

## Research Article

# Venture Capitalists' Investment Decision Criteria for New Ventures: An Exploratory Study in Morocco

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## Abstract

The Private Equity (PE) industry in Morocco is one of the most predominant players in North African countries. Funds under management in Morocco grew from 40 million USD between 1993 and 1999 to 1.11 billion USD in 2016. These developments, together with the recent announcement of the Moroccan government's vision adopting a new investment scheme provide an opportunity to examine the PE industry. In the light of the differences in investment opportunities around Morocco and the nature of industrial developments in North African countries' social context, the authors of this article anticipated that the investment criteria used by Moroccan Venture Capitalists (VCs) in their venture screening and evaluation processes would differ. Our approach is qualitative and exploratory in nature. Semi-structured interviews with a short questionnaire were adopted and eight General Partners and two VC consultants were selected due to their having greater experience in technology-based ventures funding. The study contributes to the understanding and provides insights into the screening process of Moroccan VCs. It is deemed useful in small equity markets to both VCs in their screening criteria and therefore their decision-making processes and to entrepreneurs in their venture capital applications so as to maximize their success rate.

## Keywords

Screening criteria • Decision-making process • Venture capital • Small equity markets

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The Moroccan Private Equity (PE) industry is among the predominant players in North African countries. Venture capital (VC) firms have, in recent years, come to constitute the largest PE industry in Morocco despite their being cumbersome regulatory hurdles and a myriad of institutional uncertainties faced by such firms. Although the first domestic VC firm (i.e., Moussahama fund) was established in 1993, five funds were subsequently created and invested approximately 100 million USD in 2000 (Ed-dafali, Bouzahir, & Chakir, 2016). The Moroccan Association of Private Equity (AMIC) constitutes the referential partner for PE in Morocco and was founded on the initiative of four partners in 2000. The development of the PE industry began to intensify only after 2006, when the Moroccan government adopted a new scheme to promote venture investments. Although there were 34 funds managed by 20 PE firms registered by the Moroccan Association of Capital Investors by mid-2012, only 12 VC firms were active investors in new ventures in 2018 (Table 1). Moreover, roughly 12 foreign PE firms operate in Morocco today. Between 1993 and 1999, private equity firms raised 40 million USD in funds, a steep increase to 100 million USD in mid-2000 that reached 0.166 billion USD by the end of 2016. During this period, 330 million USD were invested in more than 100 SMEs and 0.24 billion USD were disinvested. According to the African Association of Private Equity and Venture Capital, Morocco was the leading PE destination in North Africa between 2007 and 2014. This study states that 90% of investments made in volume or value for this region were registered in the following three countries: Morocco, Tunisia, and Egypt.

Venture capital is usually defined as an independently managed, dedicated pool of capital that focuses on equity or equity-linked investments in privately held, high-growth companies (Lerner, 2000). VC constitutes an important alternative source of capital for new ventures, especially for those in technology-based industries, such as information technology or biotechnology (e.g., Deventer & Mlambo, 2009; Fairchild, 2011; Gompers & Lerner, 2001), and is critical to their success (e.g., Bottazzi et al., 2008; Rubin, 2010; Zacharakis & Meyer, 2000a). Compared to debit financing, it lowers the probability of leaking a valuable tangible asset (Planès et al., 2002), does not always allow banks to have necessary guarantees for granting a loan (Jacquin, 2003), and is usually not an option (Denis, 2004). However, access to VC is a key determinant of a new venture's ability to develop, operate, and expand. Thus, VC funds finding for new ventures is the main problem faced by many entrepreneurs in the early stages, and it is still unclear as to exactly what criteria Moroccan VCs use to evaluate incipient ventures prior to funding decisions.

Table 1  
*Private Equity Firms in Morocco in 2014*

	<b>Investment policy</b>	<b>Location</b>	<b>Funds in USD (Million)</b>
Financed by government	All industries	Casablanca and Oujda	30-40
Financed by private individuals	All industries	Casablanca	>20
Financed by public companies	All industries	Casablanca	262-300
Financed by financial institutions	All industries	Casablanca	>330
Foreign	All industries	Casablanca and Rabat	>350

*Note.* Funds dedicated to Moroccan Association of Capital Investors.

A review of the literature seems to suggest that while VC continues to be recognized as an important source of financing for SMEs in developed countries, little empirical research attempting to explore VC as a means of financing for both starts-up and existing SMEs in Morocco has been conducted (Bouzahir & Chakir, 2013a, 2013b). As a result, very little is known about the nature and role of VC firms in Morocco. As such, there is a need to explore such firms in Morocco. The purpose of this study, therefore, is to address this issue. More precisely, this study initiates an attempt to examine the evaluation criteria and the investment activities of VC companies operating in the local context. Therefore, we seek to demonstrate how VCs make their investment decision and what the key influential factors are at the times of investment, particularly in the Moroccan context. Moreover, by knowing and understanding the evaluation criteria and investment activities of VC companies, entrepreneurs will be better equipped in preparing their funds acquisitions proposals to VC firms.

The paper proceeds as follows: The first section briefly presents a literature review on investment decisions in VC. The following section describes the policy capturing methodology of an explorative empirical study among VC firms from Morocco. The fourth section presents our findings and discusses them in regard to prior research. The final section concludes the paper.

## **Theoretical Background**

### **Venture Capitalists Evaluation Process**

The investment process of venture capital is part of the “venture capital cycle” (Gompers & Lerner, 2000) and has not changed significantly since the first academic studies conducted on it in the 1970s (Wright et al., 2003). However, Wells (1974) was one of the first to describe in detail VCs cooperation and the entrepreneur. Therefore, Tyebjee and Bruno (1984) analyzed the activities of VCs as a sequential process that they divided into five distinct phases: (i) deal origination, (ii) deal screening and evaluation, (iii) deal structuring, (iv) manage their investments, and (v) monitoring and value adding. Silver (1985) added a sixth phase of VCs investment process corresponding

to ventures exit. However, Fried and Hisrich (1994) gave greater attention to Tyebjee and Bruno's (1984) model when conceptualizing the investment process. According to them, VCs invest in five distinct steps: (i) deal origination, which is the main task and constitutes a very rapid progress and great selectivity in determining the validity of investment opportunities, (ii) deal screening, during which the investor minimizes the barriers impeding investment opportunities to a manageable quantity, (iii) deal evaluation, where investors carefully analyze the potential portfolio company – Fried and Hisrich (1994) proposed a more sophisticated analysis into a cursory evaluation, stating that it cannot be differentiated into a more formal rapid assessment and diligence due (so-called first phase and the second evaluation phase), (iv) deal structuring, venture capitalist and entrepreneur clarify the terms of the deal between themselves, and (v) post investment activities, which combines all of venture capitalists' activities aiming primarily at supporting company management and preparing future disinvestments. Sahlman (1990) found nearly 80% of all proposals were rejected at the deal origination stage after the first reading the validity of business plan. It is clear that the greatest hurdle that entrepreneurs have to overcome is to get past the initial screening stage. In this context, Marion (1999) provided evidence asserting that selection proposals were reduced to a very synthetic study, the main objective of which being to identify factors that are incongruent with VCs' investment policy. In summary, various research findings show that all agree that the VCs' decision-making process consists of multiple phases (Hall & Hofer, 1993) in which certain rather specific selection criteria are sought to note their importance compared to the evaluation phase. This review suggests that there is little empirical evidence to support a consistent framework or theoretical model that can be applied to VCs' decision-making, particularly in the screening and evaluation stages of the process.

### **Venture Capitalists Evaluation Criteria**

As mentioned above, research into the evaluation criteria used by venture capitalists to assess new venture has a relatively long tradition in developed countries (Hall & Hofer, 1993; MacMillan, 1985; Shepherd, Zacharakis, & Baron, 2003; Tyebjee & Bruno, 1984; Wells, 1974). It has been argued that understanding the criteria employed by successful VCs in evaluating new ventures would provide all VCs a useful framework for evaluating new ventures and reduce the failure rates of any ventures they were to finance. In one of the most widely cited works in this area, Tyebjee and Bruno (1984) identified a set of evaluation criteria. According to them, VCs invest in five major groups, namely evaluation criteria related to (i) market attractiveness, (ii) product differentiation, (iii) managerial capabilities, (iv) environmental threat resistance, and (v) cash-out potential. Conducting a regression analysis, these authors showed the close dependence of the indicator expected return on the two criteria market and product, as well as the dependence of risk on management and

environment (Franke et al., 2008). Using a personal interview of eight VC firms in the pioneering study by Wells (1974), who found that (i) management commitment, (ii) products, and (iii) markets were the key evaluation criteria used by VC firms in evaluating investment proposals.

The results of a large number of studies were analyzed to confirm Tyebjee and Bruno's (1984) findings. Contrary to these authors, MacMillan et al. (1985) interviewed 14 VCs in the US and calculated the average weight of an adequate number of criteria. Based on their findings, they produced a list of 27 criteria and categorized them into six sets, namely (i) entrepreneurial personality, (ii) entrepreneurial experience, (iii) characteristics of product or service, (iv) characteristics of the market, (v) financial characteristics, and (vi) venture team. Further attempts to refine the criteria and determine the weight age that VCs accord to different criteria. To this end, MacMillan et al. (1985) identified the ten criteria most frequently described as essential and found that while six involved entrepreneurs themselves (e.g., entrepreneurs' personality and experience as opposed to product, market, and financial considerations), the criteria of funds and the respective terms of a deal's structure were of minor importance.

The results from the large number of studies that followed showed that at least one, but often two or even all three of the top-ranked criteria pertained to characteristics of the entrepreneurial team. For example, Muzyka et al. (1996) found the most important criteria in European VCs' evaluations of venture proposals to be (i) the leadership potential of the lead entrepreneur, (ii) the leadership potential of the management team, and (iii) the recognized industry expertise in the team entrepreneur. Most prior studies agree on the assessment that both an entrepreneur's and a team's characteristics (e.g., personality, experience, and management skill) plays an important role in VCs' decision-making, a result which is intuitively accepted (Johnson, 1979; Poindexter, 1976; Robinson, 1987; Shepherd, 1999; Shepherd & Zacharakis, 1999; Zutshi et al., 1999). According to Campbell, (1997), VCs would rather invest "in a grade A team with a grade B idea than in a grade B team with a grade A idea. Kollmann and Kuckertz (2010) pointed "Venture capital literature features plenty of possible investment criteria, and due diligence checklists may well include up to 400 different criteria". However, they also suggested that while management criteria are uncertain during the early steps of the process in particular, other criteria couple with uncertainty at the end of the process.

Recently, studies have examined the effects of direct and indirect ties of entrepreneurs and VCs on investment decisions (Shane & Cable, 2002; Shane & Stuart, 2002). Most research in this area has studied how the dyadic network relationship between the venture and investor influences the new venture's ability to acquire financial resources (Batjargal, 2007; Elfring & Hulsink, 2003; Jenssen, 2001). Similarly, researchers found that VCs' screening and selection stage, the particularistic networks ties of entrepreneurs, and VCs

all moderate the effects of the technical aspects and growth potential of a project on investment selection decisions (Batjargal & Liu, 2004). Indeed, Batjargal, (2007), found that referee-venture capitalist tie, referee-entrepreneur tie, and interpersonal trust between referee and venture capitalist have positive effects on VCs’ investment decisions.

## Methodology

### Sample and Interview Process

The approach is qualitative and exploratory in nature. We conducted a semi-structured interview with open-ended questions to ensure that the VC firm participating in this study could freely express their views and experiences. Furthermore, we added a short questionnaire during the interview process to cover important issues that surfaced during earlier interviews (Gioia et al., 2012). We conducted pilot interviews with eight General Partners and two VC consultants (this third party is defined as any independent individual who explicitly provide information on a certain proposition) between April and August 2016. Most of the interviewees had prior experience with VC market investments. Furthermore, our interview partners differed in their academic and professional education. Table 2 summarizes the characteristics of our interviewees. To select interviewees, we contacted possible interviewees directly or utilized the recommendations of the Moroccan Association of Capital Investors. Containing six questions, the interview questionnaire was designed in French, and data were collected through face-to-face interviews. Each interview lasted approximately one hour. We asked each fund manager about the criteria that he used for investment decisions in technology-based new ventures based upon or despite third-party recommendations. In addition, we asked both VC consultants the criteria used by VC firms when they give recommendations for VC firms about investment proposals. Thus, we collected information on a maximum of investment decisions from each respondent. In a nutshell, we tried to explore determinant factors influencing VC investors’ investment decisions and included these in a predefined interview guide (Miles & Huberman, 1994).

Table 2  
*Sample Description*

Venture Capitalist					
Code	Term interview	Intervention stage	Experience	Age	Sex
VC1	2H	VC	8	38	M
VC2	40minutes	VC	15	40	M
VC3	1H30	VC	3	30	M
VC4	45 minutes	Development capital	3	25-30	F
VC5	1H20	VC	4	25-30	F
VC6	45 minute	VC	8	45	M
VC7	1H30	VC	10	40	M
VC8	1H20	Development capital	12	35	M
VC consultant (Third-party)					
CVC1	1H45	10 years as equity financial		40	M
CVC2	1H30	8 years as equity financial		38	M

To measure the relational social capital between Venture capitalists and third parties, we used assessment of tie strength proposed by Granovetter (1973). Consequently, this research follows the initial measure of tie strength as proposed by Granovetter, who used the indicators of intimacy, frequency, and length of the contact. Ranging from weak to strong, the indicator for intimacy is measured by the four categories not at all, very little, somehow, and very well. Similarly, frequency is measured on a four-point scale, namely never spoken before, once per year, once per month, and once per week. Finally, duration is measured following a similar trend, specifically the number of years the relationship has existed. In our explorative study, we further tried to test the value of these three variables on the acquisition of equity capital. However, it has been argued that 'closeness' or emotional intensity of a relationship is the best way to measure tie strength (Marsden & Campbell, 1984). In fact, it could be that intimacy is much more effective than the actual length of the relationship.

### **Data Analysis**

We used a thematic content analysis for interviews during the course of our study. The interviews were coded, transcribed verbatim, and then sequenced into a meaningful system of higher-dimensional categories (Miles & Huberman, 1994). According to Robert and Bouillaguet (1997, p. 4), this technique allows for the methodical, systematic, objective, and sometimes quantitative examination of the content of certain texts, which are not fully accessible to superficial reading, with a view seeking to classify and interpret some of them.

Following Corbin and Strauss's (1990) recommendations, we structured our analysis in four stages. During the first stage, we conducted a pre-analysis on coding categories that are derived directly from the text data using conventional content analysis (Bardin, 2001). In addition, information on third-parties outside the scope of the structured interview was noted as well. We subsequently divided the interviews contents into segments so as to identify meaningful, semantic units within these segments. Once the text was divided into semantic, we classified them into categories and themes. Finally, we referred to the phases that Corbin and Strauss describe as axial and selective coding so that coding may be more interpretative, as opposed to descriptive, coding. We present our research results in the following section.

### **Results and Discussion**

Prior research shows that an entrepreneur's and team characteristics (e.g., personality, experience, and management skill) play an important role in VCs' decision-making (see for example, Hall & Hofer, 1993; MacMillan, 1985; Shepherd, Zacharakis, & Baron, 2003; Tyebjee & Bruno, 1984; Wells, 1974). All interviewees stressed that a business plan is needed to make an investment decision and that 25%

of business plans not only require significant consideration but are also the subject of a first meeting with an entrepreneurial team. In a similar vein, they are required when determining investment size, investment politics, and new venture development stages. As one venture capitalist (investor) emphasized:

Practically, 75% of the proposals reached are eliminated at first view. Taking fund eligibility as the base criterion, the general policy of investment, like average ticket need, development size or sector investment, and business development stage, during initial discussion with the lead, aimed at validating or invalidating the subject that has passed the first selection phase, like project idea presentation, and business sector.

Our findings expand on prior research discussing the importance of team characteristics by new ventures (Beckman et al., 2007; Hall & Hofer, 1993a). All investors believe in the start-up, management, research, industry, and functional diversity experience of entrepreneurial teams. There are important criteria affecting VCs' funding decisions. As one venture capitalist noted:

There are several criteria, the first of which, in my opinion, is that almost 60% revolves around the team, for example, managerial and technical experience in large companies, the experience in business creation, dynamism, and team homogeneity in terms of training and education. We prefer 2 to 3 people than a solo entrepreneur with varied skills and a high execution capacity. [...] For us, the team is the most important factor in our investment decision. We prefer to have a very good team with an average project than a very good project with an average team. Another 30% related to the business project to know about the product or service proposed, innovation employed degree, viability, and market. Then, the other 10% other is the business plan, like: Are the figures well prepared? Is the presentation well done and very clear?

In the same sense, another venture capitalist also pointed out three criteria areas; his propos are as follows:

The three main criteria for selecting an innovative business project are the business sector, the quality of the management team before even starting such an evaluation, and the expected profitability.

Third-party recommendations can provide an entrepreneur and a venture with legitimacy and hence reduce its liability of newness (Rao et al., 2008; Stinchcombe, 1965). Therefore, beyond team characteristics, the importance of the deal source is crucial from an investor standpoint. The following two questions are therefore pertinent: Does a venture capitalist need to make greater use of its network during the opportunity identification phase or when is it looking for real opportunities, especially in the capital market? And is risk more developed? In this regard, we see the current trend of capital investors appealing to so-called experts (i.e., trustworthy people in more specific fields) to help them in their decision-making process. In addition, once the new venture is connected to the VC fund, researchers have shown that recommendations play an important role in VCs' due diligence process (Fiet,

1999; Hustedde & Pulver, 1992; Maula, 2001). In our interview with VCs #3, he nicely summarized the positive effects of recommendations made by a trustworthy actor involved in the process:

The first family of selection criteria is reliability of the source itself. How did the file come to us? If it came, for example, via an investor provider, how credible is it? Or if it came through our banking network, we have to know how knowledgeable this specific source of our investment policy is in order to be clear that it wouldn't simply throw any random file our way.

Our findings suggest that through the investment of a reputable third-party (e.g., from a business angel or business leaders), positive feedback regarding the venture from external stakeholders (e.g., business partners), and external certifications reduce the perceived information asymmetries of VC in equity-based funding. Consequently, third-party recommendations play an important role in whether a venture capitalist will approve of new ventures, especially under conditions of uncertainty. In addition, VCs are likely to perceive entrepreneurs as trustworthy, less opportunistic, and more motivated when they believe in third-parties. In fact, a recent study proposed that entrepreneur social capital/networks ties were not uniform in their effect, but rather varied with management, start-up, technical/technological experience, cohesion team, reputation, educational level of entrepreneurial team, and financial needs (Batjargal & Liu, 2004). If a project passes the initial screening phase and the first meeting with entrepreneurial team, an expert third-party plays a crucial role in validating a specific topic, particularly during the in-depth evaluation phase of the project. As one venture capitalist stated:

We know almost all the VC consultants operating in Morocco. Generally, we rely on their significant expertise and their reputation. Neither shareholders nor managers can be in conflict with the business opportunity at hand or interested in the case in any way, shape, or form, meaning they must be independent. Their expertise must be sufficient enough so that we can trust them and give them an assignment.

Our data further suggest that VC consultants in equity-financing try to reduce investment incertitude based on decisions' new ventures:

I use a third-party so that I can have peace of mind concerning things I don't know, like technological viability. This is the one issue that we weren't necessarily able to manage [...]. Today, the market is moving in a direction adopting an opportunist approach where we are obliged to work with intermediaries (VC Investor).

Similarly, results from studies on third-parties recommendations seem to be more effective when the third-party source is more prominent (Janney & Folta, 2006; Stuart et al., 1999), has more expertise (Baum et al., 2000; Reuber & Fischer, 2005), and is strongly tied to the financial resource partners (Batjargal, 2007). Hence, friendships may create a sense of certainty and increase confidence in transactions' positive outcomes, thereby encouraging third-parties to send strong recommendations (Batjargal

& Liu, 2004). Interpersonal affinity between friends may also influence referrals, as intermediaries are likely to see recommendations. Thus, one VC consultant specifies that in order to successfully raise funds from a VC investor, technical expertise is a determining factor and is followed by these relational networks:

If the VC firm has good expertise that will filter the deal so well before it even advises capital investors, the investor, instead of investing 80% of his time in the evaluation of a classic deal, will invest less of his expertise in a deal recommended by our firm. The second factor is our networking and our strong relational and professional ties. As members of the Moroccan Association of Capital Investors, we have a large network at the national level, and it is essential to know personally just who the stakeholders in capital are.

Therefore, third-parties oriented technology on specific venture sectors seems to be more important when accessing investors of higher-risk investments, especially VC financing. They played a crucial role when the knowledge required for the investor is more complex when considering an investment. In addition, the third-parties played a crucial role in recommending new venture when it has already been financed by another financial resource partner or government grant. In summary, the study shows that the ability of a new venture to access and acquire a venture capital funds is heavily contingent on the characteristics of the new venture and investors. Furthermore, the success of VC consultants in acquisition of equity capital is heavily contingent on the investors' characteristics (Batjargal & Liu, 2004; Lockett et al., 2006).

### **Conclusion**

This paper has focused on actual decision-making criteria adopted by VC firms operating in a local context. In our study, we sought to explore how VCs should invest in new ventures when third-parties providing them with an abundance of information are involved while also facing high information asymmetries needing to be reduced to facilitate investments. We developed a qualitative approach regarding those actors involved in financing new ventures and explained how this approach might be used to identify actual real VC-related decision-making criteria in Morocco. In recent years, VC has undergone dynamic changes, emerging as an alternative financing instrument for several new ventures in Morocco. Despite its practical relevance, there are still many unexplored areas of VCs decision-making process. For example, research on VC decision-making criteria often assumes that a rational actor collects information, balances it, and makes decisions. Studies in the VC literature have overlooked the social context in which investors make their decisions. Through the current study, we have attempted to explore and bridge this gap through 10 in-depth interviews with VCs and third-parties on equity-financing.

One key result of our study is that in addition to recommendations made by third-party actors, the entrepreneurial team itself, especially their prior (1) start-up,

(2) management, (3) research, (4) industry experience, and (5) functional diversity, influences VCs investment decision. In our interview data, interpersonal and cognitive trust between the involved actors constitutes external certifications for new ventures that reduce the perceived information asymmetries faced by VCs during the decision-making process. In addition, the study found an empirical proof of the hitherto untested postulate of VC literature that entrepreneurs and VCs get connected through third-parties who recommend founders and investors to each other (Shane & Stuart 2002).

Our study contributes to the empirical studies on VCs' funding decision, especially in a Moroccan context. Future research could be conducted to delve into greater detail regarding cultural differences in various African countries. Furthermore, it would be interesting to explore whether the characteristics of successful third-parties involved on the stage of the VC investment process differ depending on the type of information to be sourced. Finally, studies providing insight on the proper way to structure government systems and communication with investors is needed, as such insight will help new ventures secure VCs' funding decision (Steier, 2003).

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