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VENTURE CAPITAL

- Important factors for venture capital investment decisions

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Abstract

The decision process of venture capitalists has received much attention from researchers and it is a complex and unclear process. There are plenty of factors that affect venture capitalists` investment decisions. The purpose of this study is to find out the important factors in the due diligence process for the venture capital firms and venture capitalists during their investments. The authors find it interesting to find out factors that influence venture capitalists during their investment decisions according to due diligence process.

Qualitative method was seen suitable for this study. Three phone interviews were conducted with three venture capital firms in Turkey named Is Private Equity, Ilab Ventures and Bosphorous Group.

The authors find out management, market, location, product, industry and financial factors are important factors for venture capitalists to decide whether to invest or not.

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1 INTRODUCTION

In this part some information about the topic will be given. Also this section will continue with the problem discussion, purpose and delimitation parts.

1.1 Introduction

According to a definition of National Venture Capital Association (NVCA) "Venture capital (VC) 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. Professionally managed venture capital firms are generally private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves."[1]

Venture capital is a form of "risk capital and it is not a recent concept. The history of venture capital reaches until middle-age that was known as "mudaraba" in Islamic World and was known as "commenda" in Europe. But in modern world, first it appeared in USA in1950s. In 1946, venture capital investments gained institutional quality with the foundation of American "Research and development Corporation of Boston" (Okuyan, Çalışkan 2000). In 1958 a set of studies were done about small firms by "Federal Reserve System" and as a result of this "Small Business Investment Act" was effective. After that small scale private sector firms called "Small Business Investment Company" were formed. These kinds of firms performed a great role in the improvement of venture capital sector and especially in 1980s this model was applied very frequently. The model of venture capital is a consequence of knowledge age and the concept of economy which is based on knowledge (Okuyan, Çalışkan 2000)

In the past two decades venture capital industry in United States has shown an incredible growth. Many of the big companies which include Genentech, Google, Apple, Microsoft, Intel and Lotus have been backed by venture capital funds. This development has led to increasing attention to venture capital industry from all over the world. (Gompers P.A and Lerner J. 2004)

[1] http://www.nvca.org/def.html

Today the success of venture capital firms depends on their ability of predicting new firm performance during a multi-stage evaluation process of investment proposals. The researches show that VC firms' expertness in removing bad investment proposals led VC-backed businesses to achieve higher survival rates than non-VC- backed firms (Sandberg 1986, Timmons 1994). Also venture capitalists (VCs) can be seen as experts in identifying high potential new ventures- gazelles (Zacharakis A.L, and Shepherd D.A. 2001). Therefore this situation has led to increasing attention to the evaluation process of VCs by the research community of entrepreneurship and finance (Wells 1974, Poindexter 1976, Tyebjee and Bruno 1984, MacMillan et al. 1985, Sandberg et al. 1988, Muzyka et al. 1996, Zacharakis and Meyer 1998). Still most of the studies about VC decision- making still focus on decision criteria`s that can be central of selecting gazelles (Zacharakis, A.L., Shepherd, D.A. 2001).

However VC investment process is a complex and unclear process (Benoit, 1975). It is still not obvious that how and on what basic factors the venture capitalists make their investment decisions (Hill & Power, 2001). According to Roberts (1991) each venture capital firm follows its own guidelines and rules and this create uncertainty. Wu (1988) states that venture capitalists invest in people and their ability. Zacharakis & Meyer (1998) do not agree with Wu (1988). They found that market characteristics are the main determinate of the venture capitalist process to make investment. Also they defined market characteristics as market competition and market familiarity. Tybjee & Bruno (1984) and Shepard (2000) agreed with the findings of Zacharakis & Meyer (1998). But they also found that size of investment, cash-out potential, and product differentiation are the other important factors in venture capitalists investment decisions. In additionally, Zacharakis & Meyer (1998) found that "business plans" is another important factor in investment decisions. Venture capitalist can make successful investment decisions by using information in a business plan.

There are plenty of factors which can influence venture capitalists investment decision. But as it can be seen, there is no consensus in this field. One question can come into mind; why is it so important to understand the venture capitalist investment process? According to Shepherd et.al (2000) there are two reasons of this situation. Firstly, understanding the venture processes in which capability predict firms performance could be strategic beneficial. Secondly the main actors of the today`s economy have the basis which was created by the venture capitalist for the start-up firms.

1.2 Problem

What are the factors that influence venture capitalists during their investment decisions according to due diligence process?

1.3 Purpose

As mentioned in the introduction part, the venture capital investment decision process is a complex and ill-defined process. There are a lot of factors which affect venture capitalists investment decisions. Therefore the purpose of this dissertation is to find out the important factors in the due diligence process for the venture capital firms and venture capitalists during their investments.

1.4 Delimitation

When the topic comes to the venture capital there are a lot of things to talk about. The literatures study, explore and take hand in the topic from the different perspectives. The venture capital process consists of business plans, initial meetings and due diligence processes. After these three steps, venture capitalists give investment decisions (Fichera, 2001). This study is limited with due diligence process. The important factors in the due diligence process that influence venture capitalists during their investment decisions will be found out. The study will not focus on business plans and initial meeting processes. There will be just short explanations about them to understand the due diligence process clearly. Detailed information will be given about due diligence factors that include management, market, financials, product, location and industry.

2 THEORY

In this part, venture capital investment process will be introduced. Also this part will be a reference for the author's empirical findings.

2.1 Venture Capital Decision Making and Investment Process

Since 1970s most of the academic researchers tried to describe and understand venture capitalists` decision making process (Jorge Silva, 2004). The primary objective of these researches is to determine how venture capitalists can evaluate potential investments (Tybjee and Bruno 1981, Kahn 1987). The previous studies typically ask venture capitalists to list and rank decision criteria that affect their investment decisions (Tyebjee and Bruno 1981, Kahn 1987). These criteria generally relate to the quality of the entrepreneur/team, uniqueness of the product/service, attractiveness of the market as well as financial considerations (cf. Tyebjee and Bruno 1984, MacMillan *et al*. 1985, 1987).

During making investment decisions, venture capitalists use several information sources such as business plans, outside consultants, and due diligence. Venture capitalists cannot make accurate decision to their investment process whether they cannot understand it truly. Hence they may suffer from a systematic bias which obstructs their investment portfolio (Zacharakis, A. & Meyer, D.G. 1998). So VC investment process is a complex and unclear process (Benoit, 1975).

The venture capital investment process start with the decision of venture capitalists: if they will invest or not. If the venture is successful venture with good returns and capital gains, the venture capitalists will invest in that company. But if the venture is an unsuccessful venture with no return, venture capitalists will not invest in that company (Zacharakis and Meyer, 2000).

2.2 Venture Capital Process

According to Fichera (2001) venture capitalists follow a specific process called "Venture capital process" to make their investment decisions.

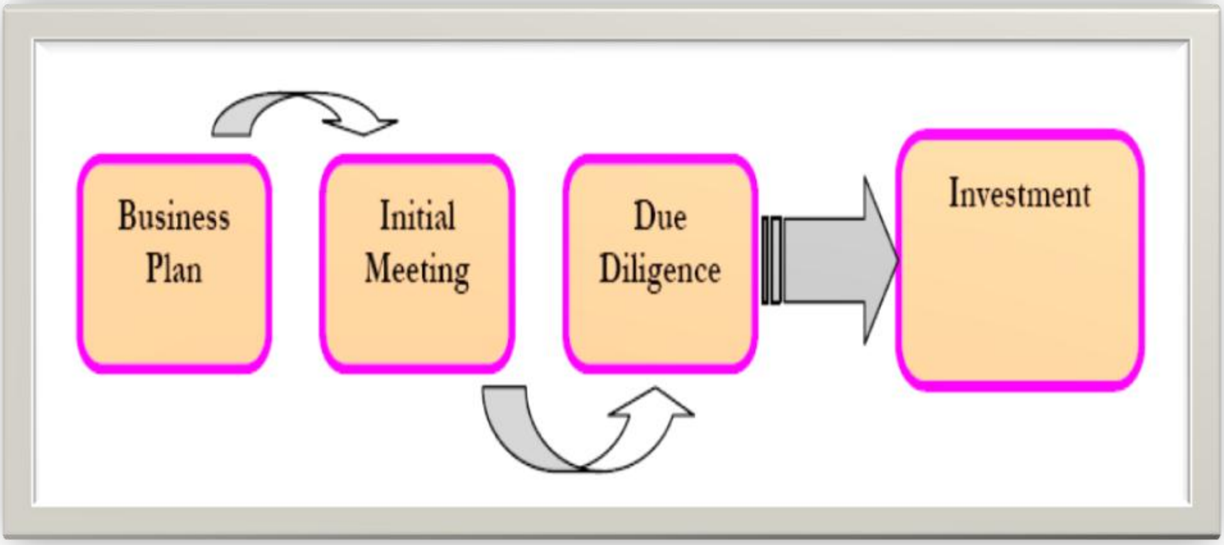

Figure 1 The Venture capital process, Fichera, 2001, page 292

The first step of the Venture capital process is viewing business plans. The second step is making a personal meeting with entrepreneurs and this step is called initial meeting. Due diligence follows these two steps and it is the process of verifying the facts about the company under investigation. After these three steps venture capitalists give their investment decisions.

2.2.1 Business Plans

The first step of the venture capital process is screening a business plan. A business plan is a written instruction which describes and analysis companies` businesses and covers financial aspects of it by giving detailed information about its future (Mike P. McKeever, 2007). Every year around 10 million business plans are written around de world (Gumpert, 2002). The findings of the Deloitte & Touche (2004) shows the executive summary is the briefest and most important part of a business plan. It covers all of the key points and it determines to be candidate of venture capitalists before read further. Particularly some researches show that venture capitalists set up their judgement chiefly on the first few pages of a plan (Shepherd and Zacharakis, 2001).. According to Mike P. McKeever (2007) business plans help companies to provide money, to decide to proceed or stop, improve their business concept, improve odds of success, and helps them to keep on track.

2.2.2 Initial Meeting

The second step of the venture capital process is initial meeting with the entrepreneurs. According to David Gladstone (2001) the venture capitalists hold a meeting with entrepreneur to accomplish three basic objectives. These objectives are to get more information about the business and how it will make money, to evaluate management team in a face-to-face situation, and to “cut the deal”, which means to structure the investment, and ultimate the goal of the meeting. If entrepreneurs do not discuss at least preliminary structure of the investment with venture capitalists during the meeting, they will probably lose the investment. Especially during the meeting entrepreneurs should give information to venture capitalists about all aspects of the business, the amount of money they need, and what they plan to do with that money. (David Gladstone 2001). Wu (1988) states a personal meeting with entrepreneurs can be a critical factor to attract venture capitalists attention and interest.

2.2.3 Due Diligence

Due diligence is the third step of the venture capital process after having business plans and having a meeting with entrepreneurs. In this process, venture capitalists work to inform themselves regarding the companies they considered for investment. Venture capitalists use due diligence process to make better investment decisions and thereby improve the returns of their venture capital portfolios (Camp, 2002). Due diligence is consist of analysis of management team, financials, market, product, location and industry (Camp, 2002).

2.2.3.1 Management

After the initial meeting, in the due diligence process, venture firms collect more facts about the entrepreneurs as well as facts about the management team in general (Camp, 2002).

Management can add more value to an acquisition than almost everything. Most of the private equity investors’ decisions on whether invest or not to invest in a target are given by their views on the management (Peter Howson, 2003). Early stage venture capital companies seldom have complete management teams which are ready to manage without help from the first moment. These kinds of companies often must look for a management support from the outside until their management teams can be completely filled out. According to famous venture capitalist Arthur Rock, venture capitalists substantially decrease the risk of the portfolio company failure by investing in companies which have top-quality management resources (Camp, 2002).

According to Camp (2002) most of the venture capitalists want to invest in high quality people. High quality people should have some characteristics which include integrity, intellectual honesty, intellectual brilliance, and interpersonal skills. Wu (1988) found that management team should understand the entire business in order to survive and grow the company. Shepherd et al. (2000) found with an investigation that industry related competence is important as well as educational capability. Muzyka et al. (1996) make an investigation around Europe with 51 venture firm and determined leadership ability of the entrepreneur and the management team is the most important factor.

2.2.3.2 Financials

When the topic comes to due diligence business people think of financial due diligence of an acquisition because it is one of the most important concentrated effort. Financial due diligence contains all of the views of revenues, expenses, and investments throughout with a review of a cash flows, profitability, dividend policy, tax status and unit costs in order to evaluate or confirm the financial health of the firm. Financial due diligence is related with the other efforts of the due diligence because all efforts have financial impacts and branches (John E. Triantis, 1999).

According to Camp (2002) and Cardis et al. (2001) the amount of capital required and sought after, valuation and exit are the financial factors which influence the venture capitalists investment decisions. Venture capitalists want to know how much capital is sought after by the start up and how much capital required for the investment (Camp, 2002). Venture capitalists generally prefer low value companies because low value companies maximize their ownership as well as return their investments (Camp, 2002). The third factor, exit, is another important factor for venture capitalists that they give importance. According to Cardis et al. (2001) if there is not a possibility to exit in an acceptable timeframe (3-5 years), they do not want to make an investment. Tybjee & Bruno (1984) stated in their study, size of the investment and ability important factors for the venture capitalists` investment decisions. Muzyka et al (1996) also found that exit is an important factor but they also found, fit with the fund and time to break are important factors in investment decisions.

2.2.3.3 Market

The comprehension of market due diligence extends from point where technology ends to where finance begins (John E. Triantis, 2003).According to J. Camp (2002) venture capitalists invest in a particular technology or a particular market more than companies. On the other hand the enormous breadth of markets and speed of innovation make these kinds of investment difficult because for them gathering information about all market spaces are almost impossible.

In the event of market factor, venture capitalists look for tremendous factors that affect their decisions. Golis (2002) and Fichera (2001) mentioned about market size, market growth and market share. Fichera (2001) accented venture capitalists want to invest in markets which are not large today but will improve in the future, briefly they prefer emerging and new markets. Wu (1988) pointed out niche markets has a better chance of survival. Zacharakis and Meyer (1998) make a study in US venture capital firms and they found to crucial factors which affect venture capital investment decisions. They are market growth and market size. However Tybjee & Bruno (1984) made a study in US and they found market accessibility, market need, low barriers to entry and markets that are not price sensitive are important factors in investment decision in addition to market growth and market size. Camp (2002) mentioned venture capital firms want to invest in markets that have potential to be large markets in the future.

2.2.3.4 Product

Product is another important factor in venture capital due diligence process. New product technologies can revitalize old industries or create completely new industries (Zahra 1996a). According to Tyebjee and Bruno (1984) venture capitalists invest in products to services, the industrial to the consumer market and nascent to the mature technology. There are number of factors that venture capitalists look when the topic comes to the product. Tyebjee and Bruno (1984) found that the product differentiation, patentability and uniqueness are important factors to give investment decisions. Elango et al. (1995) found in their study highly differentiated product are chosen by venture capitalists as well as patents. Camp (2002) stated time to market, time to get the product to market, is another important decision factor for the product. Limited time period for start up to take advantage of market opportunities therefore they should get the product as soon as possible in order to be successful.

According to Fichera (2001) uniqueness and differentiation are important factors while applying a product. Golis (2002) found that simplicity is important. Product with a first mover advantage, high barriers to entry and patents are important factors according to Cardis et al. (2001) for the venture capitalists in their investment decisions.

2.2.3.5 Location

Location is another important factor for venture capitalists decision making in due diligence process. The researchers emphasized about location and its effects on relationship at least since 1950s (Terri L. Griffith, Patrick J. Yam & Suresh Subramaniam, 2007). Zook (2002) stated that he knows venture capital firms that say if they cannot drive within an hour, they do not make the investment. Camp (2002) stated many venture capital firms will only invest in companies that are located two hours away and located in adjacency to suitable infrastructure channels. Venture capital investments are shown a cluster in geographical regions. The benefits of this geographical tendency are seen as reduced transportation costs, access to skilled labour markets, communication networks, sophisticated customers, access to technology (Powell et al., 2002), and knowledge flows more generally (Owen-Smith and Powell, 2004). Porter & Stern (2001) pointed out additional benefits of co-location: local context that encourages investment in innovation, competition among local rivals, and ample supply of risk capital. Especially they found innovation is strongly affected by location. Also Tybjee & Bruno (1984) stated that geographic location is an important factor.

Elango et al. (1995) found that location is an important factor for smaller venture firms. Larger venture firms, which generally make large scale investments, are not influenced by the location as small scale investments, which refer to as a local market. On the other hand Muzyka et al (1996) found that location is not a necessary factor for the venture capitalists investment decisions.

2.2.3.6 Industry

Industry is an important factor in venture capital investment decisions. Wustenhagen and Teppo (2006) searched that “do venture capitalists really invest in good industries” by looking risk-return characteristics of venture capital investment opportunities in sectors and they found that venture capitalists give importance to the industries during investment decisions. Their study was based on energy sectors. They found sectors like information and communication technologies and biotech account for two-thirds of all VC investments. While there are sizeable investment opportunities, only 5% of all venture capitalists choose to invest in energy sector.

The most of venture capitalists focus on high technology industry sectors (Gompers & Lerner, 2004). Evanson (1998) stated that venture investments are time limited, and venture capitalists will only be able to make good decision if they focus on industries that they have deep knowledge about. Also Camp (2002) stated being knowledgeable about industries is very important for venture capitalists to completely understand their investment opportunities and to make sound investment decisions. According to Fichera (2001) venture capitalists make investment in high- technology sectors because of strong and quick growth features of these industries. Allen (2003) stated high technology industries include higher risk than others but it brings more benefits and rewards to the company.

2.3 Exit

The venture investments always have a time limit (Issoksson, 1999). Investors want to take a capital gain and maximise their return on the investment therefore they aim to sell their shares and exit. Depending upon the venture capitalists` investment strategy, VC firms exit in 3-4 years to 10 years (Bygrave and Timmons, 1992).

3 METHODOLOGY

Methodology is an approach, that shows the way of collecting information and data, and it contains the methods, procedures and techniques.

In this part, the methodological aspects will be explained to reach the objectives of the dissertation. Also this part will show the way of working throughout the dissertation and how this study is performed. On the other hand qualitative and quantitative approach, primary and secondary data validity and reliability will be discussed in this chapter.

3.1 CHOICE of METHOD

Qualitative and Quantitative approach

According to Malhotra (1999) a qualitative research provides understanding of the problem setting. Qualitative method is used to gather information which cannot be quantified that implies directly observed and measured information such as feelings, thoughts, intentions and behaviour (Aaker, Kumar & Day, 1998).

Qualitative approach is for understanding people`s beliefs, experiences, behaviour and interactions. It is not numerical, e.g. a patient`s description of their pain rather than a measure of pain. In qualitative method there is an opportunity to look at the study in depth and detailed information about a much smaller number of people and cases. In this method researchers are interested in informants and their contexts, and putting the information in a reference time frame for interpretation in a broader sense. It increases the rate of the possibility to understand the research cases and situations. But it reduces the generalization. Also in qualitative research the researchers think that if something occurred for one time it can occur again even it is not possible to calculate the time and the place. Qualitative research gives high flexibility since the problem can be changed during the process and it is an open research.

Quantitative research seeks to quantify the data and, typically, applies some form of statistical analysis (Malhotra, 1999).

Quantitative research is based on numerical data or data can be converted into numerical data. Quantitative research estimates and quantifies the relationship between independent variables and dependent variables. Variables are things as time, performance, behaviours etc. And these variables can be used for human, animal, plant and object etc. In this kind of research, researchers talk about average, frequency, causality, prediction and statistics. Also the researchers collect data and information under investigation and often use standardized tests and do replication studies. Especially quantitative research can answer on questions as 'when', 'who', 'how much' but not answer questions like 'why' and 'how'.

In this study qualitative research method were chosen.

3.2 DATA COLLECTION

"Data are the basic input for any decision making process in a business. The processing of data gives statistics of importance of the study. Data can be classified into as primary data and secondary data" (R. Panneerselvam, 2004 pg: 30, 31)

Primary and secondary data

"Primary data is information specifically collected for the clear purpose and in direct response to a problem that has arisen and which is being investigated (Pando C. Papantoniou 1992 pg: 275)

At this type of data collection the researcher collects the information through the research for the first time and all of the information is new. Primary data is used for specific purpose and using this kind of data is usually expensive and it takes more time than secondary data. Some of the different methods of collecting primary data are observation methods, personal interviews, telephone interviews, case studies, mail surveys, dairies, critical incidents and portfolio etc.

"Secondary data are collected from sources which have been already created for the purpose of first time and features uses" (R. Panneerselvam, 2004).

Using secondary data takes less cost, time and effort. Sometimes more correct and certain data can be available just from secondary data. They provide mass information about the topic. However there are some disadvantages of these kinds of data. Sometimes they completely do not fit the problem, they can be useful for someone else`s purpose, and maybe they can create a problem with their accuracy .Secondary sources will be divided in two parts. They are internal and external sources. Internal sources are sales records, marketing activity, cost information, distributor reports and feedback, and customer feedback. External sources are government publications, foreign government publications, journals, books, magazines, newspaper, internet web pages, annual reports, research reports in universities, industry handbook, publications of statistics, and census data.

Chosen data

- *Secondary data:* The literature studies related to venture capital and private equity, internet web pages, articles, journals, and previous student thesis were used as secondary sources. Especially one of the old theses of Jönköping University helped the author to choose the topic and reach the related sources about the issue.
- *Primary data:* To get primary data, four phone interviews were conducted with four venture capital and private equity firms. The interview questions were based on the venture capital investment decision process.

*3.*3 INTERVIEW

Interviews are useful methods for qualitative researches to obtain information and opinions from experts during the research project. According to Welman and Kruger (2001) the primary advantages of interviews are the opportunity of instant feedback, the unlimited possibility to ask different types of questions and to adapt the interviews to each specific situation. Generally three types of interviews are mentioned (Nicholas S. R. Walliman, 2006):

- *Structured Interview*: In this type standardized questions are read out by the interviewer according to an interview schedule. In a structured interview the questions are clearly structured and formal.
- *Unstructured interview*: It is a flexible format. It is usually based on a question guide but where the format remains the choice of the interviewer, who can allow the interview to ramble in order to get insides into the attitudes of interviewee. In this type close format questions are not used.
- *Semi*-structured interview: This type is formed from structured and unstructured sections with standardized and open-format questions.

In this dissertation three phone interviews were conducted. The structured interview format with open-end question was asked to the respondents. Open-end questions enable respondents to transfer their feelings and opinions clearly. Structured questions let author to ask all questions in an orderly and regular way and provide to take answers from all of them.

Questions to the respondents were listed in Appendix A. There are six questions and the questions are based on the information which was given in the theory part. The questions were asked to the respondents in Turkish and then the answers were translated in English.

Firstly author called some venture capital firms and explained the situation. But all of them wanted to see the questions. Then a draft of the questions and a short explanation about the author and about the aim of the study were sent to the respondents through an e-mail. This gave an opportunity to the respondents to understand if they could answer the questions or not and to be prepared for the answers of the questions. After that they sent an e-mail that showed they would answer the questions. Finally the answers of the questions were taken through a phone conversation. The duration of the interviews was nearly one hour with each company. The answers were written on papers during the conversation.

3.4 TYPES of RESEARCH

As Yin (1993) stated a research methodology starts by identifying some types of research. They are exploratory, explanatory and descriptive researches.

- ***Exploratory research****:* It helps to understand the problem for making primary hypothesis in order to draw a kind of directions that has to be fallowed (Aaker, 2001). But an exploratory research needs a conclusion. Otherwise it will just give a small stock of knowledge about what can be expected. This type of research determines the best research design, data collection method and selection of subjects.
- ***Explanatory research****:* "It can be defined as a method or style of research in which the principal objective is to know and understand the trait and mechanisms of the relationship and association between the independent and dependent variable."[2]
- ***Descriptive research***: It is a collection of data which can be used to test hypotheses or answer questions about the opinions of people about some topic or issue. It is possible to say most of the research studies are descriptive. The purpose of a descriptive research is to gain information from all members of sample or population.

  In this dissertation descriptive research has been used to find out the main points for venture capitalists` in investment decision process.

[2] http://www.blurtit.com/q415229.html 01.08.2008

3.5 THE SAMPLE SELECTION PROCESS

In qualitative studies the selection is not statistically secured because it is not capable to represent whole population (Corbin & Strauss, 1998).

At the beginning, the aim of the author was to find some venture capital firms in Europe and make an interview with them. To achieve this, about 25 e-mails were sent to 10 venture capital firms` e-mail addresses. But most of them did not answer the e-mails. Some of them answered but they explained they cannot answer the question because they have a lot of these kinds of e-mails which includes interviews. Then the plan changed and author tried to find some venture capital firms in Turkey. It was difficult to find venture capital companies in Turkey. Finally six venture firms were found through a report of Nesrin Sirvan`s guide called Venture Capital and feasibility of it in Turkey and communicated with all of them. It was easier to communicate with Turkish companies because it was easier and cheaper to call and deal with them. Six e-mails were sent to six different venture capital firms but just three of them agreed to participate in the study. They are; Is Private Equity, Ilab Ventures and Bosphorous Venture Group. The author selected these three companies because they are most developed venture capital firms in Turkey. A short presentation will be given about the companies which took part in the study.

Is Private Equity is a capital market institution which is linking entrepreneurs to the capital markets. It`s investment operations began at 5 October at 2000. It is Turkey`s largest private equity fund with US 29.3% million. They focus on healthcare and pharmaceuticals, building materials, chemicals, retail, education, tourism, energy, and TMT (Technology, media and Telecom). Their head office is located in Istanbul. There are 10 companies in their portfolio. Their mission is to provide management know-how and capital to the companies that operate in high growth sectors and have a competitive advantage in order to support them during their projects that will create value for Turkish economy.

The interview was conducted with Murat Tasci on the 25 July 2008. He is the analyst of the Is Private equity.

Ilab Ventures was founded on April 2000. Their aim is to invest in companies and projects which have growth potential. They focused on internet. They prefer to invest in web-sites. There are 8 companies in their portfolio. Their main office is located in Istanbul.

The interview was conducted with the director of the Ilab Ventures named Cem Sertoglu on 1st of August 2008.

Bosphorous capital Group works extensively with existing and potential foreign investors in Turkey. After 20 years of its foundation in Europe, it came to the Turkey and combined its experiences with companies in the country. As well Bosphorous Venture Group helps Turkish companies seeking expansion and growth opportunities both inside and outside of Turkey. The Group is supported by product and solution partners in the US, Germany, Russia, the United Kingdom, Israel and India. The company is focused on Hi-tech. Their head office is located in Istanbul.

The interview was conducted with Mehmet Calika on 31th of July 2008. He is the chairman of the board.

3.6 RELIABILITY and VALIDITY

The terms, reliability and validity are two important terms which decide the scientific quality of a study. These parameters of the study demonstrate the standards that the research is really good or not. According to the Jacobsen (2002) the empirical data must be reliable and valid.

According to Hammersley (1987) there is no widely accepted definition of reliability and validity. Despite this claim there are consistent definitions of these terms.

According to Yin (1994) reliability demonstrates that “the operations of a study, such as the data collection procedures, can be repeated with the same results” (pg: 33). According to Sapsford and Evans (1984: 259) “Reliability is the consistency of the results when using a measure in research. It is a word used of measuring instruments, including the human observer, and refers to the basic scientific requirement that it should be possible for another worker to duplicate one`s results or produce comparable evidence, at least in principles”. Especially high reliability means that if another research would be done on the study under another time, with similar circumstances and methods, somewhat same results should be obtained. For a research in order to have high reliability, the researcher has to produce accurate results.

According to Jacobson (2002) and Carlsson (1991) reliability in a qualitative study is related with set-up of the study and how it can have influenced the found results. The influence can be because of the chosen research method, researchers or the context of the interview. In this study telephone interview influenced the interview. The author lost the benefits of the face-to-face interviews with conducting a phone interview such as body language. At the same time the author thinks this study is reliable because, the interview questions and results are consistent with the theoretical explanations and previous researches.

Wiedersheim and Eriksson (1997) stated that validity is the ability of research instrument to measure what it is supposed to be measured. According to Robson (2002) the terms of validity search if the findings are actually about what they appear to be about. Validity is a technical issue in a quantitative research however it is a hardness of a description and a credibility of an explanation in a qualitative research. It is difficult to resolve validity than reliability, because validity is a more difficult issue and broader. But if the theory can be proved in the real life, it means that the research has a high validity. Also for the validity of a research there should be relevance and correspondence between theoretical study and empirical findings.

According to Jacobson (2002), for validity in a qualitative method the readers could relate to the categorization made by the researchers, could see that categorisation is a reflection of the collected data and the sample selection process. In this study, questions were formed by using information in the theory part. So it is possible for readers to categorize the research made by researcher. Especially following categorization enables the readers that they are a reflection of data. Again according to Jacobson (2002) right people should be interviewed and related answers should be taken from them. In this research, author tried to communicate with the knowledgeable people about the topic. The interviews were conducted in Turkish. So a small misunderstanding can be occurred between interviewer and interviewee while translating the statements to English. On the other hand the conversation could not been recorded. These reasons can affect the validity of the study. But the information that collected from interviewees was checked from the secondary sources and they were found consistent. Hence using multiple sources increased the validity of the dissertation.

4 EMPIRICAL STUDY

An interview conducted and was asked to different venture capital firms. In this part the results of the interviews that were made with three venture capital companies in Turkey will be presented.

4.1 Factors that affecting venture capitalists during their investment decisions according to due diligence process

4.1.1 Management

All of the interviewed companies think that management team and entrepreneurs of the start-up companies` are important factors for their investment decisions. The company, IS PRIVATE EQUITY, stated that their management team is one of the important factor in the investment process. They develop their strategies for value creation by the help of management. They investigate start-up companies by the respectable, professional, and well-motivated management team. This team enable to enhance the value of the company for the benefit of the shareholders. They expect the same things from the other firms´ management team. On the other hand the company stated that the personal feathers of the managers and entrepreneurs are the other important factors for them. They look for the successful, moral, honest, knowledgeable, determined, people with interpersonal skills and open minded people to make manager and look for entrepreneurs who have these features. BOSPHOROUS VENTURE GROUP said that management team has a big importance and play a big role for their company. Management team give investment decisions substantially. They mentioned that the company make researches and analysis for some areas like market sectors, product etc. to give investment decisions. This role is done by managers. So the managers of the portfolio companies should have ability to achieve these works. Therefore they stated they should choose managers who can make these researches and analysis successfully and carefully. They engage managers and entrepreneurs who are careful, moral, entrepreneurial, clever and well spoken. ILAB VENTURES agree with other two firms. They stated management team and entrepreneurs are important for investment decisions. Especially they look for patient, social, hardworking, people have capability in management and leader managers and entrepreneurs. At the same time they believe that they cannot be successful and give right decisions without a well- educated management team.

4.1.2 Financials

All of the venture capital firms stated financial factors are very important for their investment decisions. According to IS PRIVATE EQUITY financial factors are significant factors for the most of the companies and the great majority of the firms are established to gain financial benefits. They stated financial factors are really important for their company too. Their most important financial factor in investment decision process is to gain a stable high profit and high cash flow. Also they mentioned about their exit strategy and they said that they exit in 3-5 years. BOSPHOROUS VENTURE GROUP also talked about the importance of the financial factors in investment decision process. They accentuated if a project is not profitable they will not invest in it. The most important financial factor for them is superior return rates on investments and profitability. They stated they exit in 3-5 years. ILAB VENTURES agreed with the other two companies. They also stated financial factors are really important when making investment decisions. They cannot think an investment without a benefit for the company. Ilab Ventures mentioned about the importance of economies of scales, high profits in the long term and valuation. They stated that they generally exit in 5 years but sometimes the situation does not let to achieve this aim and they exit in 5-7 years.

4.1.3 Market

All of the venture capital firms think that market is an important factor for their investment decisions. But different market components are important for each firm. IS PRIVATE EQUITY, mentioned that they should invest in a market which has a big growth rate and competition potential. Also global markets and market share are important market factors for them. They think they should be partner with Turkish companies where they help them not only in Turkey but also globally compete in their respective industries by sourcing acquisitions, enhancing operational efficiencies, facilitating new market expansions. At the same time they want to invest in companies which have the potential to make substantial commercial affect covering large market opportunities. BOSPHOROUS VENTURE GROUP looks for Turkish and regional emerging markets which are relatively volatile and have market growth. According to them these kinds of markets provide superior business opportunities for companies. ILAB VENTURES mentioned that they want to invest in electronic markets and markets which have growth potential and the markets which are innovator. They also accentuated, they cannot make an investment without making market analysis and investigations.

4.1.4 Product

Two of the three venture capital firms stated that product is an important factor for their investment decisions called Is Private Equity and Bosphorous Venture Group. IS PRIVATE EQUITY prefers unique, fashionable, differentiated and widely-used products. BOSPHOROUS VENTURE GROUP believes product is an impressive factor for the investment decisions. However they behave more selective than Is Private Equity. They choose technical and differentiated products. According to them, firstly a product should have a technological speciality than it should have other features. Other features which Bosphorous Venture Group looks for are inimitable and well-designed products. ILAB VENTURES also stated product is not an important criterion for their investment decisions. They mentioned they are interested in web-sites therefore they can support every product with condition having a web-site. . They are just expecting profit from the product.

4.1.5 Location

Location is important for both of Is Private Equity, and Ilab Ventures. The company IS PRIVATE EQUITY, accentuated they can invest in companies having global reach but whose main office is in Turkey. It is one of the biggest venture capital and private equity company of Turkey. They do not evaluate companies that take place out of Turkey and they look for opportunities inside the country markets. ILAB VENTURES stated that they want to grow up in Turkey so they choose companies located in Turkey and they choose Turkish electronic commerce websites. Especially they choose companies from big cities of Turkey. If a company is not located in Turkey, they disregarded that company. But BOSPHOROUS VENTURE GROUP has a different aspect. They stated the location of the firm is not important for them. They can invest in Turkish and international companies. If they can take advantage from the company, they invest in it. The location is not an important criterion for them at that point.

4.1.6 Industry

All three of the venture capital firms take into account industry during their investments. IS PRIVATE EQUITY focuses on industries which include retail, branded fast moving consumer goods, healthcare and pharmaceuticals, building materials, chemicals, education, tourism, energy, and TMT (Technology, Media, Telecom). At the same time this firm explained they can make investment to the firms which have big opportunities.

BOSPHOROUS VENTURE GROUP makes sectoral analysis before its investment decision, and then it gives the decisions about investments. They make their investment to industries which are related with technology. They accept technological markets are risky but these kinds of markets have big growth potential and high returns on investments. ILAB VENTURES consider about industry like Is Private Equity and Bosporus Capital Group before giving investment decisions. They want to be unique in internet industry and they focus on internet. Also they put into words that they want to be unique in internet area in Turkey, therefore they decide to prepare a meaningful, expressive and powerful business model for this sector. They think that this model will be very useful and unique for Turkish internet sector and help them to make real their dreams of being number one.

5 ANALYSIS

In this part the interview will be analyzed via using theory part. Also some theories will be used to make the observations clearer.

5.1 Management

Management	IS PRIVATE EQUITY	BOSPHOROUS GROUP	ILAB VENTURES
Important	Yes	Yes	Yes
Features of the managers and entrepreneurs	successful, moral, honest knowledgeable, determined, interpersonal skills and open minded	careful, moral, entrepreneurial skills, clever and well spoken	Patient, social, hardworking, capability in management and leader

Table 1: Summary of the empirical findings in management area

All of the venture capital firms stated that, management is an important factor in their investment decisions. This situation confirms the statement of the Peter Howson (2003), which says most of the private equity investors' decisions, on whether invest or not to invest in a target are given by their views on the management.

Is Private Equity looks for successful, moral, honest, knowledgeable, determined, people with interpersonal skills and open minded managers and entrepreneurs while Bosphorous Group looks for careful, moral, people with entrepreneurial skills, clever and well spoken ones. Patient, social, hardworking, capable and leader managers and entrepreneurs are chosen by the company named Ilab Ventures. Camp (2002) stated venture capitalists want to invest in people with characteristics of integrity, intellectual honesty, intellectual brilliance, and people smarts or interpersonal skills. From these features honesty, brilliance, and interpersonal skills were chosen as an important factor for the venture capitalists` investment decisions. Muzyka et al. (1996) stated leadership ability of the entrepreneur and the management team is an important factor and Ilab ventures mentioned about the importance of the leadership in their investment decisions.

5.2 Financials

Financials	IS PRIVATE EQUITY	BOSPHOROUS GROUP	ILAB VENTURES
Important	Yes	Yes	Yes
Factors	stable high profit, high cash flow	superior return rates on investments and profitability	economies of scales, high profitability in the long term, and valuation
Exit	3-7 years	3-7 years	5-7 years

Table 2: Summary of the empirical findings in financial area

Financial factors are important for all of the venture capital firms. Is Private equity, expect stable high profits and high cash flows from its investments. Bosphorous Group looks for superior return rates on investments and profitability while Ilab Ventures give importance to economies of scale, long term profitability and valuation during their investment decisions. As seen above, all of the venture capital firms give importance to profitability factor in their investment decisions and this situation verify somewhat from the statements of the John E. Triantis, (1999) which says financial due diligence contains all of the views of revenues, expenses, and investments throughout with a review of a cash flows, profitability, dividend policy, tax status and unit costs in order to evaluate or confirm the financial health of the firm.

Tybjee & Bruno (1984), Cardis et al. (2001 and Camp (2002) stated in their study exit is an important financial factor in making investment decisions. The actors in the study agreed with this statement and they represented their exit timeframes during the interview. Is Private Equity, and Bosphorous Group stated they aim to exit in 3-7years. Ilab Ventures accented, they generally want to exit in 5 year but sometimes the situation does not let to achieve this aim and they exit in 5-7 years.

5.3 Market

All of the venture capital firms stated market is an important factor in their investment decisions. Is Private Equity talked about growth rate, competition potential, global markets and market share. These are the most important market factors in making investment decisions for them. Bosphorous Group mentioned about relatively volatile regional emerging markets, and market growth. Ilab Ventures are interested in electronic markets. However they give attention to innovator markets and markets that have growth potential. The findings of three case study of this dissertation confirm some points of the previous studies of Golis (2002), Fichera (2001), Tybjee & Bruno (1984), Zacharakis & Meyer (1998) and Camp (2002) which found market growth, market share, market size, markets have growth potential (large markets in the future), emerging and new markets are important market factors to give investment decision.

Market	IS PRIVATE EQUITY	BOSPHOROUS GROUP	ILAB VENTURES
Important	Yes	Yes	Yes
Components	Growth rate, Competition potential, Global markets and market share	Relatively volatile regional emerging markets, market growth	Market that has growth potential, innovator markets, electronic markets

Table 3: Summary of the empirical findings in market area

5.4 ***Product***

Product	IS PRIVATE EQUITY	BOSPHOROUS GROUP	ILAB VENTURES
Important	Yes	Yes	No
Preferable product	unique, fashionable, and widely-used, differentiated	Technological, inimitable, well-designed and differentiated products	------

Table 4: Summary of the empirical findings in product area

Is Private Equity and Bosphorous Group mentioned that product is an important criteria in their investment. But Ilab Ventures does not think like the other two firms think. For them the kind of the product is not important, just the profitability and products with condition having a web-site are important factors for them.

Tyebjee and Bruno (1984) found the product differentiation patentability and uniqueness is important. Fichera (2001) stated uniqueness and differentiation are important factors while applying a product. Elango et al. (1995) found in their study, highly differentiated products are chosen by venture capitalists. The companies in this study confirm the findings about product features. Is Private Equity looks for unique, fashionable, differentiated and widely-used products while Bosphorous Group give importance to technological, inimitable, well-designed and differentiated products.

5.5 Location

Location	IS PRIVATE EQUITY	BOSPHOROUS GROUP	ILAB VENTURES
Important	Yes	No	Yes
Chosen Location	Turkey	------	Turkey

Table 5: Summary of the empirical findings in location area

Two of the venture capital firms stated location is an important factor for them but Bosphorous group said that location is not an important factor for their investment decisions. The determination of Bosphorous Group supports the findings of Muzyka et al (1996) that location is not a necessary factor for the venture capitalists investment decisions.

Ilab ventures and Is Private Equity focus on companies in Turkey but especially in big cities and developed regions of the country. These finding supports the notions` of Camp (2002) which say location is an important factor in venture capitalists investment decisions and notion of Tybjee & Bruno (1984) which say geographic location is an important factor.

5.6 Industry

Industry	IS PRIVATE EQUITY	BOSPHOROUS GROUP	ILAB VENTURES
Important	Yes	Yes	Yes
Sectors	Healthcare and pharmaceuticals, building materials, chemicals, retail, education, tourism, energy, and TMT etc.	Sectors related with technology	Internet

Table 6: Summary of the empirical findings in industry area

All of the venture capital firms mentioned industry is an important factor while giving investment decisions. Is Private Equity stated that they choose the healthcare and pharmaceuticals, building materials, chemicals, retail, education, tourism, energy, and TMT industries. However they choose industries which have big growth opportunities. Bosphorous Group makes sectoral analysis before its investment decision then gives its decision about investments and it prefers industries which are related with technology. Ilab Ventures accentuated they want to be unique in internet industry and they focus on internet. Also they mentioned that they decide to prepare a meaningful, expressive and powerful business model for this sector.

Gompers & Lerner (2004) stated the most of venture capitalists focus on high technology industry sectors and Bosphorous Group invest in high technology sectors. Fichera (2001) mentioned venture capitalists make investment in industries that give great potentials for growth and expansion and Is Private Equity accentuated they choose industries which have growth opportunities. Also Camp (2002) stated being knowledgeable about industries is very important for venture capitalists to completely understand their investment opportunities and to make sound investment decisions and Bosphorous Group give importance to this knowledge by making sectoral analysis before its investment decision.

6 CONCLUSION

This chapter will summarise the empirical findings and analysis

Since 1970s most of the academic researchers (see Camp 2002, Zacharakis and Meyer 1998, Tybjee & Bruno 1984, and Shepherd et.al 2000 etc.), have tried to describe and understand venture capitalists` decision making process (Jorge Silva, 2004). The primary objective of these researches is to determine how venture capitalists can evaluate potential investments (Tybjee and Bruno 1981, Kahn 1987). In this study the author demonstrated the important factors for venture capitalists investment decisions according to due diligence process. The importance of the management, financials, market, products, location and industry factors were investigated. Generally the sample companies think these factors are important to give investment decisions. According to three case studies of this dissertation, venture capitalists look for successful, moral, honest knowledgeable, determined, open minded, careful, entrepreneurial, clever well spoken, patient, social, hardworking, capable, and leader people in management area. In the market area, growth rate, competition potential, global markets, market share, relatively volatile regional emerging markets, innovator markets, and electronic markets are important factors during making decisions. In the matter of financial factors, stable high profit, high cash flow, superior return rates on investments, economies of scales and valuation were found important while unique, fashionable, technological and widely-used, differentiated products were found significant decision factors during talking about products. At the same time healthcare and pharmaceuticals, building materials, chemicals, retail, education, tourism, energy, TMT and internet were the most preferred industries for these three firms. Also short distance locations were found important for these venture capital firms.

In this dissertation most of the findings of three case studies were found suitable with the findings of the literatures. Venture capitalists give importance to factors which were defined by the literatures` researches previously (see Camp 2002, Zacharakis and Meyer 1998, Tybjee & Bruno 1984, and Shepherd et.al 2000 etc.). Therefore this study gives the structure and dynamics of the decision making process.

Briefly, most of the findings in the previous literatures (see Camp 2002, Zacharakis and Meyer 1998, Tybjee & Bruno 1984, and Shepherd et.al 2000 etc.), and three case studies of this dissertation suggest that the management, market, product, financials, location, and industry are important factors for venture capitalists to decide whether to invest or not.

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Appendix- A: Interview questions that were asked to venture capitalists

1. *How do you evaluate your portfolio companies? How do you give investment decisions?*
2. *Are financial factors important for your investment decisions or not? What are the most important financial factors for you?*
3. *Is management an important factor for your investment decisions? Which characteristics a manager or an entrepreneur should have?*
4. *What industries and locations are of greatest interest to you?*
5. *Are the type of market and the kind of product in which you want to invest important? Which types of market and kinds of product do you prefer mostly?*
6. *In how many years do you exit in a company? Is this depends on the company or not?*