How Venture Capitalists Make Decisions

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Summary. For decades now, venture capitalists have played a crucial role in the economy by financing high-growth start-ups. While the companies they've backed—Amazon, Apple, Facebook, Google, and more—are constantly in the headlines, very little is known about...

Over the past 30 years, venture capital has been a vital source of financing for high-growth start-ups. Amazon, Apple, Facebook, Gilead Sciences, Google, Intel, Microsoft, Whole Foods, and countless other innovative companies owe their early success in part to the capital and coaching provided by VCs. Venture capital has become an essential driver of economic value. Consider that in 2015 public companies that had received VC backing accounted for 20% of the market capitalization and 44% of the research and development spending of U.S. public companies.

Despite all that, little is known about what VCs actually do and how they create value. To be sure, most of us have the broad sense that they fill a crucial market need by connecting entrepreneurs who have good ideas but no money with investors who have money but no ideas. But while the companies that VCs fund may make headlines and transform entire industries, venture capitalists themselves often prefer to remain in the background, shrouded in mystery.

To pull back the curtain, we recently surveyed the vast majority of leading VC firms. Specifically, we asked about how they source deals, select and structure investments, manage portfolio companies post-investment, organize themselves, and manage their relationships with limited partners (who provide the capital VCs invest). We received responses from almost 900 venture capitalists and followed up with several dozen interviews—making our survey of VCs the most comprehensive to date.

About the Research

To solicit respondents to our survey, we used alumni databases from the University of Chicago Booth School of ...

Our findings are useful not just for entrepreneurs hoping to raise money. They also offer insights to educators training the next generation of founders and investors; leaders of existing companies seeking to emulate the VC process; policy makers trying to build start-up ecosystems; and university officials who hope to commercialize innovations developed in their schools.

Hunting for Deals

The first task a VC faces is connecting with start-ups that are looking for funding—a process known in the industry as "generating deal flow." Jim Breyer, the founder of Breyer Capital and the first VC investor in Facebook, believes high-quality deal flow is essential to strong returns. What's his primary source of leads? "I've found that the best deals often come from my network of trusted investors, entrepreneurs, and professors," he told us. "My peers and partners help me quickly sift through opportunities and prioritize those I should take seriously. Help from experts goes a long way in generating quantity and then narrowing down for quality."

Breyer's approach is a common one. According to our survey, more than 30% of deals come from leads from VCs' former colleagues or work acquaintances. Other contacts also play a role: 20% of deals come from referrals by other investors, and 8% from referrals by existing portfolio companies. Only 10% result from cold email pitches by company management. But almost 30% are generated by VCs initiating contact with entrepreneurs. As Rick Heitzmann of FirstMark told us, "We believe that the best opportunities don't always walk into our office. We identify and research megatrends and proactively reach out to those entrepreneurs who share a vision of where the world is going."

What these results reveal is just how difficult it can be for entrepreneurs who are not connected to the right social and professional circles to get funding. Few deals are produced by founders who beat a path to a VC's door without any connection. Some of the VC executives we interviewed acknowledged the downsides of this reality: that the need to be plugged into certain networks can disadvantage entrepreneurs who aren't white men. Nonetheless, many VCs felt the situation was improving. For instance, Theresia Gouw, an early investor in Trulia and a founding partner at Acrew Capital, told us, "While historically there have been significant roadblocks for women and underrepresented minorities to break into these networks, the industry has begun to recognize the missed opportunities and talent these groups represent. Firms have prioritized diversifying their partnerships, and as a result these networks are becoming increasingly easier to penetrate."

Narrowing the Funnel

Even for entrepreneurs who do gain access to a VC, the odds of securing funding are exceedingly low. Our survey found that for each deal a VC firm eventually closes, the firm considers, on average, 101 opportunities. Twenty-eight of those opportunities will lead to a meeting with management; 10 will be reviewed at a partner meeting; 4.8 will proceed to due diligence; 1.7 will move on to the negotiation of a term sheet with the start-up; and only one will actually be funded. A typical deal takes 83 days to close, and firms reported spending an average of 118 hours on due diligence during that period, making calls to an average of 10 references.

Few VCs use standard financial-analysis techniques to assess deals. The most commonly used metric is simply the cash returned from the deal as a multiple of the cash invested.

Though VCs reject far more deals than they accept, they can be very aggressive when they spot a company they like. Vinod Khosla, a cofounder of Sun Microsystems and the founder of Khosla Ventures, told us that the power dynamic can quickly flip when VCs become excited about a start-up, particularly if it has offers from other firms. “The best start-ups with inspiring entrepreneurs have intense competition to fund them,” he explained. “For VCs, having a clear message about what you will and will not do, how you provide real venture assistance, and how you approach bold visions is key to winning these types of opportunities. And they matter tremendously for fund returns.”

What factors do VCs consider as they go through the winnowing process? One framework suggests that VCs favor either the “jockey” or the “horse.” (The entrepreneurial team is the jockey, and the start-up’s strategy and business model are the horse.) Our survey found that VCs believe both the jockey and the horse are necessary—but ultimately deem the founding management team to be more critical. As the legendary VC investor Peter Thiel told us, “We live and die by our founders.”

Indeed, in our survey founders were cited the most frequently—by 95% of VC firms—as an important factor in decisions to pursue deals. The business model was cited as an important factor by 74% of firms, the market by 68%, and the industry by 31%.

Interestingly, the company’s valuation was only the fifth most-cited factor in decisions about which deals to pursue. Indeed, while CFOs of large companies generally use discounted cash flow (DCF) analyses to evaluate investment opportunities, few VCs use DCF or other standard financial-analysis techniques to assess deals. Instead, by far the most commonly used metric is cash-on-cash return or, equivalently, multiple of invested capital—simply the cash returned from the investment as a multiple of the cash invested. The next most commonly used metric is the annualized internal rate of return (IRR) a deal generates. Almost none of the VCs adjusted their target returns for systematic (or market) risk—a mainstay of MBA textbooks and a well-established practice of corporate decision-makers. Strikingly, 9% of the respondents in our survey did not use any quantitative deal-evaluation metric. Consistent with this, 20% of all VCs and 31% of early-stage VCs reported that they do not forecast company financials at all when they make an investment.

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What explains this disregard for traditional financial evaluation? VCs understand that their most successful M&A and IPO exits are the real driver of their returns. Although most investments yield very little, a successful exit can generate a 100-fold return. Because exits vary so much, VCs focus on finding companies that have the potential for big exits rather than on estimating near-term cash flows. As J.P. Gan of INCE Capital explained to us, “Successful VC deals take a long time to develop, mature, and exit. We very much focus on potential return multiple rather than on NPV or IRR at the time of investment. IRR is only calculated after the fact, when there is an exit for our limited partners.”

After the Handshake

To aspiring entrepreneurs, the typical VC term sheet often seems to be written in a foreign language. Of course, it’s critical for company founders to understand these contracts. They’re designed to ensure that the entrepreneur will do very well financially if he or she performs but that investors can take control of the business if the entrepreneur doesn’t deliver. Prior studies of VC investment terms show that VCs accomplish that through the careful allocation of cash flow rights (the financial upside that gives founders incentives to perform), control rights (the board and voting rights that allow VCs to intervene if needed), liquidation rights (the distribution of the payoff if the company flounders and has to be sold), and employment terms, particularly vesting (which gives entrepreneurs incentives both to perform and to stay at the company). In general, deals are structured so that entrepreneurs who hit specific milestones retain control and reap monetary rewards. If they miss those milestones, however, the VCs can bring in new management and change direction.

Less is known, however, about which investment terms are most critical to VCs and how they make trade-offs among them. So in our survey we asked which ones they used and which ones they were willing to negotiate.

We asked VCs what contributed most to the success or failure of their portfolio companies. The management team was identified as the most important factor by far.

The VCs indicated that they were relatively inflexible on pro rata investment rights, liquidation preferences, and antidilution rights (which protect their potential economic upside) as well as on the vesting of the founders' equity, the company's valuation, and board control (which is often seen as the most important control mechanism). As one VC put it, pro rata rights, which allow VCs to acquire an additional stake in a company, were paramount because "the biggest source of our returns is our ability to double down on our winners." VCs were more flexible on the option pool, participation rights, investment amount, redemption rights, and, in particular, dividends. Many of those terms have a smaller effect on the potential returns of the VCs and hence are more likely to be negotiable.

Nonetheless, many VCs try not to focus too narrowly on financial terms during their courtship with start-ups—and give equal emphasis to how the company fits into their portfolios and why their experience and expertise can help the founding management team. As Khosla explained to us, "To attract the best entrepreneurs, it's important to have a clear point of view beyond just making money. What are you as a venture firm trying to do, and does it align with what the entrepreneurs' vision is?"

Finding Alpha

Once VCs have put money into a company, they roll up their sleeves and become active advisers. VCs told us that they "interact substantially" with 60% of their portfolio companies at least once a week and with 28% multiple times a week. They provide a large number of post-investment services: strategic guidance (given to 87% of their portfolio companies), connections to other investors (72%), connections to customers (69%), operational guidance (65%), help hiring board members (58%), and help hiring employees (46%). Intensive advisory activities are the main mechanism VCs use to add value to their portfolio companies. (Surveys reveal that this is also true for private equity investors.) Jon Callaghan of True Ventures says his firm believes that advisory services play such a crucial role in attracting the best entrepreneurs that it has spent 15 years and $10 million developing them. "We do this because we've learned time and time again that the founders are key to building and leading the teams that create the biggest outcomes in venture capital," he notes.

The top VC funds make a spectacular amount of money. Yet a definitive explanation for how VCs deliver "alpha," or positive risk-adjusted returns, has yet to be articulated. We decided to ask the VCs directly—having them assess the relative importance of deal sourcing, deal selection, and post-investment actions to the creation of value in their portfolios. A plurality reported that while all three were key, deal selection was the most critical.

A Venture Capital Glossary

Antidilution rights allow the number of shares that current investors hold to be adjusted if future financing rounds are ...

We also asked VCs what contributed most to the success or failure of their portfolio companies. Again, the management team was identified as the most important factor by far. As Brian Jacobs, a cofounder of Emergence Capital, told us: "I have never seen a venture success for which one person deserves all the credit. The winners always seem to be the founders who can build a kick-ass team." Other factors the VCs cited included timing, luck, technology, business model, and industry, which they rated roughly equal in importance. Perhaps surprisingly, they didn't cite their own contributions as a major source of success. These answers suggest that it is entrepreneurs rather than VCs who create the most value for start-ups. One VC executive put it this way: "Our firm puts a huge amount of work into helping our companies—everything from assisting with hiring to acting as the founder's psychologist. But in the end the real success or failure of a venture comes from the founders."

The VC Way

Tourists who drive along Sand Hill Road in Palo Alto—the street where many of the leading multibillion-dollar venture capital funds are located—are often shocked to find only small, conventionally designed offices set discreetly behind leafy trees. The modest offices only add to the air of mystery around how exactly these firms are structured and operate.

In our survey the average VC firm had just 14 employees and five senior investment professionals. This pocket-sized, flat structure allows for quick decision-making and action—but perhaps fewer checks and balances.

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Although they worked more than traditional banking hours, most VCs in our survey reported that their workweek was by no means excessive. On average, they put 55 hours a week in on the job, spending 22 hours a week networking and sourcing deals and 18 hours working with portfolio companies. In a recent update to our survey, done during a peak of the Covid-19 pandemic, we found that while VCs' pace of investment had slowed slightly, venture capitalists were allocating their time in roughly the same way—pursuing new deals, performing due diligence, closing new investments, and helping portfolio companies.

Finally, we asked about their interactions with their limited partners. The majority said that they believed their investors cared more about absolute performance than about relative performance. Nevertheless, the vast majority (93%) of VCs said that they expected to beat the market on a relative basis. That optimism is understandable. As of June 2020 the VC funds raised from 2007 to 2016 in the Burgiss Manager Universe had outperformed the Russell 2000 (a small-cap index) by 7% a year, on average, and the S&P 500 by nearly 5% a year. Almost 75% of those funds had beaten the Russell 2000, and roughly 60% had beaten the S&P 500.

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How can these findings be used in practice? For academics, our results offer a good base from which to further explore the nature and relative importance of deal sourcing, deal selection, and post-investment support services.

In addition, the preeminence of the founding team in the minds of VCs points to a potentially fruitful area of research for academics: Are there experiences or attitudes that define the people likely to be successful founders?

Our survey results also offer critical takeaways to entrepreneurs. Because VCs rely on their networks to source opportunities, entrepreneurs should research who belongs to a VC's network and try to get an introduction from someone in it. Because the management team weighs so heavily in investment decisions, entrepreneurs should think carefully about how to present themselves in the best possible light when they do meet a VC. Because VCs look at more than 100 opportunities for every one they invest in, entrepreneurs should be prepared to pitch to many VCs.

As noted earlier, entrepreneurs who are not plugged into venture networks may face hurdles. Those entrepreneurs may include not only founders of color and female company builders but also those who live in regions outside the traditional hubs of venture capital, such as Silicon Valley, London, Boston, and Beijing. Sarah Kunst, the managing director of Cleo Capital, noted that years of success funding entrepreneurs in VC hubs have made the barriers to entry even higher for nontraditional founders. "Our networks are often a reflection of where we live and where we've worked. When certain groups are consistently disenfranchised, there is a cumulative network debt that accrues that can't be quickly overcome," she said, adding that even minorities who live in VC hubs are at a disadvantage. "If you've been underpromoted at every job you've ever had, your title might be several levels below your work experience, and your peers might not be in C-suites where they could hire you or appoint you to boards. If you've been underpaid, you may not have the free cash flow to join exclusive clubs or angel-invest, and those missed network nodes add up to incalculable losses in career and net worth."

It is incumbent upon educators, venture capitalists, and society at large to work to mitigate systemic financial discrimination and ensure that a broader pool of entrepreneurs receives funding and support. There are no easy answers, and research has pointed to a variety of frictions that exist in the entrepreneurial ecosystem. For our part, we hope our research can help entrepreneurs from all backgrounds successfully network with and pitch VCs by understanding the criteria they use to evaluate investments, how they spend their time, what they do on a day-to-day basis, and which factors are most critical in ensuring great returns.

Finally, many corporations have started investment arms over the past decade to try to harness the potential of entrepreneurial activity, and they can learn from the practices of the VC industry. The critical role that the management team and deal sourcing play in determining the success of investments should inform whom they choose to fund—and where and when. The many local policy makers who seek to build sustainable venture capital ecosystems to foster economic growth can likewise benefit from understanding VCs' tactics. The ability of government leaders and officials to promote high-quality, high-potential entrepreneurs should not be overlooked. Finally, universities are often the source of innovations that end up in the portfolios of VCs. University officials can learn how to better leverage the innovative activity happening within their halls. Building relationships with leading VCs and promoting an entrepreneurial community can help spur start-up activity.

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