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Venture Capital Funding and Early-Stage Startup Performance

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Abstract: This paper explores the significance of team composition, market valuation, and deal structure in venture capital (VC) investments. The research highlights that the success of a startup is heavily influenced by the skill, knowledge, and dedication of the founding team. Additionally, market valuation plays a crucial role in determining the expected return on investment for venture capitalists. Various valuation methods, such as the discounted cash flow model and the Berkus method, are discussed to aid in the assessment of a startup's future prospects. Furthermore, the paper emphasizes the importance of a solid transaction structure, which includes equity, voting rights, and clear responsibilities for both parties involved. A strong transaction structure aligns the objectives of venture capitalists and startups, encourages rapid development, and reduces conflicts. Case studies of successful VC investments, such as Airbnb and Uber, are presented to illustrate how team composition, market valuation, and deal structure contribute to their growth and success. Overall, this research provides valuable insights into the factors that influence VC investments and their implications for startup success, investment performance, and economic development.

Keywords: team composition, valuation techniques, deal structure

1. Introduction

Venture capital (VC) is a form of private equity that involves providing funding to start-ups with significant growth potential. In the United States, VC investments experienced a decline of 14% in the fourth quarter of 2022 compared to the previous quarter's total of $37.9 billion [1]. Despite this decline, venture capital activity as a whole exceeded $200 billion, coming in at an astonishing $209.4 billion [1]. Even in the context of the global economic growth decline caused by COVID-19, 2022 will be the second most successful year for venture capital, highlighting the industry's activity [1]. The large investment volume in the VC industry will spur the emergence of numerous new companies, and the emergence of more new companies will also provide the VC industry with more options. At the same time, given that venture capital promotes growth and that the richest locations have the largest supplies of it, one may envision a positive feedback loop in which venture capital encourages growth, which in turn results in a higher supply of venture capital [2]. The volume of venture capital investments has progressively increased and the increase in venture capital investment will also encourage more people to participate and generate more employment opportunities and economic development.

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The significance of this research lies in our ability to synthesize prior successful VC cases to aid everyone in understanding successful investment experiences and methods, thereby raising people's awareness of investment and lowering risk, as well as raising their exposure to COVID-19's Impact on investment and market confidence. To clarify their significance to venture capitalists and start-ups, I will study and explain the three components of the start-up team, market value, and transaction structure in this respect. Any start-up's core is its startup crew members, so the potential success of a start-up is greatly influenced by the skill, knowledge, and zeal of the founding team. The market valuation is a thorough examination of the size of the market a business is entering, its growth potential, and the competitive landscape. Investors often seek teams with varied skill sets, good leadership, adaptability, and devotion to a goal. Deal structuring refers to the terms and conditions of investment agreements between VCs and startups. By understanding the characteristics of the successful company market, both VCs and business owners can more accurately estimate the future profitability and development potential of companies. A strong agreement can benefit VCs more and aid startups in obtaining more capital or resources. As the most fundamental investment criteria for start-ups, these three factors can aid venture capitalists in swiftly estimating the risks and rewards of this venture investment. For start-ups, these factors will be related to how to assist them to obtain the money that will help the company develop; for society, it will encourage enthusiasm for new industries or business models and will help the economy grow.

2. Team Composition

The team's resume or the experience of the founding team's members is the first significant factor. According to the study analyzing data from 2.8 million small retailers in Texas, it was observed that individuals with prior business experience had a higher likelihood of success as entrepreneurs, with the number of previous businesses running positively influencing their outcomes [3]. The greater the entrepreneurial or business experience, the greater the likelihood of success for the enterprise. In addition, the researchers did discover a significant factor that predicted entrepreneurial success, namely education. They interpreted this finding as indicative of the significance of ability outweighing experience in achieving positive outcomes. Frick suggested that the applicant's educational background might have an impact on the likelihood that a business will succeed [4].

Because expertise and experience are crucial to the success of a startup. Founders who are experts in their disciplines and have a track record of success instill confidence in venture capitalists, among other things, that they will be able to overcome technical obstacles that will inevitably arise in the early stages of a company's development. Google serves as a typical example. Larry Page and Sergey Brin, co-founders of Google, have a clear vision for the company and are experts in their respective disciplines. Their revolutionary PageRank algorithm revolutionized the Internet search industry. When Google went public in 2004 and established itself as the market leader, Andy Bechtolsheim, the company's first investor, bought around $60 million.

Although education can be measured, there is no standard for measuring entrepreneurial ability. Therefore, even in practice, there is not much evidence of entrepreneurial competence. So, venture capitalists will be more inclined to evaluate the entrepreneurial and management skills of a company's founding team based on their past investment successes. A great team is an engine that lies behind any business's success by providing the necessary knowledge, skills, and experience to execute the business plan effectively. On the other hand, venture capitalists are responsible for bringing entrepreneurial concepts to life by assisting entrepreneurs in raising capital and providing the necessary resources. In addition to the skills and abilities of the start-up team members, the founding team can influence venture capital decisions through personal business management skills. For example, the creation of Airbnb, the world's hottest home-sharing company.

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Members of Airbnb's founding team lacked superior academic and professional credentials, as well as extensive entrepreneurial experience. However, the Airbnb startup team has exceptional adaptability. For instance, when they discovered that customers would be more likely to recognize high-quality room photos, they decided to rent a camera, take photos of the room in person, and post them on the website to increase customer trust. Ultimately, due to the startup team's adaptability and management, they were able to secure a $600,000 investment from Red Shirt Capital's first round of funding. With the aid of this funding, Airbnb was able to complete its early stages of growth and go public on the US stock market in 2020, becoming the largest IPO ever. In addition to not having sufficient capital and technology and relying on team management and business model to obtain VC investment, there are also start-up teams with a large amount of capital and resources, but founders who do not understand core technology, that obtain VC and market support. Founder relationships can play a significant role in capital formation, the recruitment of top talent, and the formation of strategic partnerships. LinkedIn, for instance, was founded by Reid Hoffman, a well-connected Silicon Valley entrepreneur. As an angel investor, he has invested in more than 60 start-ups, having previously served as the senior vice president of Paypal. As the founder of Linkedin, he is responsible for attracting venture capital and talented employees through his personal network. Microsoft acquired the company for $26.2 billion in 2016, and Linkedin was acquired by Microsoft. It can be demonstrated that both education level and entrepreneurial experience are factors that increase the likelihood of success for new businesses.

3. Valuation Techniques

The valuation of the startup is the second essential factor or direction for VCs to consider when determining whether a startup has investment significance. Company valuation, a foundational concept in the field of venture capital, refers to the process of determining the economic value of a startup or early-stage company. This valuation will have a significant impact on the expected return on investment (ROI) of venture capitalists (VCs), and startups and VCs will negotiate based on the company's valuation and determine that the startup will exchange a portion of its shares for the VC's investment. Valuation holds great importance as it facilitates the alignment of interests between the entrepreneur and the investor, establishes a fair framework for their relationship, and minimizes potential conflicts that may arise between them. These factors collectively influence the potential return on investment for venture capital [5]. In other words, the valuation determines the price that venture capitalists pay for an equity stake. Second, the valuation of startups establishes a benchmark for future financing rounds, as future investors will evaluate the company's progress based on the valuation growth between rounds. Thirdly, it impacts the ownership distribution among the company's founders and investors, as well as internal control and decision-making. This demonstrates that the valuation of a fledgling company is dependent on the company's future value, the profitability of the VC, and the company's growth.

This study aims to assist individuals in calculating the market valuation of a startup company and analyzing the company's future prospects by using various methods and models. The first is the discounted cash flow model. The discounted cash flow model offers the advantage of assessing the value of a company or investment by considering its potential future earnings [6]. Thus, this application is more useful for unicorn companies or startups in new industries, as there is no need to compare with other companies in the same industry. Moreover, the valuation method based on discounted cash flow models does not rely on subjective market sentiment to determine the intrinsic value of a company. Thus, it can provide a more objective valuation of a company by evaluating its returns and the time value of currency over the entire economic life cycle.

The second method for determining the value of a startup is named after its originator, the renowned angel investor Dave Berkus. This method is utilized most frequently for businesses because

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it permits valuation estimation based on non-financial characteristics. The objective of the Berkus method is to arrive at a reasonable pre-investment valuation by assigning a range of dollar values to the five fundamental aspects of the enterprise. The five essential components of the Berkus method are as follows: First, it is reasonable to consider the fundamental value of a startup, such as whether it has original and viable business ideas. If investors believe the startup fulfills the aforementioned conditions, its value will increase. This element considers the product or service's originality and prospective viability. Second, do firms have ready-to-launch products or services? The existence of a product reduces technical hazards and demonstrates that the concept can be converted into tangible goods or services. Then, does the venture possess a competent and seasoned team? Due to the importance of the quality and competence of the management team, a competent management team can have a significant impact on the ability of startups to execute business plans. Fourthly, has the startup established any strategic partnerships, collaborations, or important customer relationships? A result of the close relationship between these factors and the possibility of enhancing the reputation of entrepreneurs and accelerating their market penetration, as well as the operational growth of subsequent companies. Focusing on whether the startup's products or services generate revenue in the marketplace, the fifth crucial point is the product launch and sales situation. If the company engages in sales, it can validate the product's suitability and market demand through sales status, thereby reducing the product's production risk. The Berkus method of valuation is advantageous due to its simplicity and emphasis on qualitative factors. However, this method is overly subjective and some of its inspection methods can only be assessed based on the personal experience of investors, and its simplicity may overlook crucial aspects of the startup company's financial situation. Personal experience is frequently derived from the successful investment cases of prior investors, which can lead to excessive subjectivity and cause some investors to overlook high-quality startups.

4. Deal Structure

Deal structure is a crucial factor in the investment process of venture capitalists. It is a form of private equity investment focused on providing capital to early-stage businesses in need of funding. In exchange for their investment, the investor receives an ownership stake in the company in the form of shares or equity [7]. Startups need venture capital primarily to expand existing businesses or develop new products and services. A reasonable transaction structure can enhance the transaction's likelihood of success, and is also related to the investment income of venture capitalists, the founding team of start-ups, the development efficacy of the company, and the degree of company control. In other words, the structure of agreements between venture capitalists and startups includes the structure of the investment, with details such as equity, voting rights, and convertible notes spelled out in the contract. The transaction structure determines not only the financial aspects of the investment but also the influence and control each party has over the company's future. Therefore, entrepreneurs and venture capital firms derive numerous benefits from a solid transaction structure. They begin by aligning the objectives of VCs and startups. Second, it will encourage venture capitalists to be interested in the rapid development of the business or the size of the start-up company in order to maximize their return on investment, whereas the founding team or management of the start-up company may be more concerned with long-term sustainable growth. In addition to the substantial financial investment, venture capital funds also offer startups valuable technical or managerial expertise, access to extensive networks, and comprehensive business support [8]. In other words, a strong transaction structure includes equity, voting rights, and clear responsibilities for both parties, as well as incentives to help both parties achieve their shared objectives. In addition to providing startups with capital, venture capitalists will provide them with additional resources, such as professional management knowledge, or improved opportunities by introducing them to other

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companies in the same industry, which is intended to reduce conflict between the two parties and enhance the development efficacy of the startup company.

Benchmark was one of the main venture capital firms that initially supported Uber. The company recognized the disruptive potential of Uber's business model and invested heavily in the company's early phases, acquiring a 13 percent stake and the investment provides Uber with the capital required to expand its operations. Bill Gurley, an associate at Benchmark, joined Uber's board of directors to assist with the company's growth. Gurley has extensive experience and knowledge in the technology and transportation industries, and he provides Uber's board of directors with valuable guidance and strategic direction. Benchmark's experienced investor and advisory team provided Uber with operational expertise and guidance during subsequent company operations. They assist Uber in navigating obstacles and making informed decisions by providing insights and best practices gleaned from their work with other successful technology companies. Furthermore, Benchmark has an extensive network of contacts in the business and technical sectors, so they leverage their network to promote strategic Uber partners. These alliances have enabled Uber to expand its influence, enter new markets, and forge alliances with other companies in the transportation ecosystem. Therefore, Benchmark's assistance is not only limited to monetary investments, but also their expertise, operational expertise, and business acumen have aided Uber in numerous ways. This support was crucial to Uber's success, which ultimately led to Uber becoming the largest transportation network company in the world.

Moreover, deal structures can be used as risk management instruments [9]. A convertible note, for instance, enables a venture capital firm to invest in a startup while deferring the decision to convert the investment into equity, which mitigates some of the inherent hazards associated with early-stage investing. A clear timeline is also established by the deal structure so that you can determine when the VC can terminate the investment or continue to provide the startup with a timetable for future financing rounds [10]. These timelines offer the organization future predictability. When analyzing the various components of the transaction structure, equity allocation is the most critical factor. Equity determines ownership, which in turn determines the investment's potential return. Therefore, the structure of equity distribution between the stakeholders is crucial. Too much equity in the hands of venture capitalists may dampen the enthusiasm of the company's founders, while too little equity may not provide sufficient returns or control for the VCs. In addition, voting rights are an essential component of the deal structure, as they reflect the influence each party has over strategic decisions. Typically, venture capitalists have the right to veto decisions that could have a substantial impact on the company's future or its investment. Also take the example of Uber, which utilized a deal structure that initially favored venture capitalists but ultimately hindered the development of startups. Uber ceded a significant amount of control to venture capital firms in its early stages, enabling it to raise capital and expand rapidly. However, the absence of founder control ultimately resulted in disputes.

In conclusion, deal structure is a crucial factor in venture capital. Because, in addition to selecting which startups to invest in the deal structure has the most direct impact on the investment performance of venture capital firms. Simply put, the essence of the deal structure is to use funds to purchase equity, so using fewer funds to obtain more equity can help venture capital companies make more profits. Likewise, the deal structure will impact the consistency, risk management, and overall success of the investment in the fledgling company. Therefore, striking the right balance is therefore complex and context-dependent, emphasizing the need for careful consideration and negotiation when structuring a deal.

5. Conclusion

A proficient founding team, the valuation of startups, and the transaction structure between venture capitalists and startups may be the three most important factors influencing the efficacy and success

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of venture capital investment. A competent and experienced founding team will make a startup company more adaptable and demonstrate a strong ability to deal with unanticipated challenges, particularly in the early phases of a business's development, thereby increasing its likelihood of success. The valuation of a startup determines the prospective return on investment for a venture capitalist. It is the foundation and first point of reference for future startup financing and influences the ownership distribution between founders and investors. Before investing in enterprises with venture capital, dependable methods and instruments should be used to determine their genuine value. After an effective venture capital investment, the transaction structure significantly impacts the profit that can be obtained. It should be designed to align the interests of venture capitalists and entrepreneurs, stimulating development while distributing control and influence equitably. These findings are highly beneficial to startups and venture capitalists. A thorough comprehension of these factors can lead to wiser and more strategic venture capital decisions, thereby increasing the startup success rate. In the investment environment, venture capital firms and entrepreneurs can use these factors as a reference. Focusing on these factors can lead to higher returns for venture capitalists considering an investment. Airbnb's success demonstrates that evaluating the experience and adaptability of the founding team is an excellent first step. In addition, a discounted cash flow model or the Berks method can aid in determining a startup's intrinsic value and future potential. Ultimately, as evidenced by the early phases of Uber's partnership with Benchmark, ensuring a balance of control, assisting startups in acquiring resources, and aligning startup and investor interests can guarantee a successful investment.

In conclusion, venture capital fosters innovation, propels economic expansion, and promotes social progress. These principles can increase the efficiency of venture capital investments and contribute to the entrepreneurial ecosystem as a whole. The effectiveness of venture capital is not limited to monetary returns; it also encompasses job creation, innovation, and technological advancement, all contributing to the economy. Consequently, implementing these principles to enhance the efficacy and success of venture capital decisions can result in a virtuous cycle of improved stimuli and increased market confidence.

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