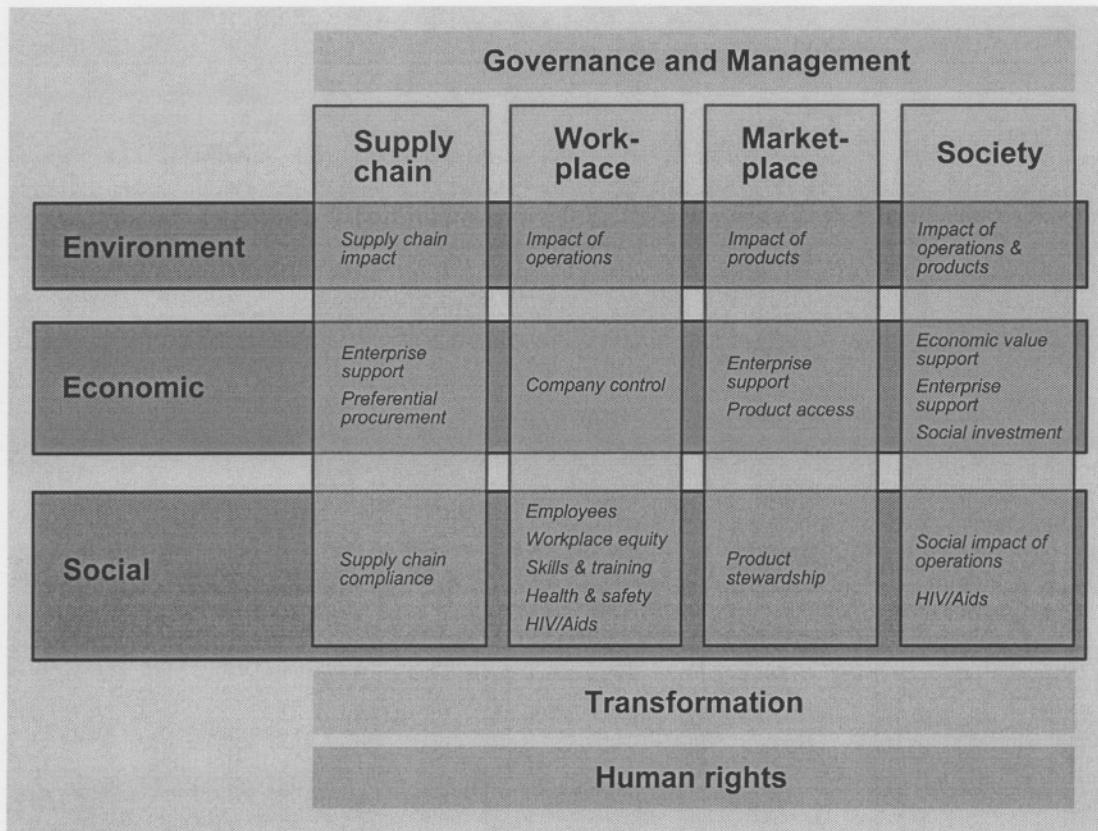
3.6.1 The role of government in the economy

The government's role in the economy should not be underestimated. One analyst added the government as a sixth force to Porter's Five Forces model (Vining *et al.*, 2000:2). In South Africa, the government plays an active role in legislation and regulatory requirements. Sometimes this involvement has the desired effect, but sometimes the law of unintended consequences takes its course. In South Africa, this 'sixth force' is extremely relevant.

3.6.2 Corporate citizenship

When we investigate the global trend of corporate citizenship the following is important: Corporations do not only exist for the purpose of maximizing shareholders' value, but also to benefit the broader community where they operate. Figure 3-1 presents an overview of the elements of corporate citizenship.

Figure 3-1
Categorizing elements of citizenship



Triologue (2004:34)

When one investigates Figure 3-1, it is important to note the following: Many of the issues surrounding corporate citizenship are part of the political debate in South Africa. These issues are not only debated, but are, in some cases, also prescribed in legislation and guidelines.

Table 3-4 presents an overview of formal precedents for good citizenship.

Table 3-4
Formal precedents for good citizenship

	International	Local
Prescribed laws, conventions and standards	Universal Declaration of Human Rights International Labour Organization Standards ISO 9000 ISO 14000 OHSAS 1800	SA Constitution and Bill of Rights Basic Conditions of Employment Act Labour Relations Act Occupational Health and Safety Act National Environmental Management Act Mineral and Petroleum Resources Development Act National Water Act Directors' fiduciary duties Common law and judicial precedent NOSA grading
Guidelines	Global Reporting Initiative AA1000 Series SA8000 Standard Global Compact Sigma Guidelines Dow Jones Sustainability Index FTSE4Good Index	King II JSE Listing Requirements JSE SRI Index
Transformation initiatives	'Region-specific' initiatives	Broad-based BEE Act Employment Equity Act Skills Development Act Industry Charters

Dialogue (2004:20)

South Africa is a highly regulated country in which to conduct business. Any venture capitalist who ignores the effect of government regulations on future ventures is foolish and doomed to run into difficulty. Furthermore, there are numerous government regulations and laws that are applicable to any industry that cannot be classified as part of good corporate citizenship.

3.6.3 Black Economic Empowerment (BEE)

The transformation initiatives reflected in Table 3-4 are extremely relevant to the South African economy today. Transformation is one of the most discussed topics in civil society

debates. Hardly a day goes by without the announcement of a new empowerment deal or initiative in the press. BEE is changing the country as never before.

A venture capitalist in South African cannot ignore this trend as it is part of the political landscape. Therefore, it is recommended that BEE be included in the initial screening phase of venture capitalist firms.

3.6.4 Conclusion

Following from the above discussion it can be argued that the following aspects are also of critical important for the success of ventures in South Africa:

- Good corporate citizenship
- BEE
- Compliance with internal legislation

These aspects must be considered during the initial screening phase, because they are of critical importance for the sustainable success of a venture.

3.7 Summary of critical factors regarding screening phase

From the preceding analysis the following is important: To screen a venture, venture capital firms first use internal fund preferences to determine if the venture fits their investment preferences. Venture capital firms conduct venture analyses according to factors that they deem important. They should include factors relating to corporate citizenship in the initial screening of a venture.

The following preliminary framework emerges from this chapter and will be tested in the empirical study:

Venture screening framework

1. Internal fund preferences

Does the venture meet the following internal fund preferences of the fund?

- Minimum investment amount
- Maximum investment amount
- Industry preferences
- Industry exclusion preferences
- Investment stage
- Minimum and maximum percentage equity taken up
- Geographic preference
- Investor control
- Familiarity with technology
- Product and market risk
- Stage of development

2. Venture analysis

Does the venture have the potential for above-average return on investment when the following factors are taken into account?

Team

- Management team
- Lead entrepreneur

Resources

- People (discussed under team)
- Financial resources
- Assets
- Business plan

Opportunity

- Industry and market
- Economics of the business
- Harvest issues
- Competitive advantage
- Fatal-flaw issue
- Strategic differentiation

3. Corporate citizenship (South Africa specific)

Will the venture be a good corporate citizen?

- BEE credentials
- Contribution to the community (for example, job creation)
- Industry-specific laws of the country

The next chapter will focus on actual preferences of venture capitalist firms in South Africa.

Chapter 4

Empirical study of venture capitalist companies in South Africa

4.1 Introduction

In the previous chapter the critical factors for venture analysis were investigated. Most analysts agree on the main factors, but disagree on the specific factors. The question arises whether South African venture capitalists should have different criteria for analysing venture opportunities.

The following empirical study will seek to answer many questions on the initial screening phase of the venture capital process in South Africa. The empirical study will focus on the critical factors that each venture capitalist believes is important in the initial screening process and the relative weight that is assigned to each factor. The study was conducted as follows:

4.2 Sample selection

The following criteria were used in the sample selection to ensure that the sample used was representative of the population of venture capitalists in South Africa:

- a) Only full members of the South African Venture Capital and Private Equity Association were investigated.
- b) Of these companies, companies with a minimum investment amount of R10 million or below were investigated.
- c) From this sample, only companies that offer real venture capital (that is, companies that invest in seed capital or in the early stages of the business cycle) were selected. All companies without clear preferences were disregarded.

Table 2-2 (Financial cycle investment stage preferences by South African VC companies) reflects all the companies that meet the above criteria. Initially this sample consisted of 23

companies. When these companies were contacted telephonically it was determined that six companies did not provide venture capital, but provided private equity only. Another company was in the process of being liquidated. The sample was narrowed down to 16 companies.

4.3 Data collection

In order to obtain information from the widest possible audience the Internet was chosen as the medium for collecting data. Respondents were asked to complete an online questionnaire. All respondents were also contacted via email and/or telephone to request them to take part in this study.

Respondents were assured that they could complete the questionnaire anonymously. However, there were fields on the response form where a user could provide his/her contact details if he/she wished to receive a copy of this research upon completion.

Although this questionnaire could be completed anonymously, the server recorded the IP address of each respondent. This data was not collected for any malicious reasons, but to ensure that invalid answers were disregarded if someone tried to manipulate the questionnaire by completing more than one form. This was not a 100 percent foolproof mechanism, but it would prevent 98 percent of all rigging attempts. The IP address could also be an indication of which respondents completed the questionnaire.

4.4 Questionnaire

As stated earlier, a questionnaire was used as the sole method of data collection. This questionnaire consisted of open-ended questions and Likert-scale questions. The open-ended questions served the purpose of enlightening us on more general information, whilst the Likert scale served to provide us with information on the relative importance of each factor. The values of each option were as follows:

- 1 – Always reject
- 2 – Sometimes reject
- 3 – Neutral
- 4 – Sometimes approve
- 5 – Always approve

4.5 The questions

From the preceding discussion a number of factors were identified. These factors are listed below together with the questions that were used to measure them.

Table 4-1
Questions to be asked to venture capitalists in South Africa

Factor		Question
Open-ended questions		
1	General	What percentage of all applications for venture capital does your company reject in the initial screening phase?
2	General	What are the main reasons for rejecting these applications?
3	General	Have you invested outside your stated venture capital criteria?
4	General	What return on investment (ROI) does your company require over five years?
Likert-scale questions		
Please answer the next questions with the following in mind: An entrepreneur presents you with a good investment opportunity. What are the chances that you will reject the opportunity if -		
Internal fund preferences		
5	Minimum investment amount	the amount requested is 10% less than your minimum investment amount?
6	Maximum investment amount	the amount requested is 10% more than your maximum investment amount?
7	Industry preferences	the industry is not on your preferential industry list?
8	Industry exclusion preferences	the industry is on your avoid list?
	Investment stage	(see stage of development)
9	Minimum and maximum percentage equity taken up	the percentage equity taken up is within your range of investment preferences?
10	Geographic preference	the venture is outside your preferential geographic area?

	Factor	Question
11	Investor control	you will have a high degree of control in the management of the venture?
12	Investor control	you can veto all important decisions in the management of the venture?
13	Familiarity with technology	you are not familiar with the technology necessary to make the venture successful?
	Product and market risk	(see opportunity analysis)
14	Stage of development	the venture needs seed capital?
15	Stage of development	the venture needs start-up capital?
16	Stage of development	the venture is in the early growth stage?
Venture analysis		
	Team	
17	Management team	the management team consists of one entrepreneur?
18	Management team	the management team has a lot of experience in the field?
19	Management team	the management team is adequate to make the venture a success?
20	Team vs. opportunity	the management team is mediocre, but it is a high-potential opportunity?
	Resources	
21	Business plan	the business plan projections look realistic?
22	Business plan	a professional-looking business plan was presented to you?
23	People	the company will be able to hire all the people needed to make the venture successful?
24	Financial resources	the company will have enough financial resources to make the opportunity a success?
25	Assets	the company has the necessary equipment to make the venture successful?
26	Resources vs. team	there are inadequate resources, but an A-rated management team?
	Opportunity	
27	Industry and market	the product has an established market?
28	Industry and market	the business is in a declining industry?
29	Industry and market	the market share attainable at year five is 20%?
30	Economics of the business	the business will take three years to break even?
31	Economics of the business	the expected ROI is 10% per year after five years?
32	Economics of the business	the expected ROI is 20% per year after five years?
33	Harvest issues	the company has a well-defined exit strategy?
34	Harvest issues	you will be able to sell your investment in the company after three years?
35	Competitive advantage	the opportunity has significant barriers to entry?
36	Competitive advantage	the company is well positioned in the value chain?
37	Competitive advantage / team	the company has an A-rated team?
38	Strategic differentiation / business plan	the company has a well-developed strategy?
39	Opportunity vs. resources	it is an A-rated opportunity, but the company does not have enough resources?
Corporate citizenship		

	Factor	Question
40	BEE credentials	a significant portion of the ownership will go to previously disadvantaged communities?
41	BEE credentials	the venture has no BEE credentials?
42	Contribution to the community (for example, job creation)	the venture will create many jobs, but at a lower profit potential?
43	Contribution to the community (for example, job creation)	the venture will not create any jobs, but it has a high profit potential?
44	Industry-specific laws of the country	the venture is in compliance with all the laws of the country?

The next chapter will focus on the results of the survey.

Chapter 5

Survey results

5.1 Introduction

Some surveys are uninteresting and generate predictable results while other surveys add more value to a topic than anticipated beforehand. This survey generated direct information on the factors investigated, but it also generated indirect information on the nature of venture capitalists. One of the indirect factors that were confirmed in this study is that venture capitalists are protective of their time. I was screened by various companies and could not get hold of the real venture decision makers to ask them to complete the survey. Other potential participants disregarded numerous emailed and telephonic messages in which they were invited to participate in the survey. A common complaint that was received was that the questionnaire was too long. This resulted in the non-participation of at least one respondent.

In hindsight, some of the above problems could have been avoided if it had been borne in mind that venture capitalists are very jealous of their time. A shorter questionnaire should have been drawn up. The rest of this chapter will focus on what can be learned from the research project. The statistically processed survey results are contained in Appendix B.

5.2 Research sample

Of the 16 eligible VC companies identified in Table 2-2 (Financial cycle investment stage preferences by South African VC companies), nine companies participated in the survey. Five companies ignored all pleas to complete the questionnaire. Two provided reasons for their non-participation, one was in the middle of a restructuring process and could not complete the questionnaire and another had a very effective screening agent. This agent stressed that all consultants were very busy and did not have time to complete the questionnaire.

These non-participating companies also provided some insight into the world of venture capitalists and it is in line with theory that venture capitalists do whatever they can to limit

unproductive demands on their time. If a company did not complete the survey it was contacted a few times telephonically and via email.

The company that was being restructured was deducted from the sample, leaving a potential sample of 15 companies. Consequently, a response rate of 60 percent was achieved.

5.3 Factor analysis

The questions set out in Table 4-1 (Questions to be asked to venture capitalists in South Africa) were posed to all participants. During the processing of the results, some surprising responses emerged. Some of the questions that were supposed to measure certain factors were thrown out, because it would be impossible to measure a certain factor with a specific question as in the case of, for example, question 26 ("Resources vs. team"). The following is an analysis of the responses obtained in the questionnaires.

5.3.1 General

A few general questions were asked. It was determined that, on average, 81 percent of all applications for venture capital are rejected in the initial screening phase. The highest value under this question was 99 percent, whilst the lowest value was 25 percent. The median for this sample was 90 percent and the value of the lower quartile (Q1) was 80 percent, pointing to extreme values at the lower end of the scale. If the lowest value is disregarded the average drops to 88 percent and the standard deviation to 10 percent. The high rejection rate in the screening phase in the South African context is in line with venture capitalist theory as discussed in Chapter 2.

5.3.1.1 Reasons for rejections

When the reasons for rejections were investigated the following responses were obtained in the open-ended questions:

- a) Company A only invests in insurance premiums generating businesses and only in niches in which the company is not already involved.

- b) Company B indicated that it rejects an application if the venture does not fall within the mandate of the fund.
- c) Company C rejects applications in the following instances: The project falls outside the company's mandate; the absence of an experienced operating partner; insufficient financial commitment from the promoter; and an overly ambitious project concept and projections.
- d) Company D indicated that its initial screening is very brief and merely consists of establishing if the company's core criteria are met.
- e) Company E currently does not have a mandate to invest in early stage or start-up operations. However, an exception is made if the management of the 'start-up' have related/similar industry experience which they use in a venture of their own. In this situation the company will assess the opportunity.
- f) Company F listed the following factors that lead to the rejection of applications: A poor business case for addressing market needs; and the inability of an applicant to provide requested information in a qualitative manner and timely.
- g) Company G rejects an application if the venture does not meet certain investment criteria, that is, if it is too small or in too early a stage.
- h) Company H listed viability, gearing, and risk as factors that contribute to applications being rejected in the screening phase.
- i) Company I rejects applications if they do not meet the company's investment/lending criteria.

At least six of the nine responses can be traced back to the mandates of the VC companies. By implication, the fund mandate is very important for venture capitalists. If the responses to the question "Have you invested outside your stated venture capital criteria?" are analysed, the aspect of fund mandate is highlighted. Only 33 percent of the respondents have invested outside the scope of their investment criteria.

5.3.1.2 ROI over five years

Question 4 regarding ROI could have been interpreted differently by different respondents. One respondent stated that the expected ROI over five years for the company is 200 percent, whilst all the other respondents expressed their ROI over five years in single-digit

figures. If one disregards the one extreme value the mean ROI over five years (expressed as ROI per year) is 26,21 percent, with a standard deviation of 9,5 percent. The lower quartile (Q1) is 19,25 percent and the upper quartile (Q3) is 32,5 percent.

Question 4 can be linked to questions 31 and 32. Most applicants will reject an ROI of 10 percent per year and most will not reject or approve an opportunity if the ROI is 20 percent per year. At an ROI of 20 percent the standard deviation is 1,8 percent which is quite high on a five-point scale. Some respondents would accept an ROI of 20 percent per year, but some would reject it. This is confirmed by the Q1 of 19,5 percent in question 4, which indicates that at least 25 percent of the respondents would accept an ROI of 19,5 percent per year.

The ROI of investments is relatively high. Given the fact that the prime rate is currently at 11 percent, the average expected return is 2,38 times more than what a company can expect if it is lending out money. This expectation is in line with the theory that venture capitalists expect an above average return on investment.

5.3.2 Internal fund preferences

From the general questions it was determined that most respondents place a high premium on their investment mandate. Attempts have been made to isolate important factors in this regard.

Table 5-1 presents the processed results obtained from the questionnaire. One factor, 'development stage', was removed, because the questions posed concerned the respondents' preferred investment stage and not the relative importance of the investment stage and their internal fund preferences.

In the processing of the results, some questions were transformed into a positive value. Question 8 is an example of a negative question. In this instance, what had to be determined was the likelihood of a venture being approved/rejected if an industry is not on a respondent's avoid list. To obtain a positive value the following formula was applied: 6 - average value. A word of caution is given to future researchers to not use too many

negative questions, as negative questions might be ambiguous and overly complicated to respondents and are relatively difficult to process.

Table 5-1
Internal fund preferences factors

Factor	Average	Standard Deviation
Familiarity with technology	3,56	1,1
Industry preferences	3,95	0,95
Geographic preference	3,89	1,5
Investment amount	3,89	1,16
Investor control	4,17	1
Minimum and maximum percentage equity taken up	4,22	1,0

The factor 'percentage of equity taken up' is the most important factor and 'familiarity with technology' is the least important factor in Table 5-1. All factors fall within the 'sometimes approve' window. The average value for this group is 3,94, with a standard deviation of 1,12. The deduction can be made that if a venture opportunity complies with the internal fund preferences of a venture capital company, it is sometimes approved. The group average will be meaningless if it cannot be compared with the averages of other groups. The next group that will be investigated is venture analysis.

5.3.3 Venture analysis - team

In respect of this factor, one question, namely question 17, was disregarded, because the size of a management team generally does not determine its strength. The average of all responses to questions 18, 19, and 37 was 4,44, with a standard deviation of 0,83. This result suggests that the strength of a management team is a relatively significant factor and if a team is strong, the opportunity sits between 'approve' and 'always approve' on the Lickert scale. The relative importance of the other two main areas of the Timmons Model will now be investigated.

5.3.4 Venture analysis - resources

Table 5-2 presents the results of the factors relating to resources. What is important is that all values are relatively close to each other. Question 38 has also been included in the calculation of the 'business plan' factor.

Table 5-2
Venture analysis – resources factors

Factor	Average	Standard Deviation
Financial resources	4	1,2
Assets	4,11	0,9
Business plan	4,22	0,7
People	4,22	1,0

The average of the responses to the resources factor was 4,14, with a standard deviation of 0,7.

5.3.5 Venture analysis - opportunity

In respect of this factor, questions relating to 'economics of the business' were disregarded, because they were used in the general section, and they were asked incorrectly and could not be used to measure the relative importance of, for example, the ROI. This was also the case with the questions relating to 'industry and market'. Question 38 was also disregarded under 'opportunity', because it cannot measure an opportunity as such, but rather a business plan. This question has been added to the business plan factor. Table 5-3 presents a summary of the 'opportunity' factors.

Table 5-3
Venture analysis – opportunity factors

Factor	Average	Standard Deviation
Harvest issues	4,17	0,95
Competitive advantage	4,19	0,82
Industry and market	4,22	0,97
General on opportunity	4,33	0,5

The average value of all factors under 'opportunity' was 4,38, with a standard deviation of 0,81. The averages of the three main factors under venture analysis, namely team, resources, and opportunity, fell within the 'sometimes approve' and 'always approve' window. The next aspect that will be investigated is the responses obtained in the corporate citizenship section.

5.3.6 Corporate citizenship

This factor was added to put this research in a South African context. Table 5-4 presents a summary of the results. One negative question ("... the venture will not create any jobs?") has been reversed to gain a meaningful result for the factor 'contribution to the community'.

Table 5-4
Corporate citizenship factors

Factor	Average	Standard Deviation
Contribution to the community	2,61	1,34
BEE credentials	3,5	1,15
Industry-specific laws of the country	4,33	1

As reflected in Table 5-4, corporate citizenship is the only section with relatively low scores. It seems that BEE credentials are only marginally important when a new venture opportunity is screened. The standard deviation regarding this factor is relatively high, pointing to dissonance among the respondents.

In respect of the factor 'contribution to the community', a more significant result was obtained. It appears that venture capitalists are keen to reject ventures that make a contribution to the community. The standard deviation under this factor was 1,34, which indicates divergent opinions among the respondents. One possible cause for the low score under this factor is that people choose to measure the contribution that a venture makes to the community in terms of job creation.

Job creation in South Africa is a complex issue. The government has implemented labour legislation that keeps people unemployed, because the legislation makes it very difficult to

terminate service contracts of underperforming workers. Therefore, venture capitalists could perceive job creation as an additional business risk.

The only factor that scored relatively high was 'industry-specific laws of the country'. The average score for 'corporate citizenship' was 3,48, with a standard deviation of 1,16.

5.4 Summary of results

From the preceding discussion of the results the following table was created, indicating the relative importance of each main factor in the venture capitalist decision-making process:

Table 5-5
Summary of results

Factor	Average	Standard Deviation
Internal fund preferences	3,94	1,12
Venture analysis – team	4,44	0,83
Venture analysis – resources	4,14	0,7
Venture analysis – opportunity	4,38	0,81
Corporate citizenship	3,48	1,16

The following ambiguities regarding these results must be investigated: 'Internal fund preferences' scored relatively high, but the score is still below the venture analysis factors taken from the Timmons Model. Furthermore, this factor is stated as a reason for rejecting applications in six of the nine open-ended questions about reasons for rejection. Given the fact that only 33 percent of the respondents have invested outside their stated investment criteria, internal fund preferences is a factor that must be taken into consideration and is more important than the Lickert-type questions indicate.

On a more practical level, if a venture capital seeker goes to 66 percent of venture capitalist companies with a strong enforcement policy on internal fund preferences there is almost a 100 percent likelihood that the application will be rejected. For a venture capital seeker to be successful (and not waste his own and the VC company's time), he must first analyse the venture capitalist company's internal fund preferences before making an application. As already stated, these preferences can usually be found on the websites of venture capitalists.

In respect of venture analysis, it was determined that this factor is also important in the initial screening phase. From the above discussion it can be argued that venture analysis is still not as important as internal fund preferences. Although all three factors scored between 4,14 and 4,44, 'management team' was identified as the most important factor. The opportunity and resources are also important. For supporters of the Timmons Model this is good news. It seems that this model can be used to analyse venture opportunities, seeing that all the main factors in the model scored high in this empirical study. A venture capitalist seeker can also use this model to analyse his own opportunity in order to determine if it has the potential to pass the scrupulous screening of venture capitalists.

Another important aspect in opportunity analysis is the required rate of return for venture capitalists. The average ROI value is 26,21 percent and the median is 25 percent. For a venture capitalist seeker this implies that the ROI of an opportunity must be at least 25 percent per year to have a 50 percent chance that the opportunity will not be rejected on the grounds that it has too low potential.

Regarding corporate citizenship, it is important for venture capitalist seekers that their idea is in compliance with the laws of the country. Internal fund preferences and venture analysis appear to be much more important to venture capitalists than job creation or BEE. This is quite surprising, given South Africa's unique problems and the government's focus on BEE.

5.5 Framework for venture capital seekers

Based on the preceding research, the following generic framework has been created for venture capitalist seekers:

FRAMEWORK FOR VENTURE CAPITAL SEEKERS

Before you contact a venture capitalist first answer the following questions:

- Does your opportunity fit the internal fund preferences of the venture capitalist that you want to contact for venture capital? (Go to the company's website.)
- Does your opportunity offer a return on investment of at least 25 percent per year to the venture capitalist?
- Do you have a good management team?
- Is it a good opportunity? (Use the following terms to prove to the venture capitalist that it is a good opportunity: industry and market, harvest, and competitive advantage.)
- Do you have the necessary resources to make the opportunity a success? (Investigate the following resources: people, assets, financial resources, and your **business plan**.)
- Is your opportunity in compliance with the laws of the country?

If you cannot answer 'yes' to **all** these questions, revisit your business plan or investigate another opportunity.

5.6 Closing

At the end of this study it will be useful to revisit the objectives to the study as laid out in Chapter 1. The primary objective of the study was to identify the critical factors that play a role in the screening phase of venture capital applications. The secondary objective was to gain an understanding of the reasons for the high rejection rate of venture capital applications in the initial screening phase. The third objective was to identify the information that venture capitalists should publish to discourage non-qualifying venture capital seekers to apply for venture capital.

All three objectives have been met. In the field study, a number of critical factors were identified. It was argued that the most important factors related to the internal preferences

of a venture capitalist fund. One of these preferences is the ROI of an opportunity. Once these preferences have been met, other factors become important. In this regard, a venture capital seeker can use the Timmons Model to analyse an opportunity. It was also determined that corporate citizenship does not play a big role in the initial screening phase, but a venture capitalist firm will reject an outright illegal venture proposal.

The second objective, that is, to gain an understanding of the high rejection rate, has also been met. Arguably, most applications that are rejected by venture capitalist firms do not meet the internal preferences of the specific venture capitalist firms.

In respect of the third objective, the argument has been made that the relevant information has already been published and is freely available on various venture capitalist companies' websites. This study did not include a detailed audit on each of the studied venture capitalist companies' websites, but the required ROI is not freely published. This might scare off some small investors.

The venture capitalist industry, as any other industry, plays by certain rules. The best advice that can be given to a potential venture capitalist seeker is to use the Framework for Venture Capital Seekers in the quest for venture capital.

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Appendix A

Evaluation factors used in different studies

Figure A-1
Evaluation factors used in different studies

Study	Wels (1974)	Poindexter (1976)	Tyebjee & Bruno (1984)	MacMillan et al. (1984)	MacMillan et al. (1987)	Robinson (1987)	Timmons et al. (1987)	Hall and Hofer (1993)	Altogether:
Method	personal interviews	questionnaire	phone survey & questionnaire	questionnaire	questionnaire	questionnaire	unstructured interviews	verbal protocol	
Sample Size	8	97	46 & 41	100	67	67	47	16	
Entrepreneur / team characteristics									17
Mgmt skills and experience	x	x	x	x	x	x	x	x	8
Venture team				x	x	x		x	4
Mgmt stake in firm		x	x						2
Personal motivation	x					x			2
Entrepren. personality				x					1
Product / service characteristics									13
Product attributes	x		x	x	x				4
Product differentiations			x				x		2
Proprietary	x			x	x				3
Growth potential			x						1
Market acceptance				x			x		2
Prototype				x					1
Market characteristics									15
Market size	x		x				x	x	4
Market growth	x		x	x		x	x		5
Barriers to entry			x				x		2
Competitive threat				x	x		x		3
Venture creates new mkt				x					1
Financial characteristics									15
Cash-out method	x		x					x	3
Expected ROR		x	x	x			x		4
Expected risk		x							1
Percentage of equity		x							1
Investor provisions		x							1
Size of investment	x		x						2
Liquidity				x	x	x			3
Other									9
References	x					x			2
Venture development stage		x	x						2
VC investment criteria							x		1

(Birrer, 2002:11)

Appendix B

Statistically processed survey results

	Main factor	Factors	Mean	Neg. quest.	Median	Std Dev.	Q1	Q3	Question
1	General	Percentage of applications rejected	81		90	23	80	95	What percentage of all applications for venture capital does your company reject in the initial screening phase?
2	General	Reasons for rejection							What are the main reasons for rejecting these applications?
3	General	Invested outside own investment criteria	33%						Have you invested outside your stated venture capital criteria?
4	General	Required ROI over 5 years	27,94		27,5	10,1	21,38	36,25	What return on investment (ROI) does your company require over five years?
5	Internal fund preferences	Minimum investment amount	4		4	1,2	4	5	... the amount requested is 10% less than your minimum investment amount?
6	Internal fund preferences	Maximum investment amount	3,78		4	1,1	4	4	... the amount requested is 10% more than your maximum investment amount?
7	Internal fund preferences	Industry preferences	3,11	2,89	3	1,5	2	4	... the industry is not on your preferential industry list?
8	Internal fund preferences	Industry exclusion preferences	4,78	1,22	1	0,4	1	1	... the industry is on your avoid list?
9	Internal fund preferences	Minimum and maximum percentage equity taken up	4,22		4	1,0	4	5	... the percentage equity taken up is within your range of investment preferences?
10	Internal fund preferences	Geographic preference	3,89	2,11	1	1,5	1	4	... the venture is outside your preferential geographic area?
11	Internal fund preferences	Investor control	4		4	1,0	4	5	... you will have a high degree of control in the management of the venture?
12	Internal fund preferences	Investor control	4,33		5	1,0	4	5	... you can veto all important decisions in the management of the venture?
13	Internal fund preferences	Familiarity with technology	3,56		4	1,1	3	4	... you are not familiar with the technology necessary to make the venture successful?
14	Internal fund preferences	Stage of development	2,67		2	1,4	2	4	... the venture needs seed capital?
15	Internal fund preferences	Stage of development	3,56		4	1,6	3	5	... the venture needs start-up capital?
16	Internal fund preferences	Stage of development	3,44		4	1,4	2	4	... the venture is in the early growth stage?

	Main factor	Factors	Mean	Neg. quest.	Median	Std Dev.	Q1	Q3	Question
17	Venture analysis – team	Management team	3,89		4	1,2	4	5	... the management team consists of one entrepreneur?
18	Venture analysis – team	Management team	4,44		5	1,0	4	5	... the management team has a lot of experience in the field?
19	Venture analysis – team	Management team	4,44		5	1,0	4	5	... the management team is adequate to make the venture a success?
20	Venture analysis	Team vs. opportunity	3	3	2	1,2	2	4	... the management team is mediocre?
21	Venture analysis – resources	Business plan	4,22		4	1,0	4	5	... the business plan projections look realistic?
22	Venture analysis – resources	Business plan	4		4	0,7	4	4	... a professional-looking business plan was presented to you?
23	Venture analysis – resources	People	4,22		4	1,0	4	5	... the company will be able to hire all the people needed to make the venture successful?
24	Venture analysis – resources	Financial resources	4		4	1,2	4	5	... the company will have enough financial resources to make the opportunity a success?
25	Venture analysis – resources	Assets	4,11		4	0,9	4	5	... the company has the necessary equipment to make the venture successful?
26	Venture analysis	Resources vs. team	4,11		4	0,6	4	4	... there are inadequate resources?
27	Venture analysis – opportunity	Industry and market	4,22		4	1,0	4	5	... the product has an established market?
28	Venture analysis – opportunity	Industry and market	3,67	2,33	2	0,9	2	3	... the business is in a declining industry?
29	Venture analysis – opportunity	Industry and market	3,56		4	1,0	3	4	... the market share attainable at year five is 20%?
30	Venture analysis – opportunity	Economics of the business	2,67		3	1,4	1	4	... the business will take three years to break even?
31	Venture analysis – opportunity	Economics of the business	1,56		1	1,0	1	2	... the expected ROI is 10% per year after five years?
32	Venture analysis – opportunity	Economics of the business	2,89		2	1,8	1	5	... the expected ROI is 20% per year after five years?
33	Venture analysis – opportunity	Harvest issues	4,22		4	1,0	4	5	... the company has a well-defined exit strategy?
34	Venture analysis – opportunity	Harvest issues	4,11		4	0,9	4	5	... you will be able to sell your investment in the company after three years?
35	Venture analysis – opportunity	Competitive advantage	4		4	1,0	4	5	... the opportunity has significant barriers to entry?
36	Venture analysis – opportunity	Competitive advantage	4,11		4	0,9	4	5	... the company is well positioned in the value chain?

	Main factor	Factors	Mean	Neg. quest.	Median	Std Dev.	Q1	Q3	Question
37	Venture analysis – opportunity	Competitive advantage / team	4,44		4	0,5	4	5	... the company has an A-rated team?
38	Venture analysis – opportunity	Strategic differentiation / business plan	4,22		4	0,4	4	4	... the company has a well-developed strategy?
39	Venture analysis	Opportunity vs. resources	4,33		4	0,5	4	5	... it is an A-rated opportunity?
40	Corporate citizenship	BEE credentials	3,89		4	0,9	4	4	... a significant portion of the ownership will go to previously disadvantaged communities?
41	Corporate citizenship	BEE credentials	3,11	2,89	4	1,4	2	4	... the venture has no BEE credentials?
42	Corporate citizenship	Contribution to the community	2,89		2	1,4	2	4	... the venture will create many jobs?
43	Corporate citizenship	Contribution to the community	3,67		4	1,3	4	4	... the venture will not create any jobs?
44	Corporate citizenship	Industry-specific laws of the country	4,33		5	1,0	4	5	... the venture is in compliance with all the laws of the country?