

What Factors Attract Venture Capital And Angel Investor Funding: Case Of Indonesia

Abrori A. Noor Esa^{*1}, Yunieta Anny Nainggolan²

School of Business and Management, Institut Teknologi Bandung, Indonesia^{1,2}

Email: abrori-ahmad@sbm-itb.ac.id

Abstract

This research aims to understand the factors that influence venture capital investment decisions in startups and create a model for making these decisions. The Analytic Hierarchy Process method gathered data from venture capitalists and investors. To design a decision-making concept model, this study examined various factors considered in venture capital and investors' decision on an investment based on previous significant studies. It employed 16 evaluation items centered on four areas —entrepreneur, product and service, market, and finance. The results concluded that the product/service sector was the most important area, with the product's value being the most important factor. Business compatibility is the second most important factor, followed by the entrepreneur sector. This research conducted a survey based on a sample from Indonesia. The conclusion of this study is expected to help venture capitalists and investors better judge startup funding.

Keywords: analytical hierarchy process; decision-making; factor determinants; startups; venture capital.

A. INTRODUCTION

The formation and growth of small and medium-sized enterprises (SMEs) and startups are recognized as one of the most critical factors for economic growth (Storey, 1994). Access to risk capital (equity capital) is often emphasized as a critical condition for SMEs and new venture startups to pursue growth opportunities. Because of limited life history and a lack of steady cash flows, young firms (such as startups and SMEs) that begin a growth phase often have problems accessing traditional debt capital. Financing the firm with the entrepreneur's capital is generally not an alternative because these resources are either already used or too small. Furthermore, quickly developing new firms can seldom compound the capital needed for fast development. Finally, equity financing is a more suitable way of financing growing young firms' investments and expansions than debt because the latter has the disadvantage of increasing a firm's financial risk (mainly due to amortizations and interest rates). The difficulties of finding (or inadequate supply of) growth capital for entrepreneurial firms are often called the equity gap. Venture Capital and Investor presence significantly narrow this equity gap.

The growing economic role and the significance of the investors and venture capital markets for creating growth in society is a critical argument for performing venture capital research, or as (Mason & Harrison, 1999, p 13-14) put it: "Venture capital is now recognized globally as playing a key role in innovation, wealth creation, and job generation and is increasingly a key element in government efforts at both national and sub-national levels to generate economic growth. It is therefore important that our knowledge of this form of finance increases.". At the same time, investors generally provide vast opportunities to young and growing firms.

Amidst the global economic downturn caused by COVID-19, efforts are being made to overcome the economic crisis and adapt to the post-coronavirus era. In this context, startups are gaining attention as significant players in the business ecosystem, offering a new economic model for the future. Startups can create innovative products and services in highly uncertain circumstances (Ghezzi, 2020). As such, they are emerging as critical contributors to economic activities, particularly in a post-coronavirus environment that requires adaptability and flexibility. By developing new business models and exploring new markets, startups play a vital role in revitalizing economic activities (Mele et al., 2020). However, financial support is often a critical prerequisite for startups to thrive and grow.

Based on research conducted by (CBInsight, 2020), a venture capital research institution, a significant factor contributing to the failure of startups is the lack of funding, which is closely tied to their survival in the early

* Corresponding author

stages. Previous studies have shown that companies receiving venture capital support are more likely to survive than those not. Peneder observed that venture capital investments in the 1980s led to an 8% increase in patent applications across industries in the United States (Peneder, 2010). This macroeconomic perspective suggests that venture capital investments positively affect firms' innovation activities, sales, and employment growth (Chemmanur et al., 2011; Paglia, 2014).

Companies that received venture capital support had a survival rate ranging from 65% to 85% (Sahlman, 1990). However, among these supported companies, 20% could not generate sufficient earnings to satisfy the venture capital investors (Ruhnka, 1992). Only 42% of the venture capital-supported companies achieved a return on investment (ROI) of 15%, indicating that 58% ultimately failed (Dean, 1990). Despite these challenges, venture capital remains a significant financial player with a profound impact on the discovery and growth of promising firms. It contributes to economic growth by fostering new industrial development and promoting innovation and progress (Ning, 2015). Additionally, venture capital catalyzes helping startups navigate the difficult early stages of development, often called the "death valley" (Savaneviciene, 2015).

Venture capital firms ultimately assess whether to invest based on their screening criteria, which involve identifying and nurturing companies with high technological capabilities and growth potential. Given the inherent uncertainties in operating startup businesses, evaluating risks and potential returns from various perspectives is crucial in investment decision-making (Arthurs, 2003; Hall, 1993). However, startups often prioritize their ideas and the potential for success without providing concrete analysis or strategic insights for venture capital firms. Consequently, while previous studies have outlined general investment factors for venture capital, there is a lack of specific recommendations or proposals tailored to startups' needs.

This study aims to introduce a decision-making model for venture capital investments and identify the crucial factors influencing investment decisions related explicitly to startups. Unlike previous studies focusing on general investment decision-making factors, this research will delve into the specific factors that affect investment in startups. The study will identify these factors in-depth and provide strategic insights and recommendations based on the perspective of attracting successful startup investments. In this research, we predominantly used the quantitative method. We interviewed investors, venture capitalists, experts, and academicians to obtain the practice of investors and venture capital in Indonesia. In addition, we measured the relative importance of the factors affecting venture capital and investors' decisions by using the analytical hierarchy process (AHP) to find their weights.

B. RESEARCH METHOD

In order to answer the research question, we designed a hierarchy of select categories based on previous studies. Entrepreneur, product and service, market, and finance categories were concluded for the first hierarchy. For the following hierarchy, 16 subcategories are delved from 4 categories in the first hierarchy. After that, we develop a decision matrix based on a pairwise comparison between the subcategory. In addition, we ask the interviewees to give relative importance scores to the factors by using AHP to find their weights.

Moreover, this method is excellent in flexibility and tracing a complex system (Saaty, 1980). However, this method's weakness is subjectivity and relativity from the input. Also, AHP is a non-parametric method without confidence limits from the created models (Saaty, 1980). To address the research question, the initial approach involves conducting questionnaire interviews with venture capital experts to gauge their level of interest in various factors through pairwise comparisons. This information is then used to create a matrix of relative weights for the compared factors. Additionally, the experts are requested to assign scores to qualitative factors for each investment analysis unit associated with the venture capital. By multiplying the relative weights and scores, rankings for each investment can be obtained.

Since we use the pairwise comparison to determine the matrix of relative weights, there are often inconsistencies in entering the input. Thus, a consistency index (CI) is required to measure the consistency of the input. To get a valid judgment, 90% of CI is expected (Saaty, 1980). Therefore, iteration should be done if there are inconsistencies in defining the weights in the matrix.

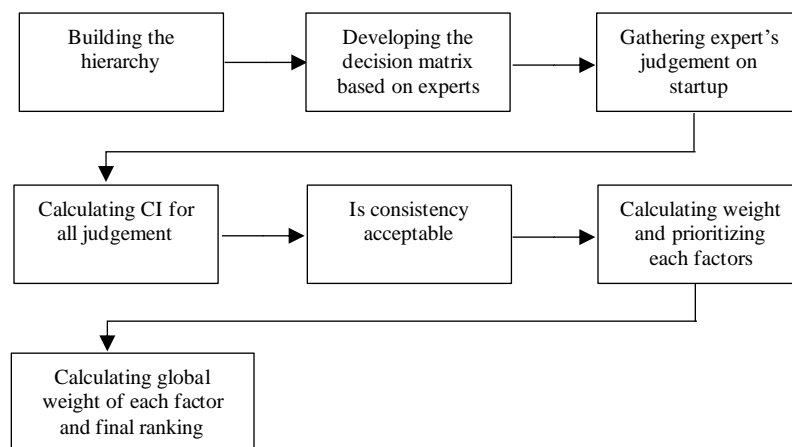


Figure 1. Research Flow Diagram with AHP

In this study, a questionnaire survey was conducted using the Analytic Hierarchy Process (AHP) methodology to gather data on venture capital investment decisions regarding startups. The survey targeted expert groups knowledgeable in the field. The AHP approach involved a pairwise comparison method, where respondents evaluated the relative importance of 16 specific factors in two hierarchical levels. Prior to this, the importance of four broader areas was evaluated at a separate hierarchical level. This process allowed for a comprehensive analysis of the factors influencing venture capital investment decisions on startups.

Table 1 Pairwise Comparison Questions

Category	Subcategory	Definitions	Previous Studies
Entrepreneurs	Management/ Operation Competence	Entrepreneur's company management competencies, startup team's operation ability	(Fried & Hisrich; 1994; Devigne et al.; 2016;
	Technical Expertise	Entrepreneur's professionalism/ Expertise and career/experience in terms of technology	MacMillan et al.; 1985; Hall &
	Entrepreneur's Character	Entrepreneur's mindset and character (character development, risk-taking, and innovation)	Hofer, 1993; Silva; 2004;
	Business Compatibility	Clear market/Customer definition and vivid understanding of business	Miloud et al., 2012; Brander et al., 2002)
Product and service	Global Potentiality	Status of product's/service's global entry possibility	(Caves, 1972; Macmillan et al., 2018; Khan, 1987;
	Technical Advantage	Time, cost, and difficulty in imitation upon technology development	Mason & Stark, 2004); Mishra, 2004)
	Value of Product	Product/Service characteristics, advantageous factors compared to competitors, and value proposal	
	Innovation	The innovation of products/services and technical differentiation compared to existing technology	
Market	Rival competition	No. of competitors, competition level, and status of competitors' appearance	(Tyebjee & Bruno, 1984); MacMillan et al. (1985); Barry (1994)
	Regulation	Status of regulations' (government, norm) existence affecting commercialization, monetization, and business expansion	
	Market size	Target market size and scale	Kirsch et al. (2009)
	Market growth	Future market growth potentiality	
Finance	Corporate value	Principles of the organization's culture	Tyebjee and Bruno (1984); Manigart et al. (1997); Lemer (1994); Zacharakis and Meyer (2000)
	Profitability	Sales estimation basis and net profit	
	Investment stage	Current investment attraction stage	
	Cash flows	Stability of a firm's fund inflow and expenditure	

Source: research data, 2023

The questionnaire survey was administered to 15 venture capitalists and 15 investors, all with a minimum of 1 year of experience in their respective roles. The survey data were analyzed to determine each evaluation factor's comprehensive priorities, weighted values, and detailed standards. In order to achieve the overarching decision-making objective at the top level of the hierarchy, a comprehensive weighted value vector was calculated, synthesizing the hierarchical, weighted values for each level. This process allowed for determining the priorities of alternatives in the lowest hierarchy.

This section must be written out briefly, concisely, and clearly, but adequately so it can be replicated. This section explains the research approach, study subjects, conduct of the research procedure, use of materials and instruments, data collection, and analysis techniques. These are not theories. Generally known formulas should not be written down for statistical uses. The researcher's specific criteria for collecting and analyzing the research data should be completely described.

C. RESULTS AND DISCUSSION

Demographic sample statistics show that men were 28 (93%) and women were 2 (7%) based on a total of 30 people according to gender. Regarding age, the subjects were investigated as 3 in their 20s (10%), 15 in their 30s (50%), 11 in their 40s (37%), and one in their 50s (26.7%). As for education, 21 bachelor's degree holders (70%), nine master's degree holders (30%), and 0 doctoral degree holders (0%) participated. Concerning majors, business administration/economics took up the most number at 15 (50%), followed by 7 for MBA (23.3%), 5 for technology/engineering, 1 for humanity/social science (3.3%), and 2 for others (6.7%).

Table 2. Statistical Characteristics of Samples

Classification	Total		Venture Capitalist		Other Investors		
	Freq	%	Freq	%	Freq	%	
Gender	Men	28	93	14	93	14	93
	Women	2	7	1	7	1	7
	Total	30	100	15	100	15	100
Age	20s	3	10	1	6.7	2	14
	30s	15	50	7	47	8	53
	40s	11	37	6	40	5	33
	50s	1	3	1	6.7	0	0
	Total	30	100	15	100	15	100
Education	Bachelor	21	70	12	80	9	60
	Master	9	30	3	20	6	40
	Doctor	0	0	0	0	0	0
	Total	30	100	15	100	15	100
Major	Business Administration/Economics	15	50	7	46.7	8	53.3
	Humanities/Social Science	1	3.3	0	0	1	6.7
	Technology/Engineering	5	16.7	4	26.7	1	6.7
	MBA	7	23.3	4	26.7	3	20
	Others	2	6.7	0	0	2	13.3
	Total	30	100	15	100	15	100

Source: research data, 2023

The importance rankings of the evaluation areas for venture capital investment determinants in startups, namely entrepreneur, product/service, market, and finance, are presented in Table 3. According to the results, the importance of the product/service was found to be the highest overall, followed by the entrepreneur. For venture capitalists, the priority order of importance was as follows: entrepreneur (0.358), product/service (0.346), market (0.164), and financial factors (0.132). On the other hand, for other investors, the priority order of importance was as follows: product/service (0.393), entrepreneur (0.313), market (0.164), and financial factors (0.130). These findings highlight the divergent perspectives of venture capitalists and startup support experts regarding the relative importance they place on different evaluation areas when making investment decisions in startups.

Table 3. Importance of Category Items in Each Specialized Area

Evaluation Area	Total		Venture Capitalist		Other Investors	
	Weighted Value	Priority	Weighted Value	Priority	Weighted Value	Priority
Entrepreneur	0.336	2	0.358	1	0.313	2
Product/Service	0.370	1	0.346	2	0.393	1
Market	0.164	3	0.164	3	0.164	3
Finance	0.131	4	0.132	4	0.13	4
Consistency Rate	0.8		0.12		0.04	

Source: research data, 2023

Based on the analysis of each aspect's importance, this study also calculated the effect values, representing each factor's weighted values. The effect value is obtained by squaring each factor aspect's value, indicating the priority of capability factors required from the overall group. According to Table 6, the factors were ranked in importance: product value, business compatibility, innovation, technical expertise, and management/operational competence. This ranking suggests that the product's value was considered the most important factor, followed by business compatibility, innovation, technical expertise, and management/operational competence. These findings provide insights into the factors perceived to have the greatest impact on investors' investment decisions in startups.

Table 4. Effect Value Priority for Total Cases

Evaluation Area	Importance	Evaluation Factors	Importance	Weighted Value	Priority
Entrepreneurs	0.3355	Management/ Operation Competence	0.230	0.0772	5
		Technical Expertise	0.237	0.0794	4
		Entrepreneur's Character	0.175	0.0587	8
		Business Compatibility	0.358	0.1202	2
Product and service	0.3695	Global Potentiality	0.119	0.0438	11
		Technical Advantage	0.203	0.0752	6
		Value of Product	0.381	0.1407	1
		Innovation	0.297	0.1098	3
Market	0.164	Market Size	0.375	0.0616	7
		Market Growth	0.298	0.0488	9
		Regulation	0.174	0.0286	14
		Rival Competition	0.153	0.0250	15
Finance	0.131	Corporate value	0.236	0.0309	12
		Profitability	0.352	0.0461	10
		Investment stage	0.189	0.0247	16
		Cash flows	0.224	0.0293	13

Source: research data, 2023

Table 5 presents the rankings for venture capitalists and other investors based on analyzing complex weighted value priorities. For venture capitalists, the order of priority was as follows, Business Compatibility, Value of Product, Innovation, and Management/ Operation Competence. Respectively, from priority to fourth priority. On the other hand, for other investors, the order of priority was as follows: Value of Product, Business Compatibility, Innovation, Technical Advantage. Consecutively, from priority to fourth priority.

The findings indicate that venture capitalists and investors agreed on the importance of product value and business suitability as the first two priorities. However, there were some differences in the rankings and priorities assigned to the 16 evaluation items in the two hierarchies of startup investment determinants between the two groups. These differences suggest varying perspectives and priorities among venture capitalists and investors when evaluating and making startup investment decisions.

Table 5. Comparative Analysis Between the Two Groups

Evaluation Area	Evaluation Factors	Venture Capitalist			Other Investors		
		Importance	Weighted Value	Priority	Importance	Weighted Value	Priority
Entrepreneurs	Management/ Operation Competence	0.232	0.083	4	0.228	0.071	6
	Technical Expertise	0.216	0.077	5	0.258	0.081	5
	Entrepreneur's Character	0.179	0.064	7	0.171	0.053	8
	Business Compatibility	0.372	0.133	1	0.344	0.108	2
Product and service	Global Potentiality	0.114	0.039	11	0.123	0.048	9
	Technical Advantage	0.187	0.065	6	0.220	0.087	4
	Value of Product	0.374	0.129	2	0.388	0.152	1
	Innovation	0.325	0.112	3	0.269	0.106	3
Market	Rival competition	0.120	0.020	16	0.185	0.030	13
	Regulation	0.200	0.033	12	0.149	0.024	15
	Market size	0.370	0.061	8	0.381	0.063	7
	Market growth	0.311	0.051	9	0.285	0.047	10
Finance	Corporate value	0.239	0.031	13	0.233	0.030	14
	Profitability	0.358	0.047	10	0.345	0.045	11
	Investment stage	0.212	0.028	14	0.166	0.022	16
	Cash flows	0.191	0.025	15	0.256	0.033	12

Source: research data, 2023

D. CONCLUSION

This study identified and analyzed the critical factors influencing startup venture capital investment decisions. The findings revealed that the product and service, entrepreneur, market, and finance were the most critical factors, although their rankings differed between venture capitalists and other investors. Venture capitalists considered the entrepreneur the most crucial factor, emphasizing the importance of suitability and reliability in assessing investment opportunities. On the other hand, other investors placed greater emphasis on the product/service, recognizing the significance of investments made based on the startup's business practicality. These differing perspectives highlight the importance of evaluating various factors and considering multiple viewpoints when making venture capital investment decisions in startups.

Based on the analysis conducted in this study, the compatibility of the business, the value of the product, and the management competence emerged as critical factors influencing venture capital investments in startups. This finding suggests that the capabilities and disposition of startup entrepreneurs play a crucial role and significantly impact investors' decision-making process. The study highlights that these factors are paramount and influence investment decisions more than others. It underscores the significance of evaluating the entrepreneur's abilities, characteristics, and value of product/service, as they are considered essential determinants in venture capital investment decisions in startups.

Previous studies have often emphasized the importance of new technological competitiveness in venture capital investment decisions. A study (Kollmann & Kuckertz, 2010) suggested that investments should be based on market size and growth potential. However, the findings of this study indicate that the reliability and capabilities of entrepreneurs and the value of products are more crucial investment determinants than the competitiveness of the business model or product in terms of technology and the market. The study findings align with the perspective presented by (Silva, 2004), which highlights the interest of venture capitalists in the quality of the entrepreneur. It emphasizes the importance of evaluating and verifying the entrepreneur's commitment to the company and the business idea. This suggests that venture capitalists prioritize assessing an entrepreneur's abilities, characteristics, dedication, and suitability of product products, which are considered essential factors in investment decision-making. While technological competitiveness and market potential are still relevant factors, this study emphasizes that the entrepreneur's reliability and capabilities with the right product value play a significant role in venture capital investment decisions, reinforcing the importance of evaluating and understanding the entrepreneur behind the startup.

Meanwhile, the importance of financial factors among the critical factors affecting investment was the lowest among venture capitalists and other investors. This differs from the typical investment practices of general firms, which often prioritize assessing a company's stability and reliability through its financial structure. The lower importance placed on financial factors in venture capital investment decisions for startups can be attributed to several factors. Firstly, early-stage startups often lack comprehensive financial data, making it challenging to assess investment risks and reliability based on financial metrics accurately. Additionally, startups typically have limited resources, and their future success relies on securing additional financial support for commercialization and sustaining operations. As a result, the focus of venture capital investment in startups differs from that of general companies, as the emphasis shifts towards evaluating technological innovation, market potential, and the entrepreneur's capabilities.

The unique characteristics and growth potential of startups necessitate a different approach to investment decision-making, where financial factors play a lesser role than other critical factors. Venture capitalists recognize that startups operate in a high-risk environment with limited financial data, and they adapt their investment criteria and decision-making process accordingly. This study aimed to identify and present the critical investment decision factors (determinants) that can promote increased venture capital or other investor investment in startups. The aim was to foster a positive synergy between investment and startup growth, particularly considering the evolving business environment where the growth and development of startups are crucial. By identifying these critical factors, the study aimed to provide insights and guidance to venture capitalists, entrepreneurs, and stakeholders to make more informed investment decisions in startups. Understanding the factors that drive successful venture capital investments in startups makes it possible to create a conducive environment for the growth and development of these early-stage businesses.

The study aimed to contribute to the overall ecosystem of venture capital and startups by emphasizing the importance of informed investment decisions, which can lead to positive outcomes for investors and startups. Only four factors (entrepreneur, product and service, market, and financial factors) were considered critical factors affecting venture capital investment decisions in startups is indeed a limitation. To further enhance the understanding of venture capital investment in startups, exploring additional factors that may significantly impact investment decisions would be beneficial. These factors could include technology, intellectual property, competitive landscape, team composition, and other relevant aspects. Some other major limitations of this study could be addressed in future research. First, the study focused on factors determining which startups to fund. Therefore, the scope will only cover identifying factors influencing venture capital to make such decisions. Second, time and distance problems. A sampling of the venture capital to be researched (collecting data, questionnaire, etc.) will only cover some of the province's major cities on Java Island. Venture capital and investors in these cities are expected to represent this study's big picture and result.

To address this limitation, future research could expand the scope of factors examined and consider a broader range of variables that may influence venture capital investment decisions in startups. This would provide a more comprehensive understanding of the decision-making process and potentially uncover new insights and considerations for venture capitalists when evaluating startup investment opportunities.

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