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A REVIEW OF EVALUATION CRITERIA USED BY VENTURE CAPITALISTS IN THE SELECTION OF PORTFOLIO COMPANIES

Vaishali Sharma*, Ph.D. Research Scholar
Department of Commerce and Business Studies
Jamia Millia Islamia (A Central University)New Delhi, India
vaishali.sh@outlook.com
*Corresponding author

Dr.Naseeb Ahmad, Associate Professor
Department of Commerce and Business Studies
Jamia Millia Islamia (A Central University)New Delhi, India
nahmad3@jmi.ac.in

Abstract

Venture capital is a necessary financial resource for start-ups, which ensures continuity and stability of the firm. Venture capitalists are skilled at selecting new firms and carefully analysing investment proposals using a variety of criteria. This review article was aimed at understanding the different evaluation criteria utilised by venture capitalists for selecting firms to invest in.For this purpose, different research articles were reviewed. In terms of selection criteria, it was discovered that investors worldwide often prioritise entrepreneur traits and management competencies, followed by market-related and product/service-related attributes. The Indian venture capitalists also exhibited similar preferences.

Introduction

Venture capital investing began in the United States. Traditionally, it has been used to finance new enterprises, especially those pioneering new technology and capturing new markets, and it further fosters business spirit (Siskos and Zopounidis, 1987). Venture capital is vital to emerging high-growth enterprises. Financing high-risk, high-reward ventures using venture capital is one available option.Venture capital investment is characterised by high risk, the likelihood of high returns, asymmetric information, and investor competence (Mishra *et al.,* 2017). The venture capital sector contributes to technological and economic advancement by funding a wide range of businesses (Timmons and Bygrave, 1986; Maier II and Walker, 1987).Funding from venture capitalists plays a significant role in promoting and developing start-ups (Hellmann and Puri, 2002). It serves as an essential source of financing for early-stage enterprises that have a higher growth rate (Baeyens and Manigart, 2003). Venture capitalists are looking to diversify their portfolios by putting their money into high-risk businesses led by entrepreneurs (Barry, 1994). They not only invest money, but they also help manage their portfolio companies (Fried and Hisrich,1995; Kumar and Kaura, 2003) and offer value-added services to them (Hellmann and Puri, 2002).This turns an

entrepreneurial company into one that is professionally run (Meglio*et al.,* 2017).Consequently, venture capital funding plays a crucial role in ensuring business stability.

Venture capitalists get tens of thousands of business plans each year (Petty and Gruber, 2011), and each one is subjected to a rigorous review (Mishra *et al.,* 2017). Prospective venture capitalists reject an estimated 50 percent of all proposals because they do not meet the predetermined requirements (Norton, 1996; Mishra *et al.,* 2017). As a result, understanding investors' investment criteria is crucial for every entrepreneur seeking to secure venture funding (Hall and Hofer, 1993).Venture capitalists are remarkably good at selecting new enterprises (Hall and Hofer, 1993; Davis and Stetson, 1985). Researchers attribute much of this success to the criteria they employ when evaluating new companies (Hall and Hofer, 1993).Venture capitalists evaluate financing proposals carefully before making a decision. A good investment selection criterion in a venture capital firm lowers the risk of bad investments.According to research, most venture capitalists support fewer than 1% of the proposals they receive (Maier II and Walker, 1987). If these investors are convinced that the company has the potential to be successful, they may provide funding for various stages of the company's development, such as the financing of expansion and ongoing operations (Ruhnka and Young, 1987). Thus, it is hardly surprising that most research on venture capitalist decision making has concentrated on understanding their evaluation criteria (Tyebjee and Bruno, 1984; MacMillan *et al.,* 1985, 1987; Muzyka*et al.,* 1996; Zutshi*et al.,* 1999; Silva, 2004; Pintado *et al.,* 2007; Wong, 2009; Nunes *et al.,* 2014; Zinecker and Bolf, 2015).

Therefore, the objective of this review paper is to understand and review the various evaluation criteria utilised by venture capitalists when selecting their portfolio companies.For this objective, several research articles were reviewed, and venture capitalists' selection criteria were studied. This review paper is part of the researcher's ongoing thesis work at Jamia Millia Islamia, New Delhi, India, titled "Role of Venture Capital Financing in Promoting Entrepreneurship".

Review of Literature

Previous researchers have examined closely at how venture capitalists make decisions and identified a number of criteria that they use to filter and critically evaluate business ideas(Tyebjeeand Bruno, 1984; MacMillan *et al.,* 1985, 1987; Hall and Hofer, 1993; Shepherd *et al.,* 2000; Mishra, 2004; Franke *et al.,* 2006). These studies were conducted using advanced data analysis techniques that can provide useful information. Different techniques like factor and cluster analysis (MacMillan *et al.,* 1985, 1987), regression analysis (Tyebjeeand Bruno, 1984; MacMillan *et al.,*1987), conjoint analysis (Shepherd *et al.,* 2000; Franke *et al.,* 2006), and verbal protocol analysis (Hall and Hofer, 1993) have been used by various scholars in their studies. Below is a discussion of some of the noteworthy studies in this area. The studies within the literature review have been divided by geographic location in order to get insight into the behaviour of venture capitalists worldwide.

America

The previous studies were carried out in a variety of different places throughout the world.In the United States, Tyebjee and Bruno (1984) studied a group of 46 venture capitalists and classified the criteria they employed into five categories: 'market attractiveness', 'product difference', 'management qualities', 'environmental threat resistance', and 'cash-out possibility'.

Another study based in the United States by MacMillan *et al.* (1985) investigated the numerous characteristics that venture capitalists examine when making investment choices.The authors defined numerous criteria and used techniques such as factor analysis and cluster analysis to analyse them on a sample size of 102venture capital investors. In terms of product attributes, some investors felt that the product did not have to be high-tech, whilst others desired that it be high-tech. The authors narrowed down the top ten criteria used by venture capitalists to make financing selections, with the first five relating to the personality and experience of entrepreneurs. These elements were deemed crucial by the investors. When making investment decisions, they placed a great value on the entrepreneur's quality. In follow-up research to the prior study, MacMillan *et al.* (1987) assessed 25 screening and performance criteria as rated by 67 venture capitalists in the United States. The venture capital investors were required to rate successful and unsuccessful companies based on the aforementioned criteria. Two major characteristics emerged in this research that were not judged relevant in the prior study: the amount to which the enterprise was initially protected from competition and the extent to which the product was market acceptable.

Similarly, Hall and Hofer (1993) investigated the decision criteria used by venture capitalists in the United States in evaluating new enterprises. However, they used semi-structured interviews and the verbal protocol analysis approach. Based on the research of 4 venture capital firms it was found that venture capitalists place a high value on characteristics such as 'fit with the venture firm's lending rules','long term development and profitability of the industry', and 'source of the business idea'. Surprisingly, during the initial screening phase, investors gave little weight to the entrepreneurial team or the proposed business's concept.

Europe

Several research studies were conducted in various European countries and regions.Muzyka*et al.* (1996) investigated the selection criteria of European venture capitalists. The authors examined 35 criteria after surveying 73 venture capital investors across Europe. Furthermore, conjoint analysis was performed to assess the relevance of overall criteria, followed by cluster analysis to discover venture capital clusters that fall into distinct groupings.According to conjoint analysis, investors as a group prefer criteria such as a competent management team and adequate financial and product-market features. Furthermore, cluster analysis identified three types of venture capital investors: those who favour a national location, those who solely focus on the deal, and those who prioritise all five management characteristics.Also, Zinecker and Bolf (2015) examined the investment selection criteria of 35 Central and Eastern European (CEE) and 14 Russian venture capitalists. Using descriptive research, the authors discovered that venture capital

investors pay attention to product attributes such as competitive advantage and return generation potential. Furthermore, investors consider market size and growth while evaluating business proposals. Also, a criterion relating to managerial expertise is critical.

Moreover, in France, Siskos and Zopounidis (1987) examined the evaluation criteria using a case study of a French venture capital firm. The most essential factor among the numerous criteria was managerial quality, whereas R&D received little weight.Another study carried out in Spain by Pintado *et al.* (2007) examined the investment strategies of 51 Spanish venture capital firms in relation to the stage of development of firms. Following the investigation, the top three criteria for assessing business proposals were identified: project feasibility, management team quality, and exit opportunity. These factors were equally essential for early-stage and late-stage businesses. For early-stage venture capital firms, high-technology and location are critical for first screening. Product and market variables were less essential than entrepreneur and management qualities.

Furthermore, Murray and Lott (1995) assessed the selection bias of venture capitalists in the United Kingdom towards technology-based, innovative, and young enterprises. When the industry data of the UK and US VC industries were examined, it was discovered that UK investors do not invest as much in technology-based enterprises as US investors. Furthermore, UK investors often fund later-stage ventures, whereas US investors fund early-stage ventures. In terms of selection criteria, venture capitalists evaluated the investee firms based on their market potential. Furthermore, an interesting finding was uncovered, suggesting that investors investing in technology-based enterprises are more directly involved with their investee firms.

One study was conducted in Germany by Franke *et al.* (2006), which used a conjoint design to examine the similarity biases that exist between a venture capitalist and a start-up team. The findings revealed that similarity biases exist, with venture capitalists preferring start-ups with similar professional and work background. Furthermore, investors with technical and management expertise favoured start-up teams with technical and management backgrounds.

Some studies werecarried out in Portugal. For instance, Silva (2004) examined the different decision-making criteria utilised by Portuguese venture capitalists. A case study was carried out utilising the observation approach. The findings revealed that, among the many criteria, venture capitalists place greater importance on entrepreneurs' personal and professional qualities, as well as their dedication to the business idea. Venture capital investors thoroughly study the business model to determine its competitive advantage and potential.Also, Nunes *et al.* (2014) examined the criteria utilised by Portuguese venture capitalists in evaluating and selecting early-stage venture capital projects. They examined 20 venture capital investors and assessed 45 criteria organized into six groups. The results suggested that the most essential set of criteria was the entrepreneur's personality and experience. Furthermore, investors with private capital rated entrepreneurs' personalities and experience higher than investors with public capital and investors that are not internationalised. Furthermore, investors with private capital place a larger value on the drive to

make money than investors with public capital. Criteria such as constant effort, attention to detail, and education record are more valued by non-internationalised investors than by internationalised investors.Furthermore, while analysing early-stage initiatives, investors emphasise criteria like as the entrepreneur's and management's long-term vision, the capacity to develop new markets for product/service, and access to distribution channels and suppliers. However, when evaluating later-stage initiatives, the most important consideration is the entrepreneurs' available capital.

Oceania

A research that was carried out in Australia was included in the Oceania region. Shepherd *et al.* (2000)evaluated the decision-making strategy of 64 Australian venture capitalists using conjoint analysis. According to the findings, the most crucial factor utilised by the investors to determine profitability is industry-related expertise. The second most significant criterion was revealed as competitive rivalry, timing, and educational competence, followed by the third most important criterion, key success factor stability, lead time, and timing-lead time interaction.

Asia

A number of research studies were conducted in various countries across Asia. In Korea, Rah *et al.* (1994) examined the selection factors employed by Korean venture capitalists. Using factor, discriminant, and regression analysis on a sample of 74 venture capital investors, the authors discovered that market attractiveness is the most significant consideration for Korean investors when making financing selections. However, when it comes to real deal appraisal, they prioritise management competence.

A study in Taiwan by Pandey and Jang (1996) investigated the assessment criteria utilised by Taiwanese venture capitalists.When it comes to the first screening of portfolio companies, venture capitalists often consider the industry, the business's financial status, and the stage of the company. They, on the other hand, do not consider the magnitude of the investment or the firm's location during the first screening process as important. According to an analysis of their assessment criteria, return on investment, entrepreneur's technical talents, market demand for product, market growth potential, and readily liquid investment were the top five significant drivers for venture capitalists in Taiwan.

Another study was conducted in China by Guo and Jiang (2013), which focused on interviewing 37 Chinese venture capitalists to understand their criteria for selecting investee firms. The criteria were divided into seven categories: entrepreneur personality, entrepreneur capability, product/service characteristics, market features, financial considerations, geographical considerations, and management team qualities. Certain criteria like entrepreneur traits, market features, product/service characteristics, financial consideration, and geographical consideration emerged as the top 10 significant selection criteria for venture capitalists.Also, Wong (2009) investigated the assessment criteria utilised by venture capitalists in Hong Kong. Several approaches were used to analyse the various criteria falling into five major categories: venture firm

characteristics, products/services and market, financial considerations, and operational performance. According to the findings, venture capitalists place a high value on financial considerations. Another aspect of the investigation found that competitive threat and market acceptability of products are critical for successful ventures. Other important criteria discovered were persistent intensive effort, degree of leadership demonstrated, and previous track record.

Some studies also formed part of south-east Asian region. In Malaysia, Narayanasamy*et al.* (2011) evaluated the decision-making procedure and investment criteria employed by Malaysian venture capitalists. The authors followed the traditional decision-making model and discovered parallels. The examination of responses from 16 venture capitalists revealed that investors prioritise characteristics relating to management integrity, leadership, exit opportunities, and higher returns above business ideas. Furthermore, another study in Singapore by Zutshi*et al.* (1999) investigated the investment selection criteria adopted by venture capitalists in Singapore. The findings indicated that while venture capitalists in Singapore have distinct investment preferences than those in the United States, their investment criteria are not significantly different. It was discovered that the traits of the entrepreneur or the capabilities of the management are crucial indications of the viability of the enterprise. The 31 venture capital investors in the sample had clear opinions about where to invest and what types of companies to invest in.

Some studies were also carried out in the Indian sub-continent. For instance, Kumar and Kaura (2003) employed a survey research approach to examine the criteria used by venture capitalists to identify successful venture teams and the qualities that aid in distinguishing between successful and unsuccessful ventures in India. According to the findings, four crucial qualities distinguish successful ventures: the capacity to estimate risk, attention to detail, market share, and earnings. It demonstrates that successful venture teams make continuous attempts to identify target markets. These teams are exceedingly cautious when it comes to details. Their experience allows them to be highly skilled at dealing with risk. Indian venture capitalists are not very interested in the technology industry. The majority of the enterprises they funded were not technological in nature.Furthermore, Mishra (2004) investigated the assessment criteria utilised by Indian venture capitalists in selecting investee companies. The 42 criteria employed in the study were divided into six categories: entrepreneur personality, entrepreneur experience, product/service features, market characteristics, financial aspects, and venture team qualities. According to the findings, Indian venture capitalists apply different criteria than venture capitalists in the United States. Furthermore, the personality and experience of the entrepreneur were highly valued qualities.Also, Mishra *et al.* (2017) investigated the criteria for 77 venture capitalists in the Indian context and discovered that, due to a variety of internal and external circumstances, investors' selection criteria in India varied from those in other nations such as the US and the UK. When considering applications, Indian venture capitalists prioritise product or service-related factors. Furthermore, business proposals with a competitive edge are more likely to get funded.

Therefore, there is a substantial amount of research investigating the selection criteria in many areas around the world.Table 1 illustrates a summary of this literature review.

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Table 1 Summary of literature review of major studies around the world

Study	Country	Sample	Method	Statistical analysis	Findings
Tyebjee and Bruno (1984)	USA	46 venture capitalists	Survey	Regression, discriminant, and factor	Venture capitalists use different criteria like market attractiveness, product difference, management qualities, environmental threat resistance, and cash-out possibility.
MacMillan *et al.* (1985)	USA	102 venture capitalists	Survey	Cluster and factor	Top five investor criteria include entrepreneur personality and experience. Investors place a high importance on the entrepreneur's qualities.
MacMillan *et al.* (1987)	USA	67 venture capitalists	Survey	Factor, regression, and cluster	Two key factors emerged in this research: the extent to which the firm was originally protected from competition and the product's market acceptability.
Hall and Hofer (1993)	USA	4 venture capital firms	Interview	Verbal protocol	Venture capitalists value criteria like fit with the firm's financing guidelines,long-term industry growth and profitability,and source of the business idea.
Muzyka*et al.* (1996)	Europe	73 venture capitalists	Survey	Cluster and conjoint	Investors prefer a good management team and solid financial and product-market attributes.
Zinecker and Bolf (2015)	CEE and Russia	49 venture capitalists	Survey	Descriptive statistics	Venture capitalists look at product features including competitive advantage and return possibilities, as well as market size, growth, and management experience.
Siskos and Zopounidis (1987)	France	1 venture capital firm	Case study	Regression	Management quality was the most important criterion, whereas R&D was less important.
Pintado *et al.* (2007)	Spain	51 venture capital firms	Survey	Regression, contingency tables, and Mann-Whitney	Project feasibility, management team quality, and exit potential are the top three factors for evaluating company proposals.

				test	
Murray and Lott (1995)	UK	40 venture capital firms	Survey	Chi-square test	Venture capitalists evaluate investee firms based on market potential, and tech investors are more active with their firms.
Franke *et al.* (2006)	Germany	51 venture capitalists	Survey	Conjoint	Venture capitalists favour start-ups with comparable professional and work backgrounds, while investors with technical and management competence prefer technical and management start-up teams.
Silva (2004)	Portugal	1 venture capital firm	Observation	Case study	Venture capitalists value entrepreneurs' personal and professional skills and their dedication to the business idea, and further examine the business model to identify its competitive advantage and potential.
Nunes *et al.* (2014)	Portugal	20 venture capitalists	Survey	Mann-Whitney and Wilcoxon test	The personality of the entrepreneur and their previous work experience were the most important sets of criteria.
Shepherd *et al.* (2000)	Australia	64 venture capitalists	Survey	Conjoint	Investors use industry expertise to assess profitability, second is competitive rivalry, timing, and educational competence, followed by key success factor stability, lead time, and timing-lead time interaction.
Rah *et al.* (1994)	Korea	74 venture capitalists	Survey	Regression, discriminant, and factor	Investors select financing based on market attractiveness and evaluate real deals based on management competence.
Pandey and Jang (1996)	Taiwan	40 venture capital firms	Survey	Descriptive statistics	Investors assess the company's industry, financial health, and stage for first screening. Evaluation criteria include return on investment, entrepreneur's technical abilities, market demand for product, market growth

					potential, and liquid investments.
Guo and Jiang (2013)	China	37 venture capitalists	Interview	Descriptive statistics	Top selection criteria include entrepreneur traits, market features, product/service characteristics, financial consideration, and geographical consideration.
Wong (2009)	Hong Kong	45 venture capitalists	Survey	Regression, factor, and cluster	Investors value financial factors, along with competitive threat and market acceptance, followed by other factors like consistent effort, leadership, and track record.
Narayanasamy*et al.* (2011)	Malaysia	16 venture capitalists	Survey	Chi-square test	Investors value management integrity, leadership, exit prospects, and profits above business ideas.
Zutshi*et al.* (1999)	Singapore	31 venture capitalists	Survey	t test	The viability of a business depends on the traits of the entrepreneur or the capabilities of the management.
Kumar and Kaura (2003)	India	11 venture capitalists	Survey	Wilcoxon signed rank test	Successful businesses have four qualities: risk estimation, detail, market share, and profits. It shows that successful venture teams identify target markets.
Mishra (2004)	India	Venture capitalists	Survey	Percentage and rank	The personality of the entrepreneur as well as their previous experience were highly regarded qualities.
Mishra *et al.* (2017)	India	77 venture capitalists	Survey	Analytical hierarchical process	Indian venture capitalists prioritise product/service criteria, and funding is more likely for competitive business ideas.

Source: Authors' observations

Discussion and Conclusion

For start-ups with significant growth potential, venture capital is an absolutely necessary financial resource.The provision of financial backing by venture capitalists is an essential component in the growth and promotion of new businesses.They invest money and provide value-added services to portfolio firms. Thus, venture capital investment is vital to firm stability.If ventureinvestors believe the firm will succeed, they may support growth and continued operations. Venture capitalists are adept at picking new businesses and carefully consider funding ideas.This is because of the criteria that they use in order to evaluate new ventures.Venture capitalists employ a variety of criteria when deciding whether to invest in a company.Many studies have been conducted in this field to better understand the criteria employed by venture capitalists in different parts of the world. Thus, the objective of this review paper was to understand the different criteria that venture capitalists use to choose the companies they will invest in.For this purpose, different research articles were reviewed.

Previous research has concentrated on understanding and analysing the decision-making criteria that are utilised by venture capitalists.Advanced data analysis methods were used in these studies, which may provide valuable information. A review of these articles revealed that in terms of geographical area, approximately 19% of the studies were carried out in the United States. Furthermore, approximately 38% of the studies were concentrated in the European regions. An equal percentage (38%) of studies were conducted in the Asian countries. However, India in particular witnessed only 14% of the total studies. Thus, there is a dearth ofresearch in this area in the Indian context. Future studies could investigate the selection criteria of Indian venture capital investors.

In terms of statistical tools employed, regression analysis was the most widely used technique in approximately 29% of the studies, followed by factor analysis (approximately 24%), cluster analysis (approximately 19%), conjoint analysis (approximately 14%), and discriminant analysis (approximately 10%). Other studies employed some parametric tests and only one study utilised verbal protocol analysis and another utilised analytical hierarchical process. This indicates the existence of a methodological research gap in this field, which may be addressed by future studies.

In terms of selection criteria, a great majority of the reviewed studies revealed that venture capitalists place a high value on entrepreneur traits and managerial competence (MacMillan *et al.*,1985; Muzyka*et al.*, 1996; Zinecker and Bolf, 2015; Siskos and Zopounidis, 1987; Pintado *et al.*, 2007; Franke *et al.*, 2006; Silva, 2004; Nunes *et al.*, 2014;Rah *et al.*, 1994; Wong, 2009; Narayanasamy*et al.*, 2011; Zutshi*et al.*, 1999; Kumar and Kaura, 2003; Mishra, 2004). This is the most important requirement for investors.Another key criteria that have emerged from the assessment relate to the features of the product or service and the market characteristics (MacMillan *et al.*, 1987;Muzyka*et al.*, 1996; Zinecker and Bolf, 2015; Murray and Lott, 1995;Rah *et al.*,

1994;Pandey and Jang, 1996; Wong, 2009; Kumar and Kaura, 2003; Mishra *et al.*, 2017). After entrepreneur and management-related characteristics, investors place emphasis on these two criteria.This pattern has been noticed among venture capitalists worldwide. Additionally, a fewstudies have shown that venture capitalists also place a high emphasis on financial (Muzyka*et al.*, 1996; Pandey and Jang, 1996; Wong, 2009)and strategic factors (Hall and Hofer, 1993;Shepherd *et al.*, 2000). However, as can be observed, venture capitalists throughout the world placed the highest weight on entrepreneur traits, product or service attributes, and market characteristics.

Nonetheless, it was interesting to explore whether Indian venture investors followed the same pattern.It was observed that Indian venture capitalists follow the same pattern. They prioritise entrepreneur traits and managerial skills (Kumar and Kaura, 2003; Mishra, 2004), followed by market and product/service-related attributes (Kumar and Kaura, 2003; Mishra *et al.*, 2017).Future research can concentrate further on elucidating the selection criteria of Indian venture investors in order to obtain a deeper comprehension of their preferences.

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