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# DUE-DILIGENE OF POTENTIAL INVESTORS BY FINNISH START-UP COMPANIES

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ABSTRACT OF THE MASTER'S THESIS

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Abstract

Start-up industry has boomed recently globally and early-stage ventures requires capital to finance their activities. Venture capital money is a traditional and the most important source for high-tech and risky ventures to seek capital.

The aim of this study is to determine how entrepreneurs evaluate their potential Venture Capital investors and what are the most important characteristics of Venture Capital firms for founder teams. To this end, the research question is as follows: How Finnish Start-up companies conduct due-diligence of their potential Venture Capital investors?

The research question is answered through semi-structured one-to-one interviews with Finnish entrepreneurs. The data of interviews was analyzed through content analyze method.

The results indicate that entrepreneurs do not evaluate Venture Capital investors enough. Entrepreneurs tend to rely on few easily available sources and ignore deeper analysis of their potential VC partners. Evaluation process is seen as a social process that emerges between entrepreneur and investor through interaction.

Entrepreneurs are keen to know reputation and values of the VC investors. Entrepreneurs are likely to accept an offer from a VC that has experience from the same industry. International connections and overall network of investor are seen as most important value-added services. Track record of VC is a moderately important for founders but reputation of VC is more important for entrepreneurs. Term sheet and valuation of venture is important for entrepreneurs and they expect to gain knowledge of VCs philosophy and values from the term sheet paper. Investors that have potential to invest to the company in future finance rounds and investors' connections to later-stage investors are also seen relevant. Formal and informal meetings and discussions with investors are seen most reliable source to gain understanding of VC companies.

Keywords
Due-diligence, start-up, venture capitalism
Additional information

CONTENTES

# 1 INTRODUCTION

Industrial changes and digitalization in past decades have affected permanent changes on national economies in developed countries (Hakkarainen 2010; Sitra 2016). Traditionally few industry sectors have employed masses of people. Changes in economy structures have squeezed employed people in these sectors when manufacturing have been imported in countries where manufacturing costs are lower. Asia have become the biggest manufacturing continent in the world. Europe and North-America have fallen behind and solely manufacturing in South-East Asia is bigger than in Europe or North-America (Okko 2007). Globalization and digitalization is happening in every country and national job markets are in transformation. Also, Finland need to consider new ways of doing things in order to compete in global markets (Sitra 2016).

Increase of outsourcing have not solely impacted only at low-level jobs but also at high-skilled jobs in technological sector when companies have outsourced jobs on third world countries. The transformation of job market does touch in every industry sector and all levels of jobs (Hakkala 2013).

Because companies in different industries have outsourced their activities to undeveloped countries, it has created a new situation in the western job market. For this reason, unemployment has also increased in technological sector in developed countries (Hakkarainen 2010). Unemployment have risen 9 percent among university educated people between years 2014 and 2015 in Finland (Tek 2015). Okko (2007) hypotheses outsourcing to be more likely when job is in technology industry, the product of the job can be transfer digitally, the content of the work can be coded or the duty includes only little amount of social interaction.

While large-scale industries and big companies have outsourced their activities in third world countries, amount of small and medium sized (SME) have increased yearly in Finland (Hietala 2008). They employ more people comparing to history when only few big firms employed a big number of people. We can read about success stories of small ventures that have grown from garage to multinational enterprises. Good examples of this are accommodation service Airbnb and transportation service Uber. These companies conduct scalable business model that is easy to transfer into new markets. Another success recipe of these companies is their ability to internalize new kind of thinking of sharing economy (Soon 2014). Sharing economy means that individuals owning underused assets can rent them on online platform provided by third party (Investopedia 2018).

Technological development has also affected other changes to high-tech sector. Policy makers are supporting nowadays more entrepreneurship and founding a company is now easier and cheaper (Laki osakeyhtiölain muuttamisesta 1998, Osakeyhtiölaki 2006). Also, developing a mobile application and distributing it to masses is getting cheaper and easier. Purchasing via mobile phone has expanded and people spent 76% more time on playing mobile games in USA in 2014 (Thomas 2014).

Start-ups are important element in creating jobs. Average European start-up create 12.9 jobs in two and half years (Kollmann, etc. 2015). Policy makers have also understood importance of start-ups for economies and provide incentives for new companies (Europa 2018). Number of investments on start-ups have risen every year in Europe (Statista 2018).

Venture capital (VC) industry is an important source of money for start-up economy (Florida & Kenney 1988; Berkovitch & Levy 2005;Monika & Sharma 2015) Effective VC industry is also an important element of flourishing economy (Gregoriou, Kooli & Kraussl 2006; Sharma 2015). Nuechterlein (2000) notes that venture-backed companies have historically created a disproportionate number of new jobs – many of them well-paid and highly skilled – and are a key source of research and development spending. Cumming and Fischer (2012) proves in their study the importance of the topic and indicate that national economies and society need to support start-up ecosystems. For this positive outcome for the economy and companies, it is not surprising that both private actors and policy makers are supporting VC industry (Florida & Kenney 1988). VC industry have developed in recent years and funding from venture capitalists and business angels have grown rapidly (Mason & Harrisson 2001). A flourishing VC industry has been shown to have a positive influence on a country's economic growth and its domestic job market (Gregoriou, Kooli, Kraussl 2006).

Recent academic literature has examined largely how VCs choose entrepreneurs (Falik, Lahti, Keinonen, 2016). VCs have various criteria when evaluating start-up companies, it is commonly called as due-diligence process (Franke, Gruber, Harhoff, Henkel, 2008). Investing in early-stage ventures is a risky business and VCs use criteria to evaluate if the venture has chance to success. In due-diligence process VC evaluate venture's market size, financial information, proprietary rights and tangible and intangible assets etc. Camp (2002). While the VC literature cover the larger issue of venture capitalists due-diligence process, there is relatively little research on the issue of evaluation criteria of entrepreneurs (Smith 2001; Zheng 2001) This study looks specifically how entrepreneurs choose VC investors. Previous studies of topic show, that usually companies do have more than one offer where to choose their VC money (Smith 2001; Falik, Lahti, Keinonen, 2016).

## 1.1 Research question and purpose of the study

We do not have a good understanding how VC financed Finnish start-up companies conduct due diligence process of potential VCs. We also have a limited understanding in other countries how entrepreneurs evaluate VCs (Smith 2001).

This paper has two main purposes. We want to get a better understanding of how Finnish start-up companies evaluate their potential VC partners. In addition, we want to know what are the most important characteristics of VC company for entrepreneurs.

The research question of this study is:

1) How Finnish start-up companies conduct due diligence process of their potential venture capital investors?

The sub question of this study is:

2) What are the most important characteristics of Venture capitalists for Finnish entrepreneurs?

One of the fundamental assumptions of this paper is that there has been more than one VC who has been willing to invest in the company. In this study, we examine how entrepreneurs have conduct due diligence processes of VCs before raising money from investors. We are also interested in knowing what are the main reasons to raise money from a particular VCs and what they had addressed before making the decision.

## 1.2 Structure of the study

In the first chapter the background of the topic is introduced and the main reasons of flourishing start-up industry is explained and why it's now on the surface more than ever. We introduce our research question and purpose of the study.

The second chapter consist of theoretical framework and literature review on previous research. Theoretical framework begin by explaining what is venture capital industry and how it works. After that we define key players of the VC industry. We define start-up company and show how it has been handled in the previous literature. We explain the what are venture capitalists and what are limited partners. We explain the history of VC industry, introduce different kind of VCs, their investment strategy and their focus on investments. Furthermore, in this chapter, we explain start-up financing cycle and venture capital investment process. Lastly, in theoretical framework different phases of the investment is explained and different kinds of exit routes from the venture.

In the third chapter, we introduce entrepreneurs' evaluation method in the previous literature and evaluation methods of VCs.

In the fourth chapter, we explain the research method, data collection method and selection criteria of studied companies. We briefly introduce the chosen companies and why they were chosen to this research.

In the fifth chapter, we analyze the results of the collected data.

In the discussion chapter, we compare our study to the previous literature. We explain how our study supports and differs from the previous literature. We explain how our study fills the research gap and what new information it brings to the world. We introduce the limitations of the study and introduce our suggestions for the future research.

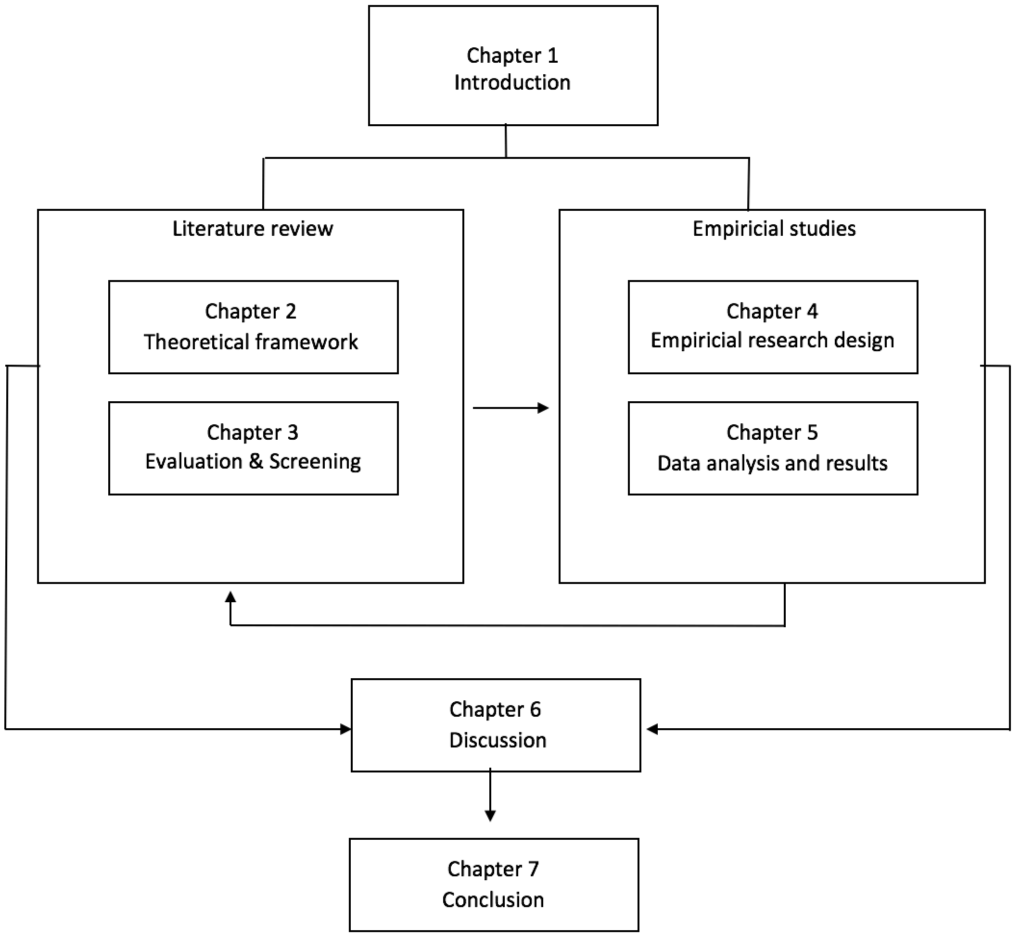


**Figure 1. Structure of study**

## 2 THEORETHICAL FRAMEWORK

Venture capital industry consist of start-up companies, Venture Capitalists (VCs) and Limited Partners (LPs). Figure 2 illustrate how the venture capital industry works. Firstly, there are entrepreneurs who are seeking for money. Secondly, there are parties with capital that are willing to invest, and thirdly they are called Limited Partners (LP). Venture capitalists are between parties with capital and entrepreneurs seeking for finance.

VC companies raise money from (LPs). Another choice for LPs would be directly invest in ventures. This could be time consuming and possibly LPs would not have resources and knowledge to pick winning ventures. In order to diversify their portfolio and delegate monitoring activities they allocate their capital through VCs. Every time when VC is investing to new venture they are making so-called "capital call" to their LPs. After a capital call LP need to give the money to VC based on the contract they have made earlier (Feld, Mendelson, Costolo 2012).

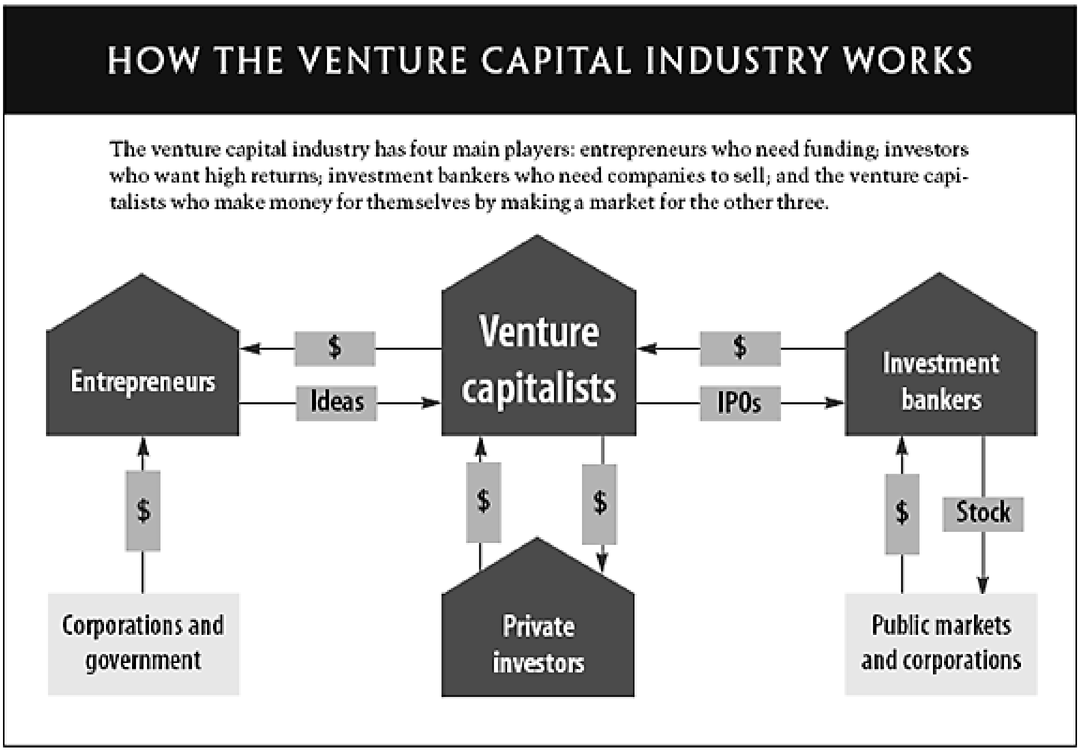


**Figure 2. Zider (1998).**

LPs are diverse and they have include typically following investors. (1) Corporate investors, (2) endowments, (3) Family officers, (4) Foundations, (5) Fund of funds, (6) government agencies, (7) Other asset managers, (8) pension funds and (9) Sovereign wealth funds (Invest Europe).

## 2.1 Start-up company

Companies can be classified on three different categories. Most of companies are "mice" companies that generate revenue but are not looking for expansion. The second category is big multinational companies "elephants" that are not aiming to maximize their growth but instead they are moving slowly. Start-up companies are the ones that aim to growth and are named "gazelles" (Landström 2005: 170).

Popularity of start-up company has risen recently. There is no consensus about the definition but there are some main features that can be found in many definition of start-up company (Yankov, Ruskov, Haralempjev 2014). One of the main feature of start-up company is the uncertainty of the success. Start-up companies create innovative products and they are backed up with investors' money (Yankov, Ruskov, Haralempjev 2014). Calopa et. al. (2014) focus the definition to the early stage of the venture, and define that it as a new company that is in a stage of market research or stage of product development. Many definitions include assumptions of high-technology and uncertainty of success. Therefore, ventures are high-risk and high-reward ventures (Calopa et. al. 2014; Yankov et. al. 2014). From the Finnish perspective, Moilanen (2013) from Institute for Languages of Finland define start-up as a company that is relatively young and whose existence is based on innovative idea.

Paul Graham is an English essayist and venture capitalist. Graham simplify (2012) the definition and outline that start-up is a venture that has been created to grow as fast as possible. The purpose of company is to maximize the growth and everything else is secondary. Everything else that is needed come with the growth. Graham (2012) argue, that the definition is overused and it is being used by companies that are not start-ups. All the new ventures are not automatically startups, only a tiny part of new companies fit into the definition. Steve Blank (2010) says that start-up has repeatable and scalability business model.

An important element to maximize the growth of the venture is that business is investment-readiness and has already passed some stages. When company is aiming to maximize the growth, private equity funding has an important role. One barrier for the growth can be entrepreneur's reluctance to sell shares of firm to outside investors (Mason & Harrison 2001). Mason and Harrison (2001) argue that entrepreneurs do not know benefits of private equity funding and do not know how to attract potential investors. Scientists talk about investment readiness when company has indicated the ability to receive outside funding and filled the requirements of outside investors (Mason & Harrison 2001).

Numerical definition can be found from Eurostat and Organization of Economic Co-operation and Development (OECD) which define minimum 20% annual employment growth for a three-year period and company employ at least 10 persons (Ahmad, 2006).

## 2.2 Venture Capitalist

There are several different definitions of venture capital money and venture capitalism. One conceptualization is that venture capital is an investment on early-stage innovative start-up companies that aims to grow fast. Firstly, VCs can be early-stage investment to seed stage. The money is used in developing a product, market research before the venture reaches start-up phase. Secondly, VC money can be also other early-stage investment to start commercialization, market research and develop the product or service. Thirdly, VC money can be expansion stage investment when money is used in aggressive expansion developing product or entering new market (Coyle 2000; Cumming 2012).

Financing of start-up and other companies have shifted dramatically in last decades. Bank lending has been traditional source of capital for companies but if fell after 1977 while VC money increased as a financial option for companies. VC market was 100 times bigger than it was 1977. In VC market both parties, companies and VC investor need to actively look for partners. (Berkovitch & Levy 2005). The size of VC market in US has raised from 1 billion in 1990 to 160 billion in 2005 (Weidig, Gregoriou 2006).

Florida and Kenney (1988) argue that even though it is not absolutely necessary for high-technology entrepreneurship to obtain VC money, there are some good incentives that help to enter market and networks when obtaining VC money. Usually, VCs have a large contact network that will help venture to grow and find the best partners. VCs also have usually long-experience in the business and different industries so start-up company benefits from this. Availability of VC money attracts entrepreneurs to region and accelerate innovation and increase economy development (Florida and Kenney 1988).

VC companies are major source of capital for start-up companies. In addition to capital, VCs usually offer help with operating services, networks, reputation, general business knowledge and governance expertise (Coyle 2000; Weidif & Gregoriou 2006). Sapienza (1992) argue that high innovation ventures benefit most of involvement of VC company. The investment of VC is usually much bigger than investment of founders. Another characteristic of VC is that they tend to protect their investment by monitoring their investment (Coyle 2000).

Early-stage company does not have cash flow to pay bank debt and interest so VC is the best choice for the company. VCs usually buy company’s shares based on the valuation. After the investment VC companies tend to look for some kind exit for their investment either through IPO, when company is sold to public stock market or acquisition of other company, when other company buy major of shares (Coyle 2000). There are also some other ways to exit that we will explain later in this paper.

**Characteristics of VC providers**

| | Professional Venture Capitalists (VC) | Business Angel (BA) | Corporate Venture Capitalist (CVC) |
|---|---|---|---|
| Source of funds | Investing funds of outside limited partners | Inversing their own money | Investing corporate funds |
| Legal form | General Partnership | Private individual | Subsidiary of large firm |
| Typical size of investment | €2-10M | €50-100K | €2-20M |
| Financial stages | All stages | Seed & Start-up | All stages, later preferred |
| Geographic proximity preferences | Close proximity is preferred | Very close proximity is preferred | Proximity is less important |
| Motive for investment | Equity growth | Equity growth and personal | Strategic value and equity growth |
| Investment criteria | Growth prospects<br>Great Management | Growth and mentoring prospects | Strategic value and "fit" |
| Finding investors<br>Reaching agreements | Regularly timed reporting requirements<br>Financially focused | Varies by individual<br>Generally light | Regularly timed reporting requirements<br>Strategically focused |
| Involvement level<br>Method | Moderate<br>Board membership direct or though syndicate | Low to extremely high, informal | Low to moderate<br>Informal or board |
| Exit planning method | Planned<br>IPO/Trade sale | Often unplanned<br>Trade sale | Often unplanned<br>Acquisition/trade sale/IPO |

**Figure 3: (Clercq, Fried, Lehtonen, Sapienza 2006).**

In the figure 3 Clercq et. al. (2006) have defined characteristics of different kinds of VC providers. In a nutshell, Professional Venture Capitalists (VC) and Corporate Venture Capitalists (CVC) tend to invest on later stages with bigger amount of money while Business Angels (BA) tend to invest at seed phase with smaller amount of money. VCs and CVCs are more professional investors. while BAs are usually non-professional investors. Hellmann and Puri (2002) says that VCs have also a major role with professionalization of start-up firms. Companies that raise VC money will be professionalized faster. VCs tend to cluster together in order to share information about start-up companies.

Hellmann and Puri (2002) used hand-collected data in their survey from Silicon Valley start-ups. Venture-capital-backed firms will usually replace top management team in start-up from outside the company. Venture capitalists also influence on development of other levels on organization with hiring outside resources, introducing IPO plans and formulating human resource policies (Hellmann and Puri 2002). In order to attract outside CEO, VCs are especially important for early stage company that does not have any revenue. They also play role in middle-stage company that already has a profitable business. After IPO attracting an outside CEO VCs does not have a role (Hellmann and Puri 2002).

VC market of USA has been considered as the most efficient in the world. European VC industry is younger and less efficient. European start-ups raised 17.52 billion US dollars from VCs in 2017 (Dow Jones 2017) while US start-ups raised 84.24 billion US dollars (Richter 2018). Investments in European VC industry is less liquid than in US because they find relatively less ways to exit the investment (Weidig & Gregoriou 2006). European VC industry also differ from the US industry with monitoring activity. According to Weidig and Gregoriou (2006) European VC companies monitor less their portfolio companies (Weidig & Gregoriou 2006)

### 2.3 Type of Venture Capitalists

There are several different kinds of Venture Capitalists. Independent Partnership Venture Capitalist. The most typical investor type of VC is **Independent Partnership VC**. Independent partnership VCs raise money from endowments, pension plans, foundations and wealthy individuals. These money sources are called as Limited Partners (LP). Bottazzi et. al. (2008) argue that Independent Partnership VCs are usually more involved in start-ups business activities and monitor their portfolio companies more frequently.

**Corporate Venture Capitalist (CVC)** is another important funding source for start-up companies especially in their later stages. CVCs are subsidiaries of nonfinancial corporations. One important element that distinguish CVC from VC is their role to find potential partner for the corporate company (Chesbrough 2002). Chemmanur and Loutskina (2008) found evidence that CVCs typically invest on riskier ventures and younger companies than VCs. Ivanov and Xie (2010) examined how IPO valuation varies between VC and CVC and found out that companies backed-up with CVC money had usually higher valuation level.

**Financial VC** is VC company that is a subsidiary of bank, insurance company or other financial institution. As well as CVCs, also Financial VCs have also other motivations for the start-up company than just to maximize the return rate. Hellman et. (2008) found evidence that those ventures that had been backed up by Financial VC are likely to get later financing from same institution. Financial start-ups can be important partners for financial organizations in order to complete their strategy (Hellman et. al. 2008).

**Government VC** has multiple motivations to invest in start-up companies. Maximizing the return profit is not the first motivation for Government VC. Purpose to invest in start-up companies is to promote entrepreneurship and innovation (Brander 2008). Lerner (1994) found out that companies backed up by government financing are more likely to get financing from other investor types in later stages and also grow more rapidly.

## 2.4 Start-up financing cycle

There are many different models to describe start-up stages, and Levie and Lichtenstein (2010) found in total 104 different kinds of models. Sources of money varies of stage of Start-up company. In the next figure, it is presented how company use different investor depending on the stage. Venture capital investors are most active in early and later stage. Levie and Lichtenstein (2010) critics life-cycle theories of their misleading roadmaps even though they agree that they are clear way to present. In this paper, we present simple model that present the start-up financing cycle.

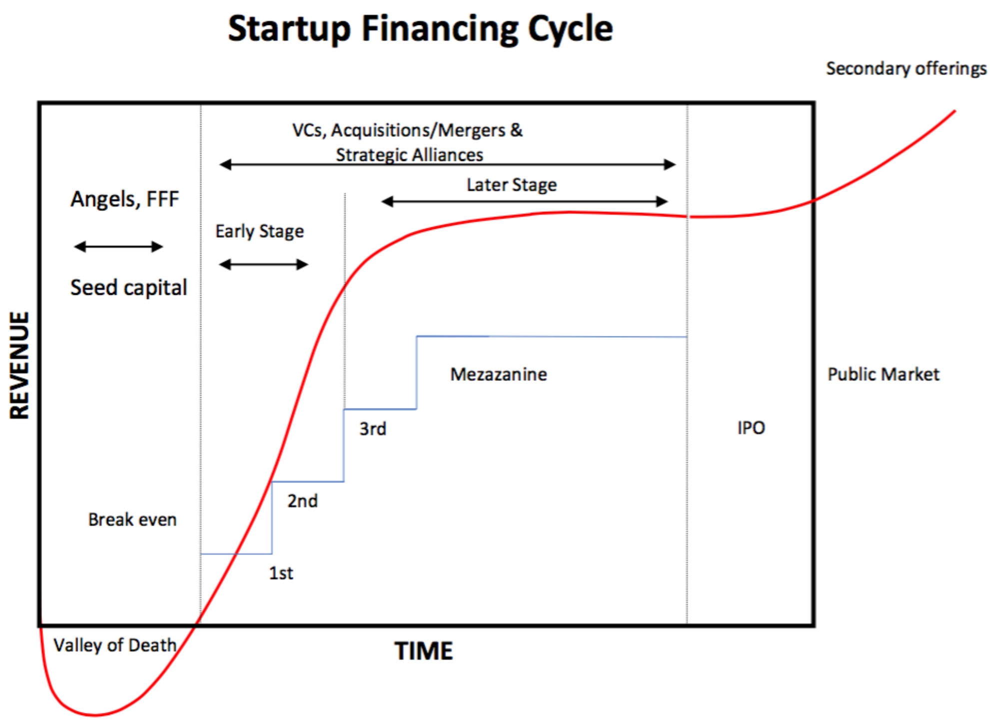


**Figure 4. Different stages of Start-up company (Etula, 2015).**

Following is from Etula (2015) and Coyle (2000) and FVCA.

**Seed stage** is very high risky venture. In the seed stage a start-up company has an idea and a team, but does not usually have an actual product or a prototype. Investments can be used for instance in market research, product development or launching a product or an application.

Typically, in the **Start-up** stage the first version of product has been launched to markets. The company already has some revenue, but it is still unprofitable. This investment is important for the company and it is used to cross the Death Valley. With this investment, company can keep developing its product. Bergemann and Hege (1997) argue that VC money is the most important money source for start-up stage companies.

In **other early stage** firm has already completed product development. The company have already gained national and international users or customers. The venture can already be profitable and the revenue is growing.

The company has already remarkable revenue in **expansion funding**, and venture aims to expand into new customer-and market segments.

**Turnarounds / Rescue** types of financing is relatively rare. The company is in decline but investors are putting more money on venture in order to stop the decline.

**Refinancing bank debt / replacement capital** is money raised from VC and is used to pay debt from the bank.

**Secondary purchase** does not provide any extra money for the company. VC money can be purchased from another VC company. VC company can also purchase shares of founders or other type of investors.

**Buyout** is type of investment and is made to conquer the company. Managers of the company buy the shares of the company with the support of VC money.

## 2.5 Investment process

There are a lot of different kinds of models in order to explain VC investment process. Scientists have developed different kinds of models in order to describe VC investment criteria and investment process. Even though, we have many models that describe VC investment process, VC investment process can be more dynamic and complex than existing models suggest (Petty & Gruberg 2011).

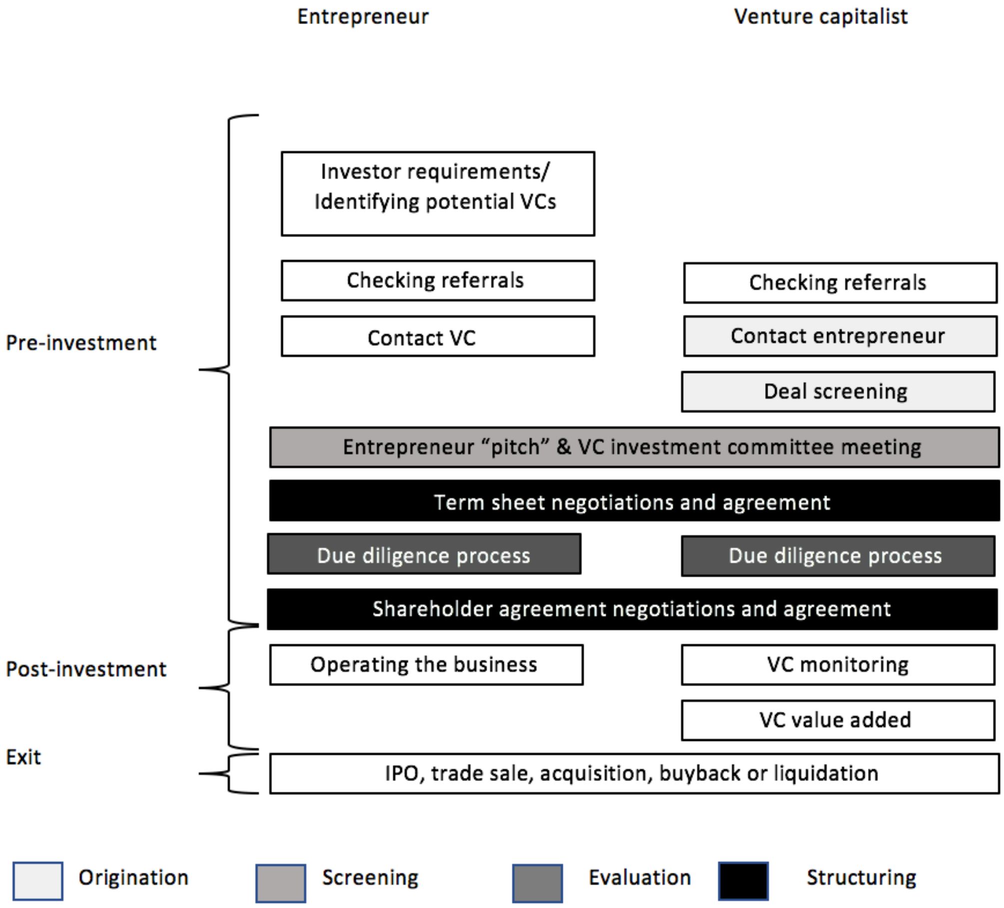


**Figure 5. Clercq, Fried, Lehtonen, and Sapienza (2006).**

One of the key activities of VC partners is to evaluate and judge venture proposals as illustrated in figure 5 (Franke, Gruber, Harhoff and Henkel 2008).

### 2.5.1 Pre-investment phase

For the entrepreneur, it is crucial to know in pre-investment phase what VC investors are looking from start-up company (Clercq, Fried, Lehtonen and Sapienza 2006). In the pre-investment phase, a goal of VC company is to make an investment to a company that provides return for the VC company (Sahlman 1990). VC company is looking for investments that give an absolute profit if venture is successful. For this reason, VC investors are looking for investments are at least half-billion in size (Clercq, Fried, Lehtonen and Sapienza 2006). Expected annual return rates are between 30-60%. For this reason, ventures need to have realistic chance to success and give returns to VC company (Sahlman 1990). From the entrepreneur perspective, the crucial thing is to find an investor that is interested in investing in to the company. Moreover, it is not just about finding an investor but also to get the money from the right investor (Clercq, Fried, Lehtonen and Sapienza 2006).

On the pre-investment phase Clercq et. al. (2006) suggest entrepreneurs to write a good business plan to present to investors because most business proposals are denied based on the business plan. If the business plan is good, it is more likely that entrepreneur succeeds to get a meeting with an investor. Delmar et. (1997) agree with Clercq. et. al. (2006) and argues that there are numerous of studies about the effectiveness of business plans. Forbes (2005) suggest that entrepreneur should be to be realistic and if entrepreneur is not aware of their weaknesses investor can deny the proposal for this reason. Anyhow, a purpose of business plan is to persuade investor so there needs to be more pros than cons (Clercq et. al. 2006).

Clercq et. al. (2006) says that VC investment process can be slow even though the business proposal is rejected. The screening can take up to months. Entrepreneur need to be patient when dealing with VC investors (Clercq et. al. 2006). Entrepreneur do have a choice when choosing a VC investors (Smith 2001). Therefore, it is important for entrepreneur to select the right investor for their company (Clercq et. al. 2006).

### 2.5.2 Post-investment phase

After the investment in order to succeed, post-investment activities are crucial to scale and develop the business. (Tyebjee & Bruno 1984). VC investor usually has two types of activities on post- investment phase; monitoring and providing value-added services (Clercq et. al. 2006). VC investors are typically much more orientated at monitoring their investments than other types of investors such as banks (Sahlman 1990). Entrepreneurs should be prepared to deliver reports to VC investor regularly because of VC's interest on their investment performance (Fried & Hisrich 1994). Value-added services can be (1) building a management team and provide help in recruiting, (2) strategic and operational planning, (3) location additional financing,

(4) networks, (5) replacing management team (Tyebjee & Bruno 1984). Money is the fuel in the post-investment phase but critical is the competence of venture and VC investor. VC investors state that their support is more important for companies than capital (Lerner 2013). On the other hand, Sipola (2015) state that the support varies between VC companies.

Addition to VC company’s monitoring and value-added services, VCs investor usually plays an active role when company is heading to IPO (Megginson and Weiss 1991; Gladstone & Gladstone 2003). Also, VC has reputational role for the venture. Studies prove that ventures backed up by reputable VC investor gain numerous benefits such as attracting potential stakeholders (Clercq et. al. 2006).

## 2.6 Exit routes

VCs seek some kind of exit for their investments. Most typical exit routes are initial public offering (IPO) and trade sale. Venture capitalist can also exit through (1) management buy back (2) Repayment of preference shares / loans or mezzanine, (3) Sale of quoted equity post flotation, (4) Sale to another private equity firm (5) Sale to another private equity firm, (6) Sale to financial institution and (7) Write off (Coyle 2000).

### Initial public offering

The most important thing to go public for start-up company is to gather as much money as possible money from investors (Deeds, Carolis Coombs 1997). IPO is another preferred way for VC to exit from start-up company Cumming 2008). From the entrepreneurs view of perspective, IPOs provide high-valuation. Anyway, IPO also means limited liquidity for entrepreneur because public market is highly aware of big sales in stock market and it can be seen as a signal that company is performing badly (Clercq et. al. 2006). Gior and Schwienbacher (2006) argue that VC backed ventures are likely to go public faster than non-backed start-ups. Lee and Walah (2004) found out that ventures backed up by VC experience underpricing at IPOs. On the other hand, Lande et. al. (2001) found out in their survey that ventures backed up by top venture capital companies get better valuation at IPO.

Lange et. al. (2001) suggest that entrepreneurs should partner with top VC firms and top-underwriters in order to maximize the valuation in the exit. Moreover, successful start-ps are more likely to get top-underwriter without top VC firm, but companies without excellent track record might find it harder (Lange, Bygrave, Nishimoto, Roedel, Stock 2001).

Douglas et. al. (2006) argue that general condition in the economy and the stock market affect dramatically on probability and success of IPO. They also found out that VC monitoring correlate positively on venture performance at IPO. Contrary, Fisher et. al. (2016) found out that this does not involve to all startu-ps and monitoring are not perceived by IPO investors.

There are several benefits for start-up company to have a VC as a partner at exit stage. Investment bankers and auditors try to solve the asymmetric information between public investors and corporate insiders in IPO. Megginson and Weiss (1991) have hypothesized that firms backed up with VC investors can certificate that the offering price is correct and all relevant inside information is available. The VC can solve this contradiction between the parties and can be presented as an objective player for both parties (Megginson & Weis, 1991). Venture capitalists have a significant role with the price of IPO of the company. Megginson and Weiss (1991) proved in a survey that IPO costs are significantly lower with firms backed up with venture capital companies. Additionally, Megginson and Weiss (1991) show that VCs hold a significant number of shares of the firm after IPO. Furthermore, the study shows that presence of VCs

**Trade sale**

Trade sale is another common way for VC firm and entrepreneur to exit the venture. It means selling the shares to institutional investors or other third party (Cumming 2008). Anyway, while the IPO might be the preferred way to exit the company for VC and entrepreneur, trade sale is the most common way (Relander, Syrjanen and Miettinen 1994). Also, Espenlaup et. al. (2011) agree with this view and found in their survey that trade sale is the most common way, while IPO is the second common way to exit the venture. While the IPO can provide higher valuation for the venture, trade sale offers immediate liquidation for VC and entrepreneur (Clercq et. al.). Gior and Schwienbacher (2006) argue that those ventures that are sold through trade sale are more heterogeneous than ventures sold through trade sale.

# 3 EVALUATION METHODS

There is a large amount of literature of VC screening processes and due diligence towards start-up companies. Instead we do not know well enough what entrepreneurs look when they evaluate VCs and what do they think is important (Falik, Lahti and Keinonen 2016). Finnish VC market is relatively small and for this reason it is not easy to find the best possible partner for early stage venture because of limited number of investors. In an efficient VC industry, there are enough VC companies and ventures looking for finance. Without enough number of VC companies in the market, the competitiveness in the start-up industry is not efficient (Sipola 2015).

## 3.1 Meaningfulness of choosing right external investor

In the USA, results of Smith (2001) indicate that 97 per cent of companies that have passed seed-stage and the death valley received more than one offer. Smith (2001) also resulted that 40 hours was the median amount that entrepreneurs used when evaluating VC offers. In the survey, also the number of VC offers was asked from entrepreneurs and the median was 3,18. The results are from the USA, which has the most developed start-up ecosystem in the world so as such it cannot be compared to Finland.

Importance of right partners with good reputation has been proven in the previous literature (Hall 1992). Firm reputation is an important intangible asset and firm can benefit from the reputation of their close partners (Hall 1992; Lange et al. 2011). Studies prove that choosing a right VC partners is an important choice for a start-up company. Previous studies indicate the huge value of right VC partners for high-growth companies. (Hallen & Pahnke 2016). While definition of high-quality partner varies, a common conceptualization is the stakeholder's collective perception of company's track record (Lee, Jin, Lashley 2015). Even though a common conceptualization bases its definition on VCs previous success and track record, privacy about VCs profits limits the details about the previous success. Therefore, it is not easy to evaluate past performance of a VC firm (Hallen & Pahnke 2016).

Based on previous literature we know that entrepreneurs evaluate venture capital companies at some level (Smith 2001; Zheng, 2001; Hochberh, Ljungqvist, Lu 2007; Hallen, Pahnke, 2016) Anyway, entrepreneurs do not have formal evaluation criteria. Instead, most of professional VC companies do have structured evaluation criteria when choosing entrepreneurs (Franke, Gruber, Harhoff, Henkel, 2008).

Nahata (2008) found in their study positive outcome on companies exit route among venture capital packed companies. Companies backed by reputable VCs are more likely to do successful exit. They also have a faster access the public market and have higher valuation at IPO. Nahata (2008) claim that their study has important implication both to limited partners (LPs) and entrepreneurs when screening potential VC partners. Botazzi et. al. (2007) found that more experienced venture capitalists do have more active role in recruiting management team and in overall they interact more frequently with their portfolio companies.

### 3.2 Evaluation methods

There are several different studies how entrepreneurs evaluate venture capital investors.

The valuation of the company is one of the key issues of private equity funding. Particularly less experienced entrepreneurs are more concerned about valuation. More experienced entrepreneurs are more interested in value added services VC can provide for the invested firm (Falik, Lahti, Keinonen 2016).

Smith (2001) examined sample of 152 entrepreneurs who have evaluated venture capital investors. Smith (2001) found out that entrepreneurs' trust most on three sources when evaluating VCs. Those three sources are other entrepreneurs, venture capital investors and entrepreneurs own experience. Smith (2001) argue that it is paradoxical because it is difficult to get an accurate image of venture capital investors and even the most experienced entrepreneurs have limited understanding of it. Surprisingly, results show (Smith 2001) that entrepreneurs rarely rely on services and knowledge of lawyers and consultants who have been traditionally considered as reliable resource of information.

Forbes (2003) examined entrepreneurs' overconfidence what comes to the valuation of venture. He found out that founder managers used to be overconfident of their companies while hired manages used to be more realistic. Anyway, Forbes (2003) argue that entrepreneurs are heterogeneous population and this cannot be generalized. Smith (2001) found out that entrepreneurs age, firm decision comprehensiveness and external equity funding effect on the degree of overconfidence.

From previous literature, we can classify attributes that entrepreneurs look from venture capitalists in to four different types of criteria (1) Valuation (2) value added services (3) reputational factors (4) VCs attributes (Macmillan et 1988; Fried et. 1995; Sapienza et. al. 1996; Smith 2001; Croce et. 2013). Literature also suggest that most entrepreneurs seek balance between these four criteria. Hallen and Pahnke (2016) argue that entrepreneurs tend to easily rely on those resources that are easily available and ignore deeper analyzes of their potential VC partners. Surprisingly, less experienced entrepreneurs tend to look more information about VC background than entrepreneurs with extensive experience (Cooper 1995). Westhead et. (2005) argue that entrepreneurs with extensive experience may have better understanding of VCs and they do not need to spend that much time on searching of information. On the other hand, Westhead et. (2005) found out that experienced entrepreneurs used more sources while less experienced were concentrated on few sources.

Smith (2001) argue that valuation of VCs is highly variable because of the uncertainty of success. Start-ups unlikely do not have any tangible assets so valuation is based more on predicted success. Valuation of the company is still one of the most important things for entrepreneurs (Smith 2001). Muzyka (1996) suggest entrepreneurs to care less about the valuation and focus on how venture capitalists can fill their weaknesses. Muzyka (1996) also suggest entrepreneurs to shop around investors internationally and not to care about location of VC. Additionally, they suggest entrepreneurs to choose VC based on their competences.

Macmillan et. al. (1998) recognized four different distinct areas of involvement; financial participation, management selection, personnel management and development and operations. Some researches see board involvement of VC as a great value-added service for a start-up company. In this way VC investor is closer to the company and can direct it to desired way (Macmillan et. al. 1998). Rosenstein et. al. (1993) interviewed entrepreneurs and found out that board members from VC company with operational experience is seen particularly important in start-up company. Investors with only financial types are not seen as relevant board members. Rosenstein (1993) suggest that entrepreneurs raising money from VC only for monetary reasons, should find an outside board member with operational experience from somewhere else. Sapienza et. al. (1996) also argue that VC investor can add value to the company at being with close relationship with portfolio companies. VC companies highly vary on this feature. Some of the VCs have and hands-on attitude and put a lot of resources on their portfolio companies while some of them put a little effort on their portfolio companies expect at monetary level. VCs themselves see their role as sounding board and financial help as important thing for the portfolio company. Interpersonal role was as second important value while third important value was their networking role (Sapienza et. al. 1996).

Sapienza et. al. (1996) found three cases when VCs add most value for start-up companies (1) portfolio company lack resources (2) environment uncertainty (3) VC had proven track record and overall experience. VCs can have many kinds of indirect positive impact on their portfolio companies. Fired and Richer (1995) found out that good reputational image of VC company will be transferred to their portfolio companies. They also argue that VCs networks are a major source for looking employees to the ventures. Not only top-management team but also to lower-level positions.

Ventures grow with same speed before and after VC investment. There is no difference between VC backed companies and non-backed companies with their growth. The difference can be seen after first round of VC investment (Croce, Marti Murtinu 2013).

Sapienza et. al. (2016) found out some other important elements that explain intensity of VC investor. VC company tends to be more active on post-investment activities and monitoring when (1) venture is on their early stage (2) when the venture is receiving milestones and success. When company is not performing well or it’s already on later financing rounds VCs are not that interested in being actively in contact with their portfolio company. Overall Sapienza et. al. (2016) suggest entrepreneurs put effort on when selecting VC partner and developing relationships with them.

Entrepreneurs appreciated similar personality that is compatible with the company culture (Smith 2001). Valliere and Peterson (2016) argue that especially when experience of entrepreneur increases they are more interested in of personality compatibility.

Entrepreneurs with no previous start-up experience used to give more weight on VCs network. This can be explained because novice entrepreneurs might lack wide contact of networks while more experienced entrepreneurs have already established their contact networks. One the other hand, the importance of VC networks decreases when entrepreneur begins to establish their own network of contacts (Falik, Lahti Keinonen 2016). Valliere and Peterson (2016) found out in their survey that the three most important selection criteria were valuation, personal compatibility and terms of conditions.

Previous literature has also examined how entrepreneurs experience relates on their attitudes towards contractual terms. Valliere et. al. (2007) found in their survey that terms of conditions are one of the top selection criteria. Falik et. al. (2016) found out that more experienced entrepreneurs put higher emphasis on contractual term, while in contrast Valliere (2007) found out that novice entrepreneurs are particularly interested in contractual terms. Entrepreneurs with extensive entrepreneurs were particularly interested in details and relationship with VC while terms and conditions also presented important role. There are some expectations. Entrepreneurs who are looking for VC money for monetary issues are less concentrated of network of contacts of VC (Falik et. al. 2016).

From reputational factors entrepreneurs in Smith (2001) survey put a lot on weigh on previous success of VCs portfolio companies. On the other hand, when inexperienced entrepreneurs are looking for VC company for their reputational benefits, they are less concerned about valuation issues. From less reputational VCs both more experienced and less experienced entrepreneurs expect higher valuation than from reputational VCs (Falik et. al. 2016). Hsu (2004) also address the reputational element of VC companies. They found out in their survey that more reputable VC companies were able to give 10-14 percent lower valuation for ventures in their first rounds because of their good reputation. Lee, Pollock and Jin (2011) suggest that entrepreneurs should accept the lower valuation from reputational VC companies. On the other hand, Lee et. al. (2011) argue that combination of good reputation and industry experience is the best match.

Lande et. al. (2001) highlight the IPO valuation depending on VC reputation. They argue that ventures backed up with more reputable VC companies get higher valuation at the IPO. Nevertheless, Lande et. al. (2001) do not think it is necessary to have top VC company as a partner for start-up company but it will predict higher valuation at the IPO. The importance of VC company increases at the later rounds of start-up life cycle. In the begin Lande et. al. (2001) suggest accepting offers also from non-top VC companies. On the other hand, entrepreneurs equally value if the exit happens through an IPO or acquisition (Smith 2001).

Smith (2001) found out that entrepreneurs appreciated experience on similar industry and amount of available capital for venture. Muzyka (1996) suggest entrepreneurs to raise money only from those VC companies that have experience from the industry. VCs themselves are likely to fund also companies that are not from their industry specialization. The priority of the funding philosophy is to invest in good business deals (Muzyka 1996). Lee (2011) agree with others and argue that investment with similar industry will have beneficial consequences and better firm performance.

In a nutshell, novice entrepreneurs are looking for quick money from VC companies and do not understand the importance of long-term relationship with VC company. Entrepreneurs can also be blind about their evaluation criteria and tend to think that they look enough information from VC companies. Anyways, many studies have found out that this is not true. Entrepreneurs tend to be overconfident, use little time on finding information of VC companies and rely on few easily available information sources (Muzyka 1996; Smith 2001; Forbes 2005; Valliere & Peterson 2007; Falik, Lahti, Keinonen 2016).

### 3.3 Investment criteria of venture capitalist

Academics have studied the topic for more than four decades but still we do not have one answer what VC investors are actually looking for when they are evaluating investing proposals (Muzyka 1996). The reason can be that different VC investors tend to stress different characteristics of venture and entrepreneur. Some of the VC companies stress entrepreneur's own characteristics while some investors are more looking at survivability of venture and financial matters (Monika & Sharma 2015).

Studies from 1980s and 1990s have been occasionally criticized by following scientists. Academics argue that self-completed questionnaires and retrospective questioning gives limited understanding and weak validity for studies. In these kind of studies, academics believe that investors might answer how they think they make their investment choices and do not give answers how the choices are actually being made. Therefore, investors might answer how they are expected to answer and cannot answer reliably. Investors also stress facts on their investment criteria and under-stress criteria of survivability of venture (Kollmann & Kuckertz 2010).

VC companies are strict about their investment criteria, only 1% pass to the final stage and investment is made. Therefore, for start-up company it is important to know what investors stress in their investment criteria (Fenn, et. al. 1995). Sipola (2015) argue that the investment criteria vary depending on the investor and their philosophy of investing. Also, Monika and Sharma (2015) agree with Sipola (2015) and say that criteria differ based on industry, geographic location, stage and size of investment. Monika and Sharma (2015) argue that in order to pursue successful investments, VC company does not necessarily need actual investment criteria. VCs are not self-aware enough in order to give an accurate image of their own investment criteria. Anyway, Monika and Sharma (2015) conclude that VCs follow multi-criteria selection process and they address different things on ventures. Some of VCs are more interested in financial and marketing perspectives and some of VCs give more importance on entrepreneurs' characteristics.

Market growth, size of the company, the expected rate of return, the risk level of the venture and product and service offering are some of the criteria VC partners use when screening venture proposals (Franke, Gruber, Harhoff, Henkel 2008). Franke et. al. (2008) also found evidence that entrepreneur's characteristics are main determinant for decision making. Five of ten most important criteria were about entrepreneur characteristics and personality.

Zacharakis and Meyer (2000) divided VC investment criteria on four different categories (1) Entrepreneur and team characteristics, (2) product and service characteristics, (3) market potential, (4) financial matters. Dimov, Shepherd, Sutcliffe (2007) argue that investment choices by VC firm are strongly depended on their own expertise.

Franke, Gruber, Harhoff, Henkel (2008) examined what VC are looking from ventures before the investment. Results show that experienced VCs are more interested in the team cohesion while less experienced VCs tend to focus on characteristics of individuals. Macmillan et. al. (1985) argue that the decision is not made based on the market, product or financial criteria but in the end entrepreneur and team cohesion determine decision making. Also, Franke et. al. (2008) argue that in the end, investors make their decision based on the quality of entrepreneur.

On the other hand, Franke et. al. (2008) found in their survey that VC companies are looking more at team cohesion than individual entrepreneurs. For this reason, it is crucial for the startup company to find members to their team that strength their weaknesses. Therefore, company should actively look for missing pieces in order to fill team cohesion criteria from VC investors. Companies in their recruitment process should hire those members to their firm that best complete the team (Franke et. al. 2008).

Product and service characteristics are not in top three most criteria in different studies (Zacharakis & Meyer 2000; Franke et. al. 2008; Kollmann & Kuckertz 2010). Anyway, Boocock and Woods 1997 found evidence in the survey from UK that product differentiation being one of the most important characteristic for VC investor.

Boocock and Woods (1997) found in their survey that market characteristics play a big role in VC investment criteria. Anyway, also they found strong evidence on entrepreneurial characteristics but do not see it above market potential in the investment criteria. Also, Jing (2007) stress in their study from China, market characteristics as an important aspect.

Muzyka (1996) found evidence in their study that exit possibility is one of the top criteria for VC investors.  Also, Tyebjee and Bruno (1984) argue if the proposal was rejected from VC investor the major reason was the risk and return perceptions.

Anyway, Zacharakis and Meyer (1995) suggest staying on simple models and argue that too much information can make it difficult to make the investments. Pennington and Hastie (1986) state that cognitive overload and story incoherence favor to stay in simple models. Previous research show that VC companies with higher finance expertise choose fewer early stage investments and focus on later stage in their investment criteria (Dimov, Shepherd, Sutcliffe 2007). Sorenson and Stuart (2001) found evidence that VCs often specialize on one industry.

# 4 EMPIRICAL RESEARCH DESIGN

This study consists of two separate units that are linked together. This paper begins by explaining what are the major historical forces that have resulted emerging of start-up industry. In the theoretical framework characteristics and key players of start-up industry are defined. In the previous chapter, due-diligence process is explained and how VCs and entrepreneurs have evaluated each other in past decades. In this chapter, empirical research design and methods are described. Furthermore, we explain data collection method and method of analysis.

## 4.1 The research method

The chapter describe the research method of this study. The research method describes used methods how new information is gathered of the world (Tuomi & Sarajärvi 2017). Researches are usually distinguished into quantitative and qualitative research. The key difference between quantitative and qualitative data is the flexibility with the research method. Qualitative methods are more flexible comparing to quantitative methods while quantitative methods are usually rather inflexible. Qualitative data is usually more verbal whilst quantitative data usually consist of numerical data and statistics (Mack, Woodsong, MacQueen, Guest, Namey E. 2011).

In order to understand how Finnish start-up companies, conduct due diligence of their potential VC investors we chose to conduct qualitative research in this study and analyze the data with content analyze method. We chose to study the phenomena in qualitative research content because it can provide deeper understanding and richer data of the topic (Nishishiba, et al. 2014). Qualitative research tends to ask rather “how” and “why” questions instead of “how many” (Nishishiba et. al. 2014). Qualitative research aims to understand individual’s or community’s experience of chosen topic. It also aims to understand different perspectives of the topic (Quinn 2002).

In qualitative research data can be transcribes, photographs, videos, audio books etc. Qualitative research is not only interested in the outcome but the whole process. The qualitative data is analyzed inductively. Deductive reasoning state one or more hypotheses and the study is trying to prove or disprove the statement.  In inductive reasoning th data is not trying to prove or disprove anything. Theory comes from the bottom up rather than top-down (Bodgan & Knopp 2005). Inductive reasoning is better when providing new knowledge of the topic (Halliday 2016). Our purpose is to provide new knowledge of the topic so we chose inductive method in this study.

### 4.2 Data collection and method of analysis

In qualitative research data can be collected in many ways. The data in this research is primary data and gathered through interviews and it is collected solely to this particular study.

Interview types can be distinguished into open interviews, semi-structured interviews and structured interviews. In structured interview, there are a set of standardized questions that are asked in the same way and same order with each participant (Wilson 2013). Semi-structured interview gives more flexibility to both interviewer and participant and follow-up questions can be asked spontaneously (Brinkmann 2014).

We chose to collect the data through semi-structured interviews. Semi-structured interview has its own benefits as a research method. 1) The researcher can ask follow-up questions during the interview, 2) It helps to understand more deeply the gathered information and 3) It allows researcher to ask argumentation for presented opinion (Hirsijärvi, Remes and Sajavaara 1997). Semi-structured interviews are also a good method when there is only a little research of the topic (Hirsijärvi, Remes and Sajavaara 1997). Semi-structured interview questions are open-ended questions and let participant freely answer to the questions with their own words. It is also suitable interview method in qualitative research (Mack, Woodsong, MacQueen, Guest, Namey 2011).

We chose to interview seven different start-up companies to this study from Helsinki area. One participant was chosen from each company. All the participants were co-founders and CEOs of the ventures. We asked fifteen to twenty-five questions from each participant. The research template can be found on appendix 1. The questions of the template are drawn from previous research of the topic. Questions are open-ended and give an interviewee possibility to answer on their own frame. In order to get better and deeper answers, questions tend to be more complex so respondents cannot answer with yes or no answers. (Bogdan & Bilken, 2005; Mack, Woodsong, MacQueen, Guest, Namey 2011).

The structure of the interview was similar with each participant and the order of the asked questions was similar with each participant. As the semi-structured interview method gives flexibility to ask follow-up questions during the interview, the questions varied slightly with each participant. The participants did not have any initial pattern of questions before the interview and all questions and information was provided in the interview setting. Interviews were held during the fall in 2017. The first interview was held on 15th of November and the last interview was held on 22nd of December. Five of the interviews were conducted on face to face meeting and two of the interviews were conducted on the phone. Interviews that were conducted in meetings were held on cafes, restaurants and offices of the companies. The length of the interviews varied from fifteen to thirty-five minutes. Mispresenting with interviews may arise when participants are not telling the whole truth about the subject or they are not able to express themselves (Bengtsson & Mariette 2016). Participants were encouraged to answer openly and freely to the questions. The atmosphere in the interviews was relaxed and interviewees were interested in sharing their thoughts about the subject. Overall, the interviews were successful and answers fit well to our research question. The interviews were recorded and transcribed later. The language of interviews was Finnish. On total, transcribed material was about 27 pages long.  In this study, we chose to analyze the gathered qualitative data with content analyze method.

The content analyze can be used in all kinds of text no matter of where the data is fathered. In this study, the data is gathered through semi-structured interviews. Content analyze try to compare the data, find similarities and differences. The method can be inductive and the themes emerge from the data through constant comparison and examination (Zhang & Wildemuth 2005). Inductive reasoning is especially common when there is a little research of the subject (Zhang & Wildemuth

2005). In this study, some of the themes come from the previous literature but because of the lack of research some themes emerge from the data.

The first step in qualitative content analyze is to transcribe interviews (Bengttson & Mariette 2016). Erlingsson and Brysiewicz (2013) divide process into five different steps. First, researcher try to find patterns from the text. Secondly, the text is divided in to smaller parts called meaning units. The third step is called condensation when meaning units are shortened, but keeping their core meaning. The fourth step of the process is to group coded condensations into categories and each category is label by a code.

### 4.3 Selection of the companies

In order to get an answer to our research questions we chose Finnish start-up companies who have evaluated venture capital investors. Companies were found from various online databases and some of them were already known by the researcher. In the beginning, it was difficult to reach companies that fit to our criteria and some of the reached companies did not reply. Selected companies were reached through e-mail or LinkedIn messages and some of the companies were reached through connections.

Companies were selected by specific criteria. Graham (2012) define Start-up company to be a venture that aim for rapid growth. We chose companies that aim to grow fast and fit to our theory framework of start-up industry. We selected Finnish start-up companies from Helsinki area. Selected companies are from different industries. All of the selected companies have not raised venture capital money yet, but they have evaluated investors. The only absolute criteria for selected company was that they had to have evaluated venture capital investors as potential partners.

Selected companies have been founded between years 2002 and 2015. Revenue of the companies vary from zero to ten million euros. Five of the companies are on the seed stage, one of them is on A-series and one of them is already acquired. Funding amount of the companies vary from one million to fifteen million euros. Number of employees vary from eleven to one hundred twenty employees. All the participants have university degree and they all are part of founding team and CEOs of the companies. Relevant working experience vary from four to twenty and working experience in the current organization from two to fifteen years.

| **Company** | **C1** | **C1** | **C3** | **C4** | **C5** | **C6** | **C7** |
|---|---|---|---|---|---|---|---|
| **Industry** | Market place | Health care | Saas | Entertainment | Customer | Logistics | Health care |
| **Founded** | 2015 | 2012 | 2015 | 2014 | 2016 | 2002 | 2012 |
| **Location** | Helsinki | Helsinki | Helsinki | Helsinki | Helsinki | Espoo | Espoo |
| **Revenue** | 0-1 | 5-10 | 0-1 | 0-1 | 0-1 | 5-10 | 0-1 |
| **Last funding type** | Seed | Seed | Seed | Seed | Series-A | Acquisition | Seed |
| **Total funding amount** | 1-10 | 10-50 | 10-50 | 1-10 | 10-50 | 0 | 1-10 |
| **Number of employees** | 11-50 | 101-250 | 11-50 | 11-50 | 11-50 | 11-50 | 11-50 |
| **Education** | MSc of Science | MSc. of Science | MSc. of Science | MSc. of Science | BSc. of Science | MSc. of Science | MSc. of Science |
| **Current title** | CEO | CEO | CEO | CEO | CEO | CEO | CEO |
| **Founder** | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| **Relevant work experience** | 4 | 12 | 10 | 15 | 15 | 17 | 20 |
| **Work experience in current organization** | 2 | 6 | 2 | 3 | 2 | 15 | 6 |

**Table 1. Selected companies.**

# 5 EMPIRICAL ANALYSIS AND RESULTS

This chapter describes the result of our data.

## 5.1 Emerging relationship between entrepreneur and investor

Venture capitalists tend to have structural process when evaluating new venture proposals. Our data shows that Finnish start-up companies do not have systematic or structural process how due-diligence is conducted of potential VCs. They deny having exact day or time when they begin to evaluate potential VCs. Relationship between entrepreneurs and VCs are built in months or years and the process is social and unstructured.

*"There is a lot of hazardousness and on the whole an idea that entrepreneurs need more VCs than VCs need entrepreneurs even though that would not necessarily be the whole truth. It is an interactive process as a whole. It is not like you go on the Internet, choose 200 different VCs and the final result is three. It is an interactive social process, you get to know people and mutual belief that you should work together and mutual understanding of developing the venture." C2*

It is crucial for the relationship get to know each other working habits, philosophies and values. Especially in the early-stage the process is even more unstructured and fragile. As the previous literature shows, VCs tend to invest on people rather than an idea. Entrepreneurs agree with this.

*"These investments on start-ups are not made on facts. They invested on us 16 million euros so the money is invested on people not into the company."C3*

Those start-ups that raise pre-seed money evaluation of VCs is more scarce than due diligence of start-ups in later stages. Start-ups on pre-seed stage also used to have less structural process and spent less time on evaluating VCs. One particular reason that stand out from the data is the lack of time and lack of resources for this.

*"We were really busy and we had lack of time. I could say that we could have invest more time on everything. At the end, the evaluation mostly was only the meetings with the investors. If we did not have total disagreement, the investor was accepted. Afterwards, I can say that maybe there was not enough due diligence of them." C1*

Even though, entrepreneurs do not like to talk about structural process how they conduct due diligence of their potential VC investors similarities with the due diligence and information seeking can be found among start-ups. Websites and personal connections are the two most important sources to start seeking for information about VCs for less experienced entrepreneurs. More experienced entrepreneurs rely more on their personal network so the structure of the process is slightly different. Webpages are also seen as less valid in order to look information of VCs.

*"Websites are always more or less only marketing speech. Good investors only put on websites where they have invested and that's it. Because they know that they cannot communicate on webpages what they bring to the table."C4*

Our data shows that Finnish start-up companies do not spend enough time for evaluating VC investors. Many times, money is raised from VCs without evaluating them properly. There is a correlation between the time used on evaluation and satisfaction of the choice of VC. Those entrepreneurs that spent more time on evaluating VC investors are more satisfied of the outcome of the VC involvement. Those entrepreneurs who spent less time on evaluation, criticize more their VC investors. The reason for less evaluation is natural. The venture lack of money and investors need to be found fast in order to keep the venture alive. Possibly, you have no time to evaluate investors or even though VC was evaluated and investor does not fit to all criteria money is raised because of the hurry. The criteria of the start-up are getting looser all the time as the venture is spending their existing money. From our data, only one of the respondents say that they did spend enough time evaluating VC investors. They also are very satisfied with their investor.

*"I would say... We spent about five months evaluating VC investors. Absolutely we spent enough time evaluating them." C5*

In conclusion, start-up companies on pre-seed stage raise money with less criteria and spend less time on due-diligence process whilst ventures in later stages spend more time on due-diligence and have more criteria which VC is chosen. Because of the social aspect of the process, entrepreneurs neither in the pre-seed nor A-series stages have matrix or structural process when choosing a VC. Entrepreneurs talk about how decision is made based on the intuitively feeling. Overall, start-up companies say they do not spend enough time evaluating VC investors. Entrepreneurs tend to focus on operational tasks and less evaluating VCs. Another reason for hurry with the business, was lack of cash in the company. When the company is going to bankrupt, money need to be raised fast and less criteria.

*"The best possible situation for investors is that they can say, let's see one more year. When the timing is fully optimal they are willing to invest. There is no risk and probably venture is going to bankrupt that they can invest cheaply. It is the thing you have to fight against as an entrepreneur. Same time you have to get a high valuation for your company and same time "yes" from the investor. That is the balance." C4*

## 5.2 VC attributes

Some of the VCs characteristics and traits are rather inflexible and come by nature. These are characteristics that effect also when choosing VC investor for a start-up company. These reasons can be industry of the VC, size of the VC and location of the VC. These can be seen rather easily but still need to be considered when making a research how start-up companies evaluate VC investors and why particular VC was chosen as an investor.

Investment sector is a very important thing for entrepreneurs. Previous investments in the same industry where start-up is working is one of the most important reasons why particular VC was chosen or why particular VC was dropped out. If the VC does not have any experience in the industry, probably it cannot bring anything else to the table besides money.

*"Of course, the industry focus. If you see already from their portfolio that it is not even close to our industry it is not even worth to meet. Because probably they do not know anyone who invest on our industry so it is just time-waste for everyone." C4*

One of our companies in this research is in hardware business they realized that besides investments in the same industry are important, investments in hardware business are also equally important for them.

*"In our case we do hardware business. We learned fast in very early stage when we started to look for the VC investors that they had to have invested in hardware before. Otherwise it is just wasting time in our case. Maybe this is generalizing, but look for the investment from those VCs that have invested in your industry before. It also feels like that VCs are especially about hardware that it is not assimilated in industry but it is kind of own dimension. If you have never invested in hardware, you will not invest in this time either. For us, it was one of the main criteria."C5*

Location as a selection criteria cannot be overestimated. It might seem like in the first glance it is not important where the VC is located. Anyway, by the nature usually in the early stages VC is located in the same country or at least in the same continent as start-up company. The main reason to choose VC investor from the same country is natural but there can also be other reasons to choose VC which is close to start-up.

*"For us it was important that the VC is based in Europe so we are in the same time zone. We had already potential partner and our negotiations were pretty far with a VC from US but we decided to raise money from UK investor for practical reasons. It is easier to work with them when you are in the same time zone. VC investors are bringing other things that money to the company so we can now closely work with them" C5*

Good understanding how VC money works helps entrepreneurs do an accurate selection of VC investor. VC companies raise money from LPs in regular cycles and knowledge when they last time raised money from LPs helps entrepreneur to understand how long they are making investments.

*"If the fund is about to end soon and they have not raised money for last years from LPs it's a good question if this VC is willing to make reinvestments or if the whole VC company is going to exist in few years" C4*

VC companies usually have specific amount of money and specific start-up stage where they are willing to invest. Therefore, it is important for the start-up to look investments from VCs that are focused on investing their size of businesses.

*"Of course, VC has to be the right size, there is no reason to try raise money from the too big VCs because it is waste of time for both parties." C5*

Some respondents told that they had situations when VC with little money was willing to invest in their company and offered a bad offer.

*"We do not do anything with half-million euros because our annual profit is already bigger than half-million euros. It is not worth the effort to take that size of investment" C6*

Portfolio of invested of VC can be a reason to choose a particular VC investor.

*"It helps if there are companies in portfolio that you would like to work with. VCs many times want that their portfolio companies also work together. They want that things between their portfolio companies work better than anywhere else, so this is also noticeable." C5*

Additionally, due diligence process of VC can also be too long for a start-up company when they have raise money fast.

## 5.3 Philosophy and values of VC investor

Philosophy and values of the VC company can be an important factor for a start-up company when selecting an investing partner. In our study, respondents talk about values, mutual understanding, same goals and mission, founder focus and intuition in their selection criteria.

Conflicts between outside investors and founders are possible inside the company. In order to minimize conflicts detailed contracts between two partied reduce risk of the conflict. First and foremost, it is crucial to have similar kind of understanding how company should be developed and where each party see the company in few years. Getting to know each other before the investment decision reduce conflicts. If investor and entrepreneur have different kind of views about the future of the company the investment decision will take longer and possibly never happen. Often entrepreneur is in the position by nature with a new innovative idea when they have to explain their existence and mission for investors and outside world.

The weight of VC's values is depending on of the sensitivity of start-up's business. One of the studied company is working in a sustainable business industry when specific values and green thinking are important part of the business. For the company, it is crucial that it will not be associated partnering with parties that are associated in unsustainable activities.

*"For us it was an important that the investor has same kind of values…. First and foremost, the most important thing was the similar core values with us… One of our mission is urban sustainability and if the investor was not interested in this kind of things, things just won't work."C1*

It is common that general partners of the VCs have been founder themselves in the past. Our data shows, that entrepreneurs have respect for these companies and believe that VC companies with entrepreneurial mindset can understand start-up visions better.

*“I would say that the most important characteristic of the VC is this kind of founder focus in their business. The best possible situation is that general partners have been founders themselves in the past and they truly invest on entrepreneurs. Many of the VC companies are ran by bankers from and they can have experience in big investment banks. Those VCs are extremely good at raising money from LPs. But these folks invest like bankers, like in the same way they invest in stock market. Our business requires investors of entrepreneurial mindset. C4*

Values could also have been in the term sheet if they were not seen in the meetings. Founders and investors can have disagreements on how much new recruitments should be included to the option plan.

*“We had disagreements among existing investors and founders what kind of sources we should consider when raising new money. Some of people liked the idea of the crowdfunding while others thought it is a suicide. Another conflict that can appear is the equity policy inside the company. We had discussions how many new recruitments and who should be included to the option plan.”C1*

Exit strategy can also be a conflict between investor and the founder. Traditionally, an ideal exit for VC is through an IPO.

Intuition and feeling cannot be well-explained but entrepreneurs seem to put a lot on weight on that.

*“We had the feeling that this is not a good investor for us.” C2*

*“With our current investor, the thing was that our chemises matched right away and we knew that our collaboration will have a great flow.” C5*

### 5.4 Value-added services

VC investors add value to the companies in which they invest. Besides money VC can provide their portfolio companies access to VCs networks, help portfolio companies to make partnerships, present as sounding board, provide support in legal issues and help with market making and PR issues.

In order to expand the business in to other countries international networks, become crucial for start-up company. Our data demonstrates that international networks and international presence is one of the key value-added service entrepreneurs look from the VC investors. US market can be especially tricky for start-up companies and the market is much easier to access with VC investor on the board.

*"It is important that the investor can bring international presence to the company. If you are an investor from US it is totally different thing comparing to European investor. European investor, only very few of them are good in US market. If you want to make your business in US, it is better to have US investor. It requires certain things before it is even possible in theory. They neither invest in companies that do not have significant presence in US market." – Blueprint*

Many of the entrepreneurs do not see that relevant VCs possible connections to Finnish VC market. Respondents address Finnish market to be small and most of VC investors are already known and all the key players in the VC market. Nevertheless, in pre-seed stage when entrepreneurs are either young or do not have experience from the certain industry, also Finnish VC investors and their networks can make contribution to the business.

Some VCs do have good track record and great connections but necessarily they do not make contribution to the business. Possibly start-up already have had access to the same networks or they have similar experience themselves with the VC company.

*"If we look at the VC investor from Finland we were only interested in money. Finnish VC companies did not bring a lot of added value to our company. Possibly you get on the board your ex classmates and you have pretty much same experience with them. Probably they were good people but they could not bring anything else to the table besides money. We were more interested in international VC companies because they had different experience and access to different networks."C6*

Overall, our data relives that entrepreneurs see VC investor as a strategical partner that can make contribution to the business especially through their networks. Data shows that international connections are seen relevant among all respondents. This data shows that contacts in Finland are less valued among entrepreneurs. The size of the Finland VC industry can explain that.

### 5.5 Track record and reputational factors

VCs past success and past performance align how entrepreneurs respect the VC. Reputation and track record are important things for entrepreneurs when choosing a VC investor.

Reputation seems to be even more important aspect than VCs previous success with their investments. Finnish entrepreneurs are keen to know if VC is ethical and understands and listens to entrepreneur. When entrepreneurs talk about ethics of VC they usually mention fair deals with founder team of shares and that VC company have not been associated any kind of suspicious or criminal activities.

*"One of the investor that was considered was dropped out because we heard rumors that they might soon get bad reputation. We thought that maybe it is safer to stay out from that investor that we will not be associated with this particular VC. C5*

*"One of the key reason to drop out VC was if they could be a threat for the brand of the start-up. If we had a feeling that it does not fit to our philosophy. If it is published probably people do not know what kind of investor it is but if it is clearly an investor that there might be some suspicious people behind that we did not want to be associated."C1*

Some of the VCs have reputation being banker style investors. They invest bigger amount of money with less support for the start-up company. Our data shows that entrepreneurs feel unfamiliar to work with banker style VCs in the beginning of the start-up cycle. They want VCs to be close partners. They expect VCs give support and strategical advice for the company.

*"When you look at their portfolio and you do not know or respect any of the VCs portfolio companies so probably they invest on these businesses that are these kinds of simple businesses for instance e-commerce. You build them step by step from zero to 100 million and that's it. Our business is not like that so it is not worth to talk with them. These VCs have focused on investing these kinds of companies." C4*

Whilst entrepreneurs want to have investors who are supportive, entrepreneurs have also been surprised of the initiatives from the VC and effort VCs put on their business.

*"We have had positive surprises with our investors. We did not understand that they think so much of their own contribution. They actually have some own initiatives inside the company." C2*

Finnish VC market is relatively small so usually experienced entrepreneurs already know who is running which VC.

*"I have been in the industry for so long so I have already heard a lot of stories. I already know pretty well who is who." C4*

Sometimes entrepreneurs might know other companies that are doing business with VC so they ask for the portfolio companies how things are with this particular VC. Entrepreneurs seem to put weight on other entrepreneurs' reviews and assume that they would ask feedback from VCs portfolio companies in the future.

*"In the future, I would ask a lot more references from portfolio companies and probably I would also ask references of the contact person you are going to work with if they are with the same philosophy as you are." C1*

### 5.6 Term sheet and valuation

Term sheet and valuation of the venture can be an important issue in the negotiation process. Naturally, there is no deal if the VC valuation offer and entrepreneurs' expectations do not meet. Even though it might not be rational, valuation matter a lot in the end.

*"The truth is that conditions and valuation matter in the end. It can be a little irrational if you really think about it. You should not think of the term that much but they truly matter. For instance, if you have three different options you look at the one that has best terms. It is important criteria at the end." C2*

Term sheet can also give a hint of the values of the investor.

*"One criteria that matter for us is that what kind of terms investor want to address or want to add to the contract paper. Those can be dividing of shares or such things. It tells a lot about the philosophy and values of the investor. Possibly, they do not say these things directly in the meetings but when you get to final negotiations they have added certain terms. You can predict certain behavior in the future and assume values of the investor."C1*

Entrepreneurs have to balance themselves between the fact that they are burning money continuously and they need reinvestments regularly in order to keep business alive. Both parties, entrepreneurs and founders know that. Therefore, it is important for the company to keep eyes open all the time for potential investors and build relationships continuously. In this way company can reduce the possibility for undervaluation of the venture by investors because of the lack of money in the start-up company. VCs try to find as low valuation as possible for the venture and founders are trying to look for as high valuation as possible for the venture.

*"The best possible situation for investors is that they can say, let's see one more year. When the timing is fully optimal they are willing to invest. There is no risk and probably venture is going to bankrupt so they give a low valuation. It is the thing you have to fight against as an entrepreneur. Same time you have to get a high valuation for your company and same time "yes" from the investor. That is the balance." C4*

Our data reveals that sometimes it is hard to find agreement with valuation and terms. Some of the VCs offers have been declined because of the too little valuation.

When entrepreneurs were asked for the criteria how they choose for the VC and what kind of criteria they use, some of them were hesitating to mention the money. But when questions were specified and asked why one particular investor was dropped out then they tell the valuation was too low. Therefore, the results of our data are incoherent and we cannot answer if the valuation matter a lot at the end.

## 5.7 Reinvestment issues

Theory of start-up industry presents the investment cycle of the start-up company. After receiving an investment, company need to be prepared for the next round. One possibility to look for the next round investor is from the existing investors. Another possibility is to look for the next round investor with the help of existing investor.

*"One of our criteria for the VC is contacts to the next round investors. If we talk about A-series investor so then contacts to B-series investors. Existing investor can help us to close the deal with next round investors."C1*

Our data demonstrates that entrepreneurs are interested in knowing if the VC itself is a potential investor in future rounds.

*"It is important to understand from the VC if it is an investor that is brave to do reinvestments or do they wait that someone else come and invest on the next round. It is very important to understand are they hungry to do reinvestments."C2*

Founder team can get a good image of the chances for reinvestments from the VC company. Looking at the fund cycle of the VC entrepreneurs can get an understanding in which phase the VC is with their fund. If they have not raised money from the LPs in a long-time probability for the reinvestment is low.

Traditionally, VC company is looking for the exit actively from the venture. Anyway, our data reveals that sometimes VC company is not that active looking for the exit as founder team wishes. Our data reveals that entrepreneurs are interested in knowing if the VC has done successful exits in the past.

"*It is important that VC has capability to push towards selling of the company. If the investor is just waiting that the founder team looks for the buyer or is it an investor that when time is right, the investor itself start actively look for the buyers. For us, our investor was just an owner of the company and did not do anything that the company would find a new owner. They were more like a traveler. I would have thought that it is their duty to look for the new owner and negotiate with terms. If I would do it all again I would be interested in knowing if the VC has references that it has sold ventures actively and has been part of the selling process."C6*

### 5.8 Sources

Entrepreneurs rely on different kinds of sources when looking for information of VCs. Mostly entrepreneurs rely on contacts when looking for information of VCs. Especially entrepreneurs rely heavily on contacts in the seed stage when the money is raised from Finland. Experienced entrepreneurs claim to know already pretty well Finnish investors and they do not need to look for them that much.

*"We rely pretty much on contacts. I knew two of our investors before they invested in our company. It is pretty much all about contacts." C2*

Additionally, to contacts, entrepreneurs look information of VC companies from webpages even though webpages are often seen as unreliable source and give only little understanding what the VC actually does. Webpages are seen as way to get an initial image of the VC company but getting a better understanding of the VC meetings are required.

Events and accelerator programs are physical meetings where entrepreneurs and investor can meet in casual setting. In these events, entrepreneurs have chance to meet investor and gain information of each other.

Overall, less experienced entrepreneurs rely more on webpages and events whilst entrepreneurs with more experience have already built their network and rely more on it. Nevertheless, also experienced entrepreneurs see some events as a good source to get information of VC companies.

# 6 DISCUSSION AND CONCLUSION

In this study, this chapter answers to 1) how the research answer to the research question and what information was found, 2) how results are supporting or differing from the previous research, 3) how reliable are the results and what kind of limitations are connected to the research 4) what kind of implications this research can provide and 5) suggestions for future research.

## 6.1 Discussion

Previous literature indicates that entrepreneurs evaluate VCs at some level (Smith 2001; Zheng, 2001; Hochberh & Ljungqvist 2007; Hallen & Pahnke, 2016). Our data support previous literature from this point of view. Entrepreneurs do some evaluation and compare characteristics and skills of VCs inside the company. Previous literature also argue that entrepreneurs do not evaluate VCs enough and only a little due diligence is conducted. Our findings are aligned with previous research. Entrepreneurs evaluate VCs only slightly, compare only few VCs to each other and do not always match with the best possible VC for the start-up. Smith (2001) found out that 97 per cent of companies that have passed seed stage have gotten more than one offer from VCs. Our study demonstrate that start-up companies do have meetings and discussions with VCs all the way after getting seed money. After showing capability to make money with the business idea, investors start to approach companies more actively.

Track record is closely associated with reputation. Lee, Jin and Lasheley (2015) conceptualize reputation to mean track record of the company. In this research, we separate definition reputation from track record because of reasons that arise from the data. When our respondents talked about the reputation of the VC they did not mean only track record and success of the VC. Reputation in these findings mean more about the brand of the VC, their core values and how they work whilst track record only means the success of the previous investments of VC. Lange (2011) shows that start-ups benefit of good reputation of their close partners. Track record and especially reputation of VC company is an important thing for start-up companies. Entrepreneurs want to avoid being in relationships with partners with bad reputation and this is important for entrepreneurs. Offers from VCs with bad reputation is easily rejected and entrepreneurs actively observe the field and try to avoid being associated with bad reputable investors. Entrepreneurs are keen to protect their brand and rightly so. Hall (1992) have demonstrated the importance of having investors with good reputation. Also, Fried and Richer argue that good reputational image will be transferred to their portfolio companies. Therefore, it is reasonable from start-up companies to look at the reputation of their investors.

In previous chapter, we talked about how entrepreneurs value reputation of the VCs. Track record in this research is mainly viewed how investments of VC company have succeeded in the past, what kinds of portfolio companies they have had and what kinds of exits they have made. Track record is also an important characteristic for entrepreneurs but nevertheless our study does not find that strong relationship with previous research. The reason for this can be that Finnish VC industry is relatively young and small and we do not have VC companies that have actually made numerous IPOs. When the VC industry reaches certain level of maturity entrepreneurs are expected to rely during their due diligence process on track record more heavily.

Our interview data consists of start-up companies that have not made an exit except one of them. The company that had made a successful exit was through M&A. Nahata (2008) argue that companies packed up by VC companies are expected to exit faster and successfully through IPO. The experience of our respondent is in contradiction with this research. Our interviews reveal that VC companies are not always as active with their role to find potential buyers as entrepreneurs would expect. On the other hand, our data reveals that VCs exit strategy are not always in line with the strategy of entrepreneurs. VCs tend to look for exit in shorter timeframe than entrepreneurs. Our data reveals that this can be an issue that might arise during the start-ups evaluation process of VCs.

Botazzi et. al. (2007) argue that more experienced investors do have more active role recruiting management team and overall are more active communicating with their portfolio companies. Even though this can be true, our data reveals that start-up companies do not always expect active role from the VC to build the business. Our answers reveal that entrepreneurs have been positively surprised how much VC investor think about their own contribution to the business. Active role is seen as positive when VC company can actually make contribution but if their thoughts heavily differ from founder's team thoughts they are seen as disturbers. This can be explained that entrepreneurs see VCs as supportive partners and sounding boards when their thoughts about development of Stat-up company align with the founders' team but if it doesn't align, they are seen as distributes. Forbes (2005) examined entrepreneurs' overconfidence and resulted that cognitive biases of entrepreneurs can be reason why entrepreneurs are overconfident and reluctant for critic and evaluation of their ideas from outsiders. Entrepreneurs can rely too much on their own vision and if other thoughts and suggestions are in contradiction with their own vision they are seen as irrelevant and false. On the other hand, the reason for this can be that VC is not part of the business and cannot see the vision as clear as it seen from founders' perspective.

Falik, et. al. (2016) found in their study that less experienced are more concerned about valuation than more experienced entrepreneurs. Our data support their evidence. More experienced entrepreneurs are more concerned about value added services whilst less experienced entrepreneurs are more concerned about valuation of venture. On the other hand, our data reveals that many entrepreneurs admit they avoid saying that they care a lot about the valuation even though it could be true. The reason is unsure, but one explanation can be that entrepreneurs are aware that experienced, reliable entrepreneurs do not concern about the valuation but are more interested in provided value added services from VC. Our data is mainly in align with Smith (2001) evidence and they argue that it is still one of the most important things for entrepreneurs.

Smith (2001) examined what are the most important sources to seek information about entrepreneurs and found out that entrepreneurs rely mostly on other entrepreneurs, VCs and entrepreneurs own experience. Our data support this study. Contacts were seen as the most reliable source. Webpages were seen as less reliable source but they were a good source to get the first image of the VC. In addition to the previous literature, events were seen as good place to get to know VC companies but they were not always efficient way to really understand the VC. Smith (2001) also found that lawyers and consultants are seen as less reliable source to get information about VCs. Our findings differ from in this aspect. Our respondents encourage entrepreneurs to seek information and support from outside advisors and lawyers especially what it comes to term sheet.

Hallen and Pahnke (2016) argue that entrepreneurs tend to easily rely on those resources that are easily available and ignore deeper analyzes of their potential VC partners. Our study supports this evidence. Entrepreneurs tend to evaluate VCs with little criteria and spend too little time for the evaluation. Westhead et. al. (2005) argue that entrepreneurs with extensive experience may have better understanding of VCs and they do not need to spend that much time on searching of information. Our data support this research especially in the seed stage. When start-up is rising seed money from local VC companies, only little research is made if the entrepreneur knows already key players in the industry.

Muzyka (1996) also, suggest entrepreneurs to shop around investors internationally and not to care about location of VC. Our data reveals that Finnish start-ups tend to raise the money from Finnish VCs in the beginning. This is natural choice but necessarily not always the best option. International VC investors can help the company get straight to the international markets and save time and money.

Rosenstein et. al. (1993) interviewed entrepreneurs and found out that investors board members from VC company with operational experience is seen particularly important for start-up company. Investors with only financial types are not seen relevant board members. Our data support the previous literature and there can be possible contradiction between entrepreneur and VC. If the VC do not have experience building particular kind of Start-up they cannot bring anything to the table. On the other hand, start-up need to think if it is actually relevant at all to raise money from this kind of VC that brings only money and cannot do contribution to the business. Especially, in the beginning VC should bring value added services to the company and not only money.

Valliere et. al. (2007) found in their survey that terms of conditions are one of the top selection criteria. Our findings mostly support this previous study. On the other hand, it is not usually the first thing that entrepreneurs look. It is in the background and possibly VC company with good reputation and good track record won't offer totally unfair deal for the entrepreneur. Entrepreneur expect to get more likely a fair deal from the reputational VCs. Falik et. al. (2016) found out that more experienced entrepreneurs put the highest emphasis on contractual terms while Valliere (2007) found out that novice entrepreneurs put higher emphasis on the contractual terms. Our data suggest that all of them concern on the contractual terms but novice entrepreneurs put more emphasis to the division of shares and valuation issues.

Smith (2001) found out that entrepreneurs appreciated experience in the similar industry. Our data highly support this study and this was the top criteria for our respondents. This is the first thing entrepreneurs look from VC.

Anyway, Zacharakis and Meyer (2000) suggest staying on simple models and argue that too much information can make it difficult to raise the money. Our data shows that actually entrepreneurs are not fully aware why money was raised from particular entrepreneur. There is a lot of coincidence and intuition in the process. Therefore, too complex models do not benefit the entrepreneur. Pennington and Hastie (1986) also suggest entrepreneurs to stay in simple models when entrepreneurs are choosing VC investors. This can be true because few key issues that are crucial are easy to evaluate and monitor but if the evaluation is too difficult it does not benefit the company.

## 6.2 The research quality – Validity and reliability and limitation of research

One of the steps in the research is to evaluate the reliability and validity of the research. The research has to be valid. In qualitative research the researcher evaluate the data all the time which reduces hazardless and coincidental (Varto 1992).

Validity and reliability can be defined from two perspectives. 1) Is the measurement and research method valid and reliable? 2) Are the results valid and reliable (Hiltunen 2009). Validity describes how the used research method measures the chosen feature (Hiltunen 2009). The validity of the research is good when the sample and asked questions are proper. If the research is not valid, the research does not have any value. The research does not examine the chosen topic but examine something else. In this research, our purpose was to examine how Finnish start-up companies evaluate their potential VC investors.

Validity can be distinguished into internal validity and external validity. The question in internal validity, in qualitative research known as credibility, means if there are the differences between results and differences between variables that are expected to affect them (Kumar 2011). In a qualitative research, we evaluate is the research strategy chosen based on factors of research subject and how it minimizes systematic error (Hiltunen 2009). In qualitative research, there can be issues that reduce the internal validity (Hiltunen 2009). We can assume that in the interview setting interviewees do not answer accurately for the research question and it reduces the validity. They are answering to the questions in a way that they are expected to answer.

External validity, also known as transferability means how much results can be generalized to the whole population (Miller 1986). In this study, we examined seven different Stat-up companies from Helsinki area and the question is, can the results be generalized to all start-up companies in Helsinki or Finland. The researcher can reduce external validity problem by choosing sample that is proper for the research question (Kumar 2011). In this research, chosen companies had evaluated VC investors in the past so the sample is good and selection bias is reduced. The sample was heterogeneous and companies were from different industries. Answers were pretty much consistent. Therefore, we can assume that results can be generalized to the whole population.

Reliability of the research means that the research can be repeated and it produces the same results in similar settings. Reliability means how reliably research method examines the chosen research topic. Reliability can be increased by repeating the research (Hiltunen 2009). This research mostly aligns with previous literature so we can expect high reliability. Anyways, qualitative research is many times flexible so repeating the research can be hard if the researcher does not give very detailed explanation how the study was conducted (Kumar 2011).

## 6.3 Suggestions for future research

This paper examined how Finnish start-up companies evaluate their potential VC investors. This paper provides understanding what kind of methods entrepreneurs' use, what are the most important characteristics of VC and what are the expected value-added services.

Personally, the purpose of the research is rather sincere. The purpose of the research was to understand how entrepreneurs evaluate VC investors and how they see VC investor as a partner. Additionally, I got a great experience and comprehensive of Finnish start-ups and the funding field they are working at. From the personal perspective, the purpose of the study was well filled.

Previous literature has well-examined how VC companies evaluate start-up companies. Aim of this research was to understand from opposite perspective; how start-up companies evaluate VC companies. Future research topics could deepen our understanding of entrepreneurs' evaluation methods. Future research could try to categorize entrepreneurs based on their skills or experience and try to understand what kinds of methods and evaluation skilled and experienced entrepreneur use. Research could try to understand what are the most important characteristics or skills of VC company that entrepreneurs actually should look at. Another suggestion could be to carry a research in a longer period. In this research data describes that some of the entrepreneurs were unaware if their choice of VC was actually successful or not because they had worked only for a little time with the investor and they did not know if the venture is going to make a succeed. These future research topics could help us to understand better the nature of evaluation and give practical implications for entrepreneurs and Finnish start-up industry as a whole.

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# APPENDICES

## Appendix 1. Company and interviewee information

### Company information

1. Company name:

2. Industry/Categories:

3. Founded date:

4. Location:

| | | | | | |
|---|---|---|---|---|---|
| 5. Revenue m. | 0-1 | 1-5 | 5-10 | 10-50 | 50+ |
| 6. Last Funding type | Seed | Series-A | Series-B | Series-C | Series-D |
| 7. Total funding amount | 0-500k | 500k-1m | 1m-10m | 10m-50m | 50m+ |
| 8. Number of employees | 1-10 | 11-50 | 51-100 | 101-250 | 250+ |

**Interviewee information**

1. Education:

2. Current title:

3. Founder: Yes / No

4. Relevant work experience:

5. Work experience in current organization:

## Appendix 2. Questionnaire

### Evaluation

1. How did you start evaluation process of potential venture capital investors?

2. Did you have a complete evaluation table when evaluating companies or did you create one yourself inside the company?

3. Did you spend enough time on evaluating VC offers?

4. How long it took from the beginning of evaluation till raising money?

### Source

5. How did you search information about VC companies? (VC itself, websites, personal contacts, Startup events, seminars, common reputation, books, articles)?

6. Can you name one or more source you found the most relevant and the most important when searching information about VC companies?

### Important characteristics of VC

7. What are the most important characteristics of VC investor for your company?

8. What was the key reason to drop out a particular VC company?

### Accuracy

9. How do you describe the accuracy of your evaluation of VC companies?

10. What skills or experience entrepreneur needs in order to analyze VC companies accurately?

**Impact on evaluation of possible new rounds**

11. How the evaluation criteria would differ from the last funding round to possible new round?

**Board Involvement**

12. How your company thought about VC involvement on the board?

13. What are the possible advantages and disadvantages if VC involves on the board?

**Challenges**

14. What was the most challenging part of the whole process of VC involvement on company?