# Pre-Investment Factors and Their Roles in Backing the Startups Growth in Malaysia

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## Abstract

*The objective of this paper is to provide venture capital investors with pre-investment criteria to eliminate possible uncertainties and to assist the venture to grow and exit successfully. In this study, we conducted personal interviews with some venture capital executives and two entrepreneurs in Malaysia. Out of 52 active registered venture capital firms in Malaysia, only eight firm representatives agreed to participate in in-depth interviews with the CEOs. Moreover, some VC participants recommended two entrepreneurs to participate in the study, too. The interviews covered all pre-investment aspects that could assist in a successful investment. Our findings displayed that innovation and investment environment are key pre-investment criteria. Consequently, our results support what previous relevant studies concluded. The significance of these results is providing further support for the decision making process.*

**Keywords:** innovation; venture capital; startup performance; business investment; business environment; entrepreneur; multi-level communication; growth

## *1. Introduction*

Due to the rapid expansion of the global economy in the past few decades, businesses and industrial concerns have become highly competitive all around the world. To be competitive, organizations must have innovative products and services as innovation plays a vital role in developing economic growth through focusing on science and technology-based knowledge (Minniti and Levesque, 2010; Youtiea and Shapira, 2008) and has become an important stimulant for growth in both developed and developing countries. In new start-up firms, competitors that are more creative may have a competitive advantage over firms with less innovative products. Hence, new ventures must start to fill the gap between innovation and existing understandings and practices of managing and commercializing these innovations (Hargadon and Douglas, 2001).

Another key part of the entrepreneurs' business need is obtaining funds from various financial sources. The reasons for requiring financial support are to expand or extend the start-up risk, to gather start-up capital and to fund expansion and development (Gnyawali and Fogel, 1994). Well-known firms having verified products and market share have a higher chance of finding venture capital funds than small early-stage firms, as funding smaller firms is considered risky due to the uncertainty of their business opportunities (Sanz and Lazzaroni, 2008; Boadway et. al, 2005; Cumming, 2005).

Financial performance by itself may inadequately measure a new venture firm's performance as it may take a gestation period of several years to see financial gains, as observed in some cases of the biotechnology and medical equipment industry (Rothaermel and Deeds, 2001). Moreover, for new start-up firms, return on investment cannot be a suitable performance indicator, as these firms are still developing their products. Nevertheless, Parmenter (2007) argues that there are three ways to measure performance: (1) key result indicators such as customer satisfaction, net profit before tax, profitability of customers, employee satisfaction; (2) return on capital invested; and (3) performance indicators and key performance indicators (KPIs).

However, many firms do not use these methods to monitor their performance because they do not understand these methods, especially the KPIs. For the lack of studies on venture capital in Malaysian context and since the startup stage of every business is risky, it is important for decision makers, especially those investing in the early stages, to base their decisions on reliable criteria. To do so, this study concentrates on some pre-investment criteria, mainly innovation and investment environment, which, in turn, will contribute to a successful exit in the startup firms. In other words, it is helpful to find a suitable guidance to improve startup performance and, in turn, to alleviate the high risk.

This article consists of five sections in addition to the introduction. Section two presents a background of the relationship between venture capital and innovation in developing national economies. Moreover, the pre-investment success factors can help in analyzing and then identifying venture capital stages and characteristics.Section three analyzes the methodology of developing the themes of the qualitative study. This section also contains a comprehensive description of the methodology for its development (design, methods for obtaining information, and methods of analysis). In the fourth section, we go on to describe the most prominent results obtained, whilst the most relevant conclusions and contributions of the study appear in the final section.

## *2. Literature Review*

### 2.1 Innovation

The main characteristics of innovation tasks are the generation of new knowledge and ideas that may lead to new organizational processes, products, or services. Innovative processes and performance in firms have important implications for the firm's economic performance as well as societal welfare (Sauermann, 2008). Accordingly, it is clear that both Small and Medium Enterprises (SMEs) and large firms are opposite to each other in terms of innovation. The latergroup is less innovative (Dobón and Soriano, 2008; Limet. al, 2008; Maroto and Rubalcaba, 2008; Utschet. al, 1999).

According to the European Union (EU), innovationcan be defined as "*the successful production, assimilation and exploitation of novelty in the economic and social spheres*" (OECD, 2005). Throughout history, innovation derived from new scientific and technological knowledge can improve productivity, living standards, and long-term economic growth (Balzat and Hanusch, 2004).

Innovation, from a system point of view, is recognizing and explaining economic growth and economic development (Lundvall, 2007). Active contributions of a firm in its innovation system is achieving higher innovative performance and determining the institutional environment evolving in its industry (Tsai et. al, 2008).

According toNiosiet. al(1993) and Yim (2006), innovation system implies more factors and actors such as technology transfer centers, venture capital, banks, managerial consulting companies, entrepreneurs, and so on, needed to utilize the research outputs. To achieve this comprehensive implication,Ulku (2007) suggests that innovation expects something more (like marketing, commercializing and financing) that are required to create high-quality science and technology based actual innovation in the world. The most important determinant of innovation is the supply of knowledge and the rate of innovation has a positive effect on the growth rate of output in all sectors. The most important components of the NIS are financial institutions, business firms, educational institutions, public research establishments, relative government departments, and legal institutions. Moreover, it is also important to understand the relationship among these components for NSI (Chung, 2002; Niosi et al., 1993).

Understanding the linkages among the NSI components actors involved in innovation is the central idea of having national innovation systems. The relationships amongst actors involved in producing, distributing and applying various kinds of knowledge and resources can result in innovation and technical progress. Private enterprises, universities, public research institutes, and the people within these entities are examples of the prime actors. As a result, the ultimate purpose of the national innovation systems is the improved economic performance (Hekkert et. al, 2007; OECD, 1997). The national innovation system theory concentrates on establishing relationships and processes between these various innovation actors. For these reasons, all of the innovation players work together with each other and substitute knowledge, financial and human resources (Yim, 2006; Kayal, 2008). As a result, they can decrease information asymmetry and agency problems (Bergemann and Hege, 1998; Casamatta, 2003; Cornelli and Yosha, 2003; Schmidt, 2003; Wang and Zhou, 2004), enhance performance (Bottazzi et. al, 2008; Gompers et. al, 2008; Hochberg et. al, 2007), and enrich innovations (Kortum and Lerner, 2000a).

Globally, the success of the Silicon Valley in pushing the growth of innovation and technology has motivated governments to encourage the duplication of technology and venture capital centers in their own countries by (Butler, 2005; Lalkaka, 2001; Wright et. al, 2007). Besides, starting and developing a business without capitalis a difficult proposition. As a result, there are several sources in backing startups with the necessary capital such as personal capital (friends, fools, and family members), arranging bank loans, or pursuing an equity partner from private equity and venture capital firms (Carmona et. al, 2008; Cumming and Johan, 2009; Kaplan and Strömberg, 2003; Lerner, 1994; Sahlman, 1990; Tan, 2010).

Start-up companies with new business ideas and high-growth potential combined with a lack of liquid assets may be unable to obtain bank finance because of the high risk they represent. Venture capital involves the supply of equity finance to enable the investor to share the benefits of high growth alongside *hands-on* governance to assist in achieving the success of such companies (Armour, 2002; Bottazzi et al., 2008). The following section will discuss venture capital as one of the important alternative sources of supporting funds.

**2.2 Venture Capital**

According to Wong (2005), Venture Capital (VC) is "capital for equity investment in higher risk start-up and early stage private companies, with the objective of achieving above-average medium term investment return."

At the beginning of the 21st century, the importance of venture capital companies (VCs) for the funding of new high-growth potential firms is universally recognized (Kaplan and Strömberg, 2003; Kenney et. al, 2004;Lerner, 1994; Sahlman, 1990) and is highly preferred by start-up companies over commercial banks. These venture capital companies find potential firms due to their enormous future growth potential, while banks only provide loans and are mainly interested in earning the loan interest. As a result, VCs concentrate on areas where their managerial contribution is vital rather than being general financial intermediaries (de Bettignies and Brander, 2007; Bottazzi et al., 2008).

By understanding the improved value of venture capitalists, it leads to the achievement of their equity as the business firm grows up. The craft of venture investing is risky since newly established firms have a high mortality rate. In case of major setbacks, investors may lose everything in the investment or at least could recover only a little capital since these new ventures have a small number of fixed assets (Boadway et al., 2005; Ensley et. al, 2006; Kenney et al., 2004). However, venture capitalists believe that they can get a return of at least ten fold in less than five years when investing in a recently established high potential firm. Moreover, they do not care about the social aspects of doing business such as reducing joblessness (Kenney et al., 2004) as business thrives indirectly will solve these problems. On the other hand, Chenet. al(2009) argue that new ventures are an engine for job creation, innovation, and, in turn, regional development.

Kortum and Lerner (2000a) argue that start-up and early stage firms could access venture capital markets through linking finance and innovation as a means of high-risk, high-return activities. As a result, Giat (2005), and Wang and Wang (2011) claim that innovative ideas, technology transfer and supporting private companies are financed, fostered and transmitted by means of investment in venture capital to achieve and consequently play a vital role in economic growth. For example, venture capital financed many reputed firms during their early-stage development (de Bettignies and Brander, 2007).

The major characteristic of small firms is their uncertainty and informational asymmetries that confuse the decision-making of suitable investments and taking immediate advantage of possible benefit by entrepreneurs after obtaining the funds. By reducing such information asymmetries, financing limitations would disappear (Kortum and Lerner, 2000b). Specialized financial intermediaries, such as venture capital organizations, can deal with these problems. They can improve some of the information gaps and eliminate capital constraints to drive new ventures forward to founding positive firms (Chen et al., 2009; Kortum and Lerner, 2000b). Previous studies, Cochrane (2005), Kaplan and Schoar (2005), Phalippou and Gottschalg (2006) have documented some common characteristics of venture capital investment performance and these characteristics are syndication, industry competition, investment environment, exit conditions, age and size of VC, cumulative investment, number of investments, and reputation.

**2.2.1Successful Investment Factors**

The venture capital firms work very hard, in the entire investment processes, to minimize the risks inherent in the investments and to maximize the investment returns.

In the screening stage, pre-investment process, VC managers are very selective of investment opportunities that are determined suitable for funding. The following stage concerns the careful evaluation of the accepted proposals (Koh and Koh, 2002; Patzelt, 2010). According to Koh and Koh (2002), the selectivity procedure is tedious where "the rejection rate is very high; typically, only one out of every ten to twenty projects will pass the initial screening where more than one partner will review the project in detail". Various previous literature studies have specified many factors that have an impact on venture capital firms. For example, Kollmann and Kuckertz (2010) claim that: "due diligence checklists may well include up to 400 different criteria." Other studies focused on some factors such as syndication, industry competition, investment environment, exit conditions(Nahata, 2008), age of VC, cumulative investment, and number of investments (Gompers, 1996; Hochberg et al., 2007; Sauermann, 2008). Reputable VCs have a better investment chance and they expect to have a higher portion of cumulative VC investment (Hsu, 2004; Chen et al., 2009). The VC firm adds to its reputation of being a winning venture investor through the assessment process of its portfolio starting from a private start-up to an initial public offering (IPO) (Nahata, 2008). Investors recognize that VC firms obtain the majority of their investment earnings either through IPOs or acquisitions and mergers (Cochrane, 2005; Cumming and MacIntosh, 2003b).

It is clear that since startup firms are new and small, they are short of resources yet their responsibilities are great(Stuart et. al, 1999; Shane and Cable, 2002).Informal private networks and even social ones are vital ways for entrepreneurs to depend on widely during the early stages of new venture development (Sherer, 2003; McAdam and Marlow, 2008). The growth of both business and public networks are important for enterprise for survival and development in the business environment (Uzzi, 1997; Hisrich and Smilor, 1988; Hoang and Antoncic, 2003). The main reason for having these relationships is to provide innovative thoughts and information for the survival and expansion of the venture (Hite and Hesterly, 2001; Witt, 2004). By cooperating with them, they achieve the latest knowledge in the field. These enable the development of modern products (Lockett and Wright, 2005), hence may lead to lowering the development expenses in the long run (Markman et. al, 2005) while offering the newest accessible knowledge to the client (Zucker et. al, 2002). Hoang and Antoncic (2003) highlight that entrepreneurs use such networks to keep up to date with new business developments, acquire motivation and learn to beat challenges.

This research will concentrate on some aspects of pre-investment issues such as innovation and the investment environment. The first issue, innovation, utilizes knowledge while the investment environment discusses the business industry/sector, working experience, building an effective network, and fund raising. Integrating all of these factors will lead to the ability to predict whether the investment criteria are pioneering, profitable and, in turns, will allow for an effective exit. As a result, all business parties can make appropriate judgments of the investment once they meet the requirements.

## *3. Methodology*

The objective of this study is to determine how pre-investment factors improve startups performance. The research focuses on the early stages of venture capital in Malaysia. The main contribution is enhancing the investors and decision-makers, who are interested in startups' investment, to build their decisions on studied criteria. Moreover, this study focused on exploring these startups' performance issues in detail through interviewing experts in the business industry to build a solid base for investors in Malaysian venture capital industry.

### 3.1 Data collection and sample

According to SC (2009), there are 57 venture capital firms and fund management companies in Malaysia. There are 52 active registered venture capital management corporations with more than five years of operating experience. The researchers sent a request letter to each Venture Capital Company to obtain permission to setup an in-depth interview with the CEO, while assuring respondents anonymity and information confidentiality. Only 8 out of 52 venture capital firms agreed to participate in the study, which represents 15% of the research population. Creswell (2005) argues the importance of locating other people to the study through *snowball sampling* where those participants answered a set of questions, during interview or through informal conversations, to recommend some other suitable individuals forconductinginterviews.Moreover, we interviewed only two entrepreneurs agreed to participate.

According to Creswell (2005), the accurate number of participants is less important in qualitative assessments. Besides, the researcher's ability to study the research topic in more detail decreases as the sampling size increases (Kalof et. al, 2008; Creswell, 2005; Ritchie et. al, 2003). Johnson and Harris (2002) argue that mailed questionnaires to 700 people in a quantitative research might only be targeting 30 informants. This argument shows that in qualitative researches, researchers use smaller numbers to understand the phenomena in greater detail.

This research involved a sequence of personal interviews between the researcher and successful participants in their business field. Through a personal one-on-one interview, we gathered the required information by asking the participant a set of questions. Interviews enable the capturing of diverse views about a theme from various social viewpoints. This is one of the reasons for using an interview approach in research (Kvale, 1996). In addition, during the conversation, the researcher can evaluate the participant directly by observation of the live experience (Cassell and Symon, 2004).

The researchers divided data collection strategy into a two-part approach. In part one; we collected general information to aid in the appropriate selection of participants. This information included personal information, work history, existing business type, specific environmental discipline, date of starting the business, position within the company, and other firm information, as shown in Table 1.

In part two, the data collection strategy involved conducting personal one-to-one interviews. Researchers obtained qualitative data about improving the start-up performance through related later stages factors of venture capital during on-site interviews using a list of interview questions. The researchers asked every participant a series of open-ended interview questions over a period of one to two hours to relate his experience with venture capital financing, start-up performance, and the later factors that can have an impact on improving the performance of start-ups. We tape-recorded and then transcribed all interviews as narrative data. In addition to the data gathered from interviews, we also reviewed the organizations' documents to support and/or verify the information gathered from interviewees. The researchers carried out this research during the second quarter of 2010, from April to June. The data obtained refers to that particular moment in time, given the fact that changes may occur in the firms.

### 3.2 Data analysis

The information collected from interviews and analysis of documents was organized and rigorously interpreted to extract the key findings using the content analysis method. We analyzed the information using spiral steps for data analysis as proposed by Creswell (2009). First, we organized the collected data into several forms (i.e. database, sentences, or individual word). Second, we scrutinized the collected data sets several times to obtain a complete picture or overview of what it contains as a whole by taking notes and summarizing the key points that suggested categories or themes related to the research. Third, the researchers identified and classified the general categories or themes accordingly. The themes that are applicable to this study are capital, venture, performance, innovation, start-up, among others. Finally, we integrated and summarized the data to describe the relationship between the categories or themes.

## *4. Results and Discussions*

Our fieldwork provided some evidence that both good direct and indirect links influence positively startup investors' decisions, both fund receiver and supplier. Building noble networks is a key of innovation. There are many papers discussed this issue such as OECD (1997) but our results assured that multi-level communications is very important for innovation. The multi-level communication helps in knowledge sharing and problem solvingwith all investment parties as well as externals to organizations. As investor P2 said, "*..according to your communication level … so, they will refer the deals to you*". Through knowledge sharing and problem solving meetings all team members are updated to the latest technologies as well as the best solutions for most of inconvenience matters. In addition, another participant stressed:

> *Many ranks of networking are extremely important for entrepreneurs, startups, mature companies. Through networking, people come and talk to us. Sometimes we meet through conferences, and then we network. They show interest in our company and we talk.* (P6)

Moreover, the knowledge sharing and problem solving meetings enable the member team to know their opportunities and threats during planning process to put alternative plans just in case of any crisis to recover faster with lower costs.

It is clear that venture capital can play a significant role in promoting innovation. Despite extensive studies on innovation, it is still indistinguishable what kinds of innovation abilities are critical to explain the performance of new startups. The innovative performance of a startup depends largely on how players such as entrepreneurs, venture capital firms, and other public institutes and the people within them relate to each other. To be innovative, management team members should consider facilitating such multi-level communications. They could evaluate the innovative products or services according to networks in updating their knowledge about them, pricing strategies, marketing activities, etc. Through these channels, theysupport investment environment and then enhance the startup to raise fund easily, recruit skilled staff, be updated to the latest industry technologies, etc. Studies of investment environment as investment criteria have been, until now, of more interest to entrepreneurs seeking venture capital funding than they have to venture capitalists looking for appropriate investment criteria. Evaluating the environment of investment, as the present study does, is therefore an important criteria and an advanced step on the way towards linking it to innovation criterion and its contribution to the success of an investment decision as a uniqueness of this paper. Moreover, the other findings of this study are in line with Armour (2002), Bottazzi et al. (2008), Koh and Koh (2002), and Patzelt (2010) who reported that business industry, working experience, building an effective network, and fundraising tend to be more efficient factors on the investment environment.

## *5. Conclusion*

Discussing the criteria that will help decision makers to build their decisions is a difficult issue. A long list of factors can positively support the growth of startups. Actually, it is hard to apply them all to companies at once. This research aims to study some aspects of pre-investment issues such as innovative matters and investment environment. The first issue, innovative matters, utilizes multi-level communications might support knowledge and innovative ideas, while the investment environment discusses the business industry/sector, working experience, and fund raising and their role in building an active network to deliver a successful startup. Integrating all of these factors will lead to predicting whether the investment criteria are pioneering, profitable and, in turns, will exit effectively, or not. Moreover, practicing the pre-investment issues earlier will give the entrepreneurs a good chance to find the right venture capitalist. Kollmann and Kuckertz (2010) emphasize, "Postponing this to a later phase of the process heightens the risk that this part of the process will not be reached." This study has concentrated on the experience of funding start-ups in Malaysia. Innovative concepts are huge issues. The researchers recommend also studying innovative concepts that appear in the later stages of venture capital firms. Studying, in-depth, the governments' role in promoting cooperation between universities and venture capital firms, especially the private VCs, is necessary as most VCs argued that they are not in touch with each other. Moreover, this study focuses on pre-investment factors of both investors and entrepreneurs. One suggestion is studying innovative concepts and the investment environment of both of these groups separately, in-depth in other country.

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**Table 1. Participants' information**

| Participant's Code | Position | Experience Years | Business Sector | Business Location |
|---|---|---|---|---|
| P1 | Senior Vice President | 10 | ICT | Malaysia |
| P2 | Senior Investment Manager | 8 | Oil & Gas | Malaysia / Asia |
| P3 | Director | 7 | Hi-Tech (non-ICT)<br>Bio-Technology | Malaysia/ USA<br>Worldwide |
| P4 | Associate Director | 10 | Oil & Gas / Hi-Tech | Malaysia China<br>Indonesia |
| P5 | Senior Vice President | 9 | ICT | Malaysia |
| P6 | Principal | 16 | Hi-Tech | Malaysia/ USA<br>China |
| P7 | Project Manager | 5 | IT / Hi-Tech | Malaysia |
| P8 | Chief Executive Officer | 5 | Qualitative Services<br>Healthcare<br>Automotive Research | Asia / Australia<br>Middle East<br>New Zealand |
| P9 | Executive Director | 17 | Healthcare / Media<br>Technology<br>Telecommunications<br>Bio-medical | Malaysia<br>Hong Kong |
| P10 | Group Chief Executive Officer | 12 | R&D / Voice Services<br>Internet Services<br>Telecommunications | Malaysia<br>Worldwide |