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**Determinants of Venture Capital Funds'
Investment Decisions in Early-Stage Startups:**
An Analysis of Financial, Strategic, and Qualitative Factors

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Abstract

This thesis analyzes the determinants of venture capital investment decision-making in early-stage startups. While existing literature often examines financial, strategic, and qualitative factors independently, this study explores how these elements interact in practice and shape investment decisions in an integrated way. The aim is to better understand how venture capitalists make decisions under high uncertainty, especially when traditional financial metrics offer limited guidance.

The research adopts a qualitative and explanatory case study approach, focusing on Sequoia Capital's investment in Airbnb and Index Ventures' backing of Revolut. These two cases provide insight into how leading VC firms evaluate startups with strong growth potential but limited historical financial performance.

The findings are analyzed through three theoretical perspectives: Agency theory, Signaling theory, and the Resource-Based View (RBV). The results show that VC decision-making goes beyond financial projections. Investors rely on governance mechanisms to align incentives, assess credible signals that reduce information asymmetry, and identify intangible resources, such as founder capabilities, organizational culture, execution speed, and network effects, which can support long-term competitive advantage.

Overall, the thesis argues that VC investment decisions are not based on a single factor, but on the alignment of multiple dimensions. Investment conviction emerges when a startup's strategic position, the founding team's execution capacity, and the investor's ability to add value come together in a coherent way.

Acknowledgment

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Introduction

The role of the venture capital (VC) industry is significant for the global economy, as it offers funding and support services to new startups with high growth potential. Contrary to other financial institutions, venture capitalists invest in highly uncertain environments, where startups may not have any financial history or business models. Thus, it is not possible for venture capitalists to rely solely on financial models for making investment decisions.

Instead, venture capitalists use a variety of financial, strategic, and qualitative factors for making investment decisions. For example, venture capitalists consider factors such as founder endurance, flexibility of the team, and long-term competitive advantage for making investment decisions. However, there is limited understanding of these determinants and how they work together to make investment decisions.

This thesis attempts to bridge the knowledge gap with respect to the financial, strategic, and qualitative factors that affect VC decision-making, both independently and collectively. The study is grounded in Agency Theory, Signaling Theory, and the Resource-Based View Theory. The study also examines the case study of Sequoia Capital investing in Airbnb and Index Ventures investing in Revolut.

The primary aim of this study is to create a holistic framework to comprehend the role of qualitative factors in mitigating risks and the role of post-investment governance in the success of the firms. This study will also contribute to the existing body of knowledge by proposing a multi-dimensional framework to understand the decision-making process in the VC industry. The study will also be beneficial to entrepreneurs who want to attract top-tier investors to their firms. It will emphasize the need to adopt a holistic framework to evaluate high-potential firms in the context of high uncertainty.

Chapter 1: Conceptual and Theoretical Foundations of Venture Capital Investment Decision-Making

1.1. Venture Capital Investment Decision-Making

Venture capital is defined as the investment of long term, unquoted, risk equity finance in new firms made by professional investors, where the primary reward is a capital gain supplemented by a dividend yield (Wright & Robbie, 1998).

It involves the financing of new or radically changing firms which contrast in established companies quoted on the stock market the problem of asymmetric information.

Venture capital can be used also in firms undergoing radical restructuring. Early stage and start-ups are only 6% of the annual value of European venture capital investments (EVCA, 1995 in Wright & Robbie, 1998).

The key distinction between venture capital and mainstream corporate finance is related to the problem of asymmetric information. Venture capital investments are made in companies that aren't quoted on stock markets, where the investor trades off the short-term illiquidity in the shares for the prospects of a future return. New and radically changing firms are characterized by information asymmetrical problems between insiders and outsiders. Venture capitalists typically take an active and interventionist role in firm decision making. They are more actively involved than non-management shareholders in quoted corporations, including institutional ones. Their portfolios are likely to be undiversified compared to those of institutional investor (Wright & Robbie, 1998).

The task of the venture capitalist is to take the enterprise to a stage that is appropriate to other forms of financial intermediation and corporate ownership and control. It is appropriate for a specific subset of firms with non-redeployable or highly specialized assets. This, combined with the greater uncertainty associated with the cash flows of new technology firms in the early stage, implies that equity finance, as provided by the venture capitalist, is preferred to debt finance. The concentrated ownership and direct board position provided by the venture capitalist is preferred to the diffuse ownership implied by the mainstream corporate finance theory, because of the need to have timely access to

information and to intervene to control management (Wright & Robbie, 1998). Venture capital involves for early-stage projects the provision of several rounds of financing, which may bring complications to the investment decision but allows investor to exercise more control over multi-stage contracts (Wright & Robbie, 1998).

1.2. Stages and Processes of Venture Capital Investment

1.2.1. Deal Generation

In the beginning of the process of venture capital, it is important to have access to viable projects that can be funded at entry prices that will yield target rates of return. It is linked at the strategic level to venture capitalists' preferences with respect to investment stages and deal size, as well as information availability and the recruitment of venture capitalist executives with specific skill to search for deals. The problem with this link is to understand the dynamics of the power of customers in different segments of the market. In markets with high competition in deals, there is a shift to a more proactive approach, even though it involves higher costs and requires more technical and financial skills that some segments of the market may possess (Wright & Robbie, 1998).

1.2.2. Initial and second screening – Pre-contracting problems

When a venture capital investment is being considered, institutions face a potential adverse selection problem in which they are unable to measure the manager's performance in the enterprise prior to the deal completion. This also raises crucial problems in the potential effectiveness of post-transaction monitoring by institutional investors. As a result, the control mechanism introduced to meet the cost of servicing external finance may lead to sub-optimal decisions. Amit et al. (1990) developed a model that examines the nature of the adverse selection problem for venture capitalists. The general assumption is that the entrepreneur knows his own ability level and the venture capitalist does not. In the initial case, it is assumed that the entrepreneur is at risk neutral, and no new investment is needed. With these conditions, only entrepreneurs with below average ability will choose to involve a venture capitalist who, because of lack of information, makes a bid to fund a project

based on the average ability level. Which in the end results in a negative net present value investment and due to the problem of adverse selection, the market breaks down. Venture capitalists may enter a low bid because of the fear of the consequences of over-bidding for projects revealed to be poor performers. By doing this, they may attract less skillful entrepreneurs but also some higher ability ones who are seeking risk-sharing. Sweeting (1991) points out that venture capitalists have been particularly initiative-taking in deal generation to reduce adverse selection problems by becoming more involved with entrepreneurs at an earlier stage. Fried & Hisrich (1994) suggested that venture capitalists use three generic criteria for screening investments, the viability and novelty of the project; the integrity, track record and leadership skills of the management; and the possibility for high returns and an exit, before proceeding to detailed evaluation.

1.2.3. Valuation and Due diligence

DCF and discounted dividend yield methods are theoretically correct but pose problems in venture capital investments. With DCF it is difficult to forecast future cash flows in the highly uncertain environment of a start-up, so the expected error of the forecast will increase. On the other hand, applying the dividend yield method to early-stage investments can be difficult as they rarely pay significant dividends. The expected increase in the value of the VC is unlikely to be reflected in the dividend stream at least in the short term, though a higher value may have been generated at the time of the exit of the venture capitalists. For venture capital investments, it may be better to use the Options theory as it offers a potential interesting theoretical development in respect of the valuation of the investment since most of the value comes from the options being created on the future growth of the investment because of new opportunities. Venture capital investments give rise to two types of options. The multi-stage nature of venture capital investments presents an opportunity to invest now with the option of investing further later. The investor does not have any obligation to make subsequent investments but can wait until added information reveals the true nature of the potential benefits. So, as further

investment is a right and not an obligation, the investor owns a valuable option on the value of the investee. The second type of option arises from the nature of venture capital projects since investments in company specific knowledge may result in future cash flows that either exceed by far the initial outlays or total loss, which are difficult to exceed. The options theory has clear implications for the raising of venture capital since financial market participants will place greater value on the investments that create options and are more hesitant to finance those which exercise options (Wright & Robbie, 1998).

Evidence suggests that venture capital projects are typically valued by applying one or more valuation techniques to the financial and accounting information related to the potential investee contained in the business plan submitted by the management to the venture capitalist. The main importance appears to be attached to price earnings multiple-based valuation methods, with greater emphasis on DCF-based methods, particularly among later stage investors. The process is likely to involve several iterations based on assumptions about future trends in performance to test the robustness of the point at which the proposed venture meets an acceptable IRR; the most common measure of performance used in the industry. Murray and Lott (1995) show that venture capitalists perceive technology-based projects as riskier than alternative later stage projects and use higher target rate of return when assessing them, but also that the stage of financing is significantly more important in determining project risk than the state of technology involved.

A variety of issues such as time restrictions, cost constraints and situational factors may directly impact on the level of due diligence during an acquisition process. Evidence from buy-ins identifies a major problem related to the ability to obtain adequate updated information concerning the target company (Wright & Robbie, 1998).

1.2.4. Deal approval and structuring

Appropriate structuring of venture capital investments has important implications for the ability of the venture capitalists to earn their target rates of return. Sahlman (1990) shows that venture capitalists use various mechanisms to

encourage entrepreneurs to perform and reveal accurate information. These include staging of the commitment of investment funds which are disbursed incrementally and contingent upon the startup's achievement of predefined milestones. This structure reduces the downside risk for investors and incentivizes entrepreneurs to meet performance targets. In addition to this, venture capitalists usually employ convertible financial instruments, including preferred convertible equity and ratchet mechanisms, which allows them to adjust the ownership or control positions in the venture underperforms. Moreover, VCs often incorporate mechanisms that secure their rights to recover capital and profits, such as liquidation preferences or contractual provisions governing the distribution of returns. Finally, governance rights embedded in the company's Articles of Association, such as veto powers over major decisions, grant investors the authority to monitor and intervene when necessary. All these mechanisms enable venture capitalists to manage risk, exert influence and safeguard their expected returns in the uncertain environment of the early-stage ventures (Wright & Robbie, 1998).

In the first developmental phase of the project, a cash flow is generated and reinvested in the project, and it is what reveals the entrepreneur's skill to the venture capitalist. Based on this information, the venture capitalist determines whether to allow the entrepreneur to control the project for the second period or to transfer control to the venture capitalist. The cash flow produced at the end of the second period is shared between the two parties according to the initially agreed contracts.

The main characteristic of venture capital financing is the use of staged investments, where funding is released in multiple rounds depending on the achievement of specific milestones. While staging serves as a mechanism for risk management, it can also generate distortions in behavior. Entrepreneurs and first-round venture capitalists, acting as insiders, may face incentives to present selectively optimistic or misleading information to external investors to secure subsequent rounds of financing. These dynamic short-term to myopic decision making, where short term goals are prioritized over long-term value creation or

over-investment, where additional investment is made in projects that may no longer be viable.

Admati and Pfleiderer (1994) created a model to manage the agency problems in multistage venture capital investments which considers a project requiring three distinct stages: an initial investment to access the opportunity, a second stage continuation investment depending on the results observed after the first stage, and a final payoff realized in the third stage. They assume risk neutrality, which is later relaxed, no discounting, limited liability, competitive capital markets, and asymmetric information. Within this framework, they examine two alternative financing structures. In the first one, “entrepreneur-led financing”, the entrepreneur approaches external investors independently in both investment stages. Under this arrangement, only the entrepreneur observes the true state of the project, leaving in severe informational disadvantage the second stage investors. In the second structure, the entrepreneur involves a venture capitalist from the outset. The VC provides all the initial funding and contributes part of the capital required in the second stage. In this scenario, the entrepreneur and the venture capitalist observe the state of the project, but no additional second-stage financiers do not. Their analysis shows that, under venture-capital financing, a contract in which venture capitalists maintain the same equity fraction across all rounds of financing can neutralize the venture capitalist’s incentive to mislead about project’s state. In contrast, under the entrepreneur-led financing, no fully revealing signaling equilibrium exists that could eliminate asymmetric information problems. When the assumption of risk neutrality is relaxed in the venture capital setting, the contract must additionally be structured to address risk-sharing concerns between parties.

With a fixed-fraction contract, it is possible to vary the division of payoffs between entrepreneurs and outside investors who put up capital in the second stage as opposed to the initial venture capitalists. The entrepreneur’s risk can be mitigated by giving outside investors warrants which can be exercised when high-pay-off realizations give outside investors a large share of equity and vice versa in poor performance situations.

1.2.5. Post contractual monitoring

- **General:** Barney et al. (1989) show that venture capitalists adopt more elaborate governance structures when agency and business risks are high. Complementing this, Sapienza and Gupta (1994) examined some monitoring processes and found that the frequency of interaction depends on the CEO's prior new venture experience, the venture's developmental stage, technological innovativeness, and goal congruence between parties. Contrary to expectations, managerial ownership does not affect interaction frequency, suggesting that in highly uncertain environments, information exchange remains necessary even when incentives are aligned. Another finding was that entrepreneurs often possess irreplaceable, firm specific knowledge.

Additional research indicates three key insights about monitoring intensity. First, the level of monitoring depends more on the venture capitalist's preferred style of involvement than on characteristics of the investee firm itself. Second, monitoring decreases as venture becomes more developed and therefore less risky. Third, there is substantial variation across venture capitalists: different investors devote different amounts of time, provide different types of support, and take different actions when problems arise, even in similar investment context (Wright & Robbie, 1998). These patterns reveal that formal governance structures and monitoring mechanisms alone cannot fully explain investor-entrepreneur interaction. Even when appropriate contractual safeguards exist, much of the relationship depends on how information is shared, how decisions are communicated, and whether both parties perceive the governance process as fair. All this provides a natural bridge to the procedural justice perspective. Unlike the agency theory, procedural justice focuses on the fairness and transparency of decision-making processes. In the context of venture capitals, where entrepreneurs retain operational control and investors rely heavily on timely and accurate information, perceptions of fairness can significantly influence trust, cooperation and the need for intensive monitoring.

Taken together, these literatures suggest that effective governance in venture capital relies not only on contractual mechanisms designed to mitigate risk, but also on relational and procedural factors that influence how entrepreneurs and investors engage with one another over time (Wright & Robbie, 1998).

- **Restructuring and Failure:** active investor governance becomes particularly critical when venture-backed firms require restructuring. Ruhnka et al. (1992) show that “living dead” investments, companies that remain viable but fail to generate sufficient growth, typically result from managerial or market problems, and successful turnaround occurs only in around half of the cases, depending largely on the venture capitalist’s ability to intervene effectively. Implementing restructuring can be challenging due to difficulties in reaching consensus among entrepreneurs and co-investors, especially in smaller deals where founders hold significant equity. In larger transactions where institutions hold stakes, restructuring is easier, but large syndicates may still delay decisions due to conflicting priorities among investors (Wright & Robbie, 1998).

- **Investment realization:** issues relating to the exit or realization of venture capital investments concern when and how investors choose to exit. Exits may occur through an IPO, a full or partial sale to an external buyer, a secondary buy-out or buy-in, or receivership, and the duration of venture capital investments varies widely.

A key insight from the literature is that successful timing and structuring of exits requires alignment between the objectives of the parties involved. Venture capitalists often use board seats, monitoring, and contractual mechanisms to influence exit timing and ensure a timely realization returns. Governance structures must be flexible, especially when initial conflicts of interest were suppressed (Wright & Robbie, 1998).

Well timed IPOs reduce ownership dilution and yield substantial benefits for venture capitalists, although incentives may sometimes

encourage premature listings (Barry, 1994). Venture backed IPOs show lower underpricing and stronger post-issue operating performance, which is positively related to the quality of investor monitoring.

Valuation at exit can be difficult in low-information environments due to estimation risk. Since this risk declines as more information becomes available, venture capitalists may adopt staged withdrawal plans to maximize realized value (Lam, 1991).

- Entrepreneur's exit and assessment by venture capitalist, post exit monitoring – serial contracting and post-exit careers: studies on habitual entrepreneurship generally find little performance difference between novice and experienced founders. However, prior success can make fundraising easier, even if experienced entrepreneurs may risk repeating past behaviors. At the initial investment stage, venture capitalists often negotiate more favorable terms with inexperienced entrepreneurs by leveraging screening expertise (Birley & Westhead, 1994).

Existing theoretical models of contracting under asymmetric information do not address re-contracting with the same entrepreneur. In those cases, the entrepreneur now understands the venture capitalist's monitoring style and the fairness or advantages of prior contracts. Meanwhile, the venture capitalist has better information about the entrepreneur's skills but may need to revise assumptions about their risk preferences, which can change after the outcome of the first venture. This creates a multi-period strategic interaction that may make investors cautious about reinvesting in entrepreneurs from their own portfolio (Wright & Robbie, 1998).

Re-contracting becomes more complex when entrepreneurs exit from other investors' portfolios, as venture capitalist must manage adverse selection risks while dealing with entrepreneurs who understand the

negotiation process but not the specific investor. As a result, investors may adopt more cautious strategies.

Finally, understanding why entrepreneurs exit their ventures is strategically important. Ronstadt (1986, 1988) did research where is shown that many early exits do not reflect a lack of entrepreneurial potential which highlights the need for targeted monitoring and engagement by venture capitalists following an entrepreneur's departure.

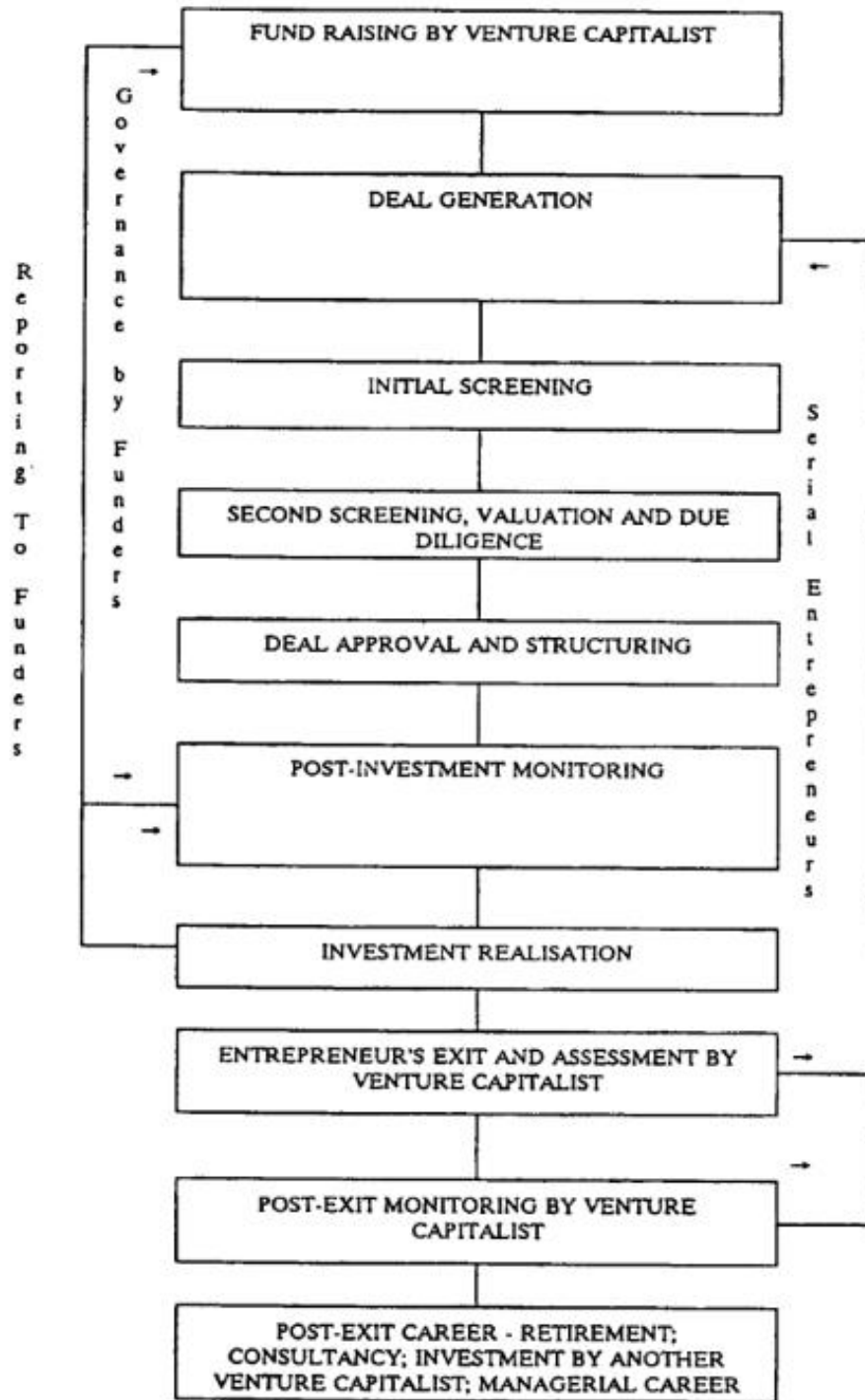


Figure 1- Venture Capitalist Fund Raising, Deal Appraisal, Monitoring and Serial Entrepreneurs

1.3. Determinants of Investment Decisions

1.3.1. Financial Factors

Venture capitalists focus on ventures based on financial criteria, which measure the probability of achieving high returns. Some of these criteria are based on growth and scalability of the venture, as they measure the probability of achieving large future cash flows (Gompers & Lerner, 1999).

Furthermore, valuation and deal structures are important criteria for venture capitalists because they determine ownership and downside risk for investors, especially during periods of uncertainty (Kaplan & Strömberg, 2004). Venture capitalists' exit strategies are also important criteria for venture capitalists, especially for those who rely on exit routes for returns on investment (Megginson & Weiss, 1991). Lastly, good governance is essential for mitigating risks and making ventures more attractive for investment (Sahlman, 1990).

- **Expected returns and growth potential:** venture capitalists work under a high-risk, high-reward model in which most of their investments may not do well or may fail, and therefore, there is a need to make sure that a few investments do extremely well to make up for the failures and generate wealth for the limited partners. Hence, venture capitalists look to fund startups that have the potential to grow very quickly and attain market leadership in a big or growing market (Gompers & Lerner, 1999).

To figure out how much a startup can grow, you need to look at more than just its financial performance. First, venture capitalists look at how financially scalable the startup is. This means figuring out if the revenue can grow faster than the costs as the business gets bigger. To do this, you need to look at things like the venture's unit economics, which means figuring out if the lifetime value of customers (LTV) is higher than the cost of acquiring customers (CAC) and if the venture can keep its marginal costs low (Metrick & Yasuda, 2021). A business with good unit economics can grow faster and has a better chance of making money over the long term.

Second, there is market sizing and adoption analysis, where one evaluates if there is an addressable market (TAM, SAM, SOM)¹, and its size is large enough for exponential growth. Markets undergoing rapid technological change, deregulation, and unsatisfied customer demands are considered more attractive because they present opportunities for a company to dominate (Baum & Silverman, 2004). These market indicators, such as customer acquisition, conversion rates, and retention rates, are essential for ensuring that there is a chance for market penetration and expansion.

The third dimension is where one evaluates the competitive advantage of the new venture, which is defined as its ability to create a defensible market position. Investors want to identify unique technology, patents, network effects, and data-driven differentiation, among other barriers, which prevent new market entrants from easily replicating the business model (Gompers, Kaplan, & Mukharlyamov, 2020). This is essential for ensuring that not only is there rapid growth, but it is sustainable as well.

Additionally, the strategic fit with respect to the product, business model, and market trends will be assessed. If the business opportunity matches the upcoming changes in the industry, like AI, digitalization, or sustainability, VCs will be more confident about the business's ability to grow. In addition, strategic partnerships or market leadership will provide a high degree of confidence about the business's ability to grow.

In conclusion, the ability to grow will be assessed in a complete manner that includes not only the business's ability to grow in the future in financial terms but also its ability to grow in the market and sustain its competitive advantage to achieve high returns that can be expected in venture capital investments.

- **Risk assessment:** This entails a thorough assessment of the uncertainty involved in new and early-stage ventures, during which tangible financial performance is minimal, and results are highly uncertain in the future. The

¹ TAM (Total Addressable Market), SAM (Serviceable Available Market), and SOM (Serviceable Obtainable Market) are metrics used to measure a market's size and potential.

risk analysis is multidimensional because venture failure is often caused by numerous sources of risk, and only a few successful firms are expected to produce high returns to offset systematic losses of firms in the portfolio (Gompers & Lerner, 1999). Perhaps one of the most important aspects is team and execution risk since it is highly dependent on the competence of the founding team and their capacity to handle challenges and change throughout the venture's life cycle (Baum & Silverman, 2004). Ventures led by coachable entrepreneurs with visionary and strategic leadership are positively assessed.

Additionally, VCs also look at the product and technology risk, which involves assessing the degree of innovation, the defendability of the intellectual property, the complexity of the development, and the possibility of scaling the product from the prototype stage. For the deep-tech industries, the period of the research and development process, the regulatory risks, and the capital costs involved make the uncertainty of the market entry a major area of concern (Metrick & Yasuda, 2021). Moreover, the market and adoption risks are also critical factors that need to be considered while making the evaluation, as a technology with the potential for success can fail if the customers are not willing to adopt the changes from the existing solution, the purchase behaviors of the customers are not well understood, and the timing is wrong.

In order to evaluate the financial risk involved in a business, venture capitalists make use of a range of quantitative factors, which include factors such as the ability of the startup to create value in relation to its growth rate, such as the burn rate, which is the rate at which the startup is burning its cash reserves, and thus the runway, which is the rate at which the startup is running out of money, and thus the rate at which the next round of funding has to be raised, such as in cases where the runway is short, implying high chances of bankruptcy and unfavorable conditions (Metrick & Yasuda, 2021). Another factor that is taken into consideration by the venture capitalists is the scalability of the gross margin created by the startup in

order to create value in relation to the growth rate (Sahlman, 1990). Another factor taken into consideration is the amount of funding that may be required by the startup in order to create the next round of value, such as in cases where the startup has a long runway before creating the next round of value (Admati & Pfleiderer, 1994).

Furthermore, the process of assessing the risk of dilution exposure is done through capitalization structure, which ensures that the founders remain aligned and incentivized as subsequent funding rounds take place (Kaplan & Strömberg, 2001). All these factors enable the investor to assess the viability of the venture in terms of surviving the uncertainty associated with the early growth stage and eventually providing risk-adjusted returns in accordance with the expected returns from a venture capital investment. Competitive risk is also assessed by considering the incumbent's response, entry barriers, and the possibility of saturation in the market before the venture gains scale (Gompers, Kaplan, & Mukharlyamov, 2020). Lastly, the risk associated with governance and incentives is addressed by structuring the vesting schedules, board representation, liquidation preferences, and milestone-based funding tranches.

Essentially, the risk assessment process for venture capital investments is not just to mitigate the possibility of failure, but to determine if the risk return asymmetry is such that the probability of success is substantially higher than the probability of failure. While the startup may be characterized by high risk and high potential, the startup may be considered viable if the startup has the potential to create, capture, and grow to such an extent that capital gains may be realized, which are substantially higher than the capital losses that may be incurred on the venture capital portfolio (Gompers & Lerner, 1999; Metrick & Yasuda, 2021).

- **Capital requirements and investment staging:** It represents a key mechanism for managing uncertainty for venture capital decisions. VCs, before making any investment decision, make a critical evaluation of the capital requirements of the venture, ensuring that the capital required by the

venture is aligned with realistic business goals and objectives, and the need for additional rounds of funding emerges as a result of the growth of the venture (Sahlman, 1990). It also includes the evaluation of the burn rate of cash, availability of cash, and capital requirements of industries, where ventures in industries such as biotechnology and hardware require significantly higher amounts of capital before any revenues are generated (Metrick & Yasuda, 2021).

As a mechanism of managing risk, venture capitalists rarely provide the total amount of capital at one go, where the amount of capital invested by venture capitalists is staged, and investment is made at multiple stages subject to the achievement of performance milestones (Admati & Pfleiderer, 1994). Each stage of investment of venture capitalists represents a real option, where venture capitalists have the right but not the obligation of investing additional amounts of capital subject to the demonstration of progress of venture capitalists (Gompers, 1995).

The staging of the deal also aids in mitigating information asymmetry. This is because, as the entrepreneurs begin to demonstrate their entrepreneurial abilities over time, investors continually update their beliefs regarding the actual potential of the firm. This aids in better risk assessment and valuation of the firm in the next stages of funding (Bergemann & Hege, 1998). The staging of venture capital also aids in better corporate governance. This ensures accountability and maintains bargaining power for investors during negotiations of the next stages of funding (Tian, 2011).

At last, ventures with better capital efficiency, wherein there is higher value inflection with lower capital requirements, become more attractive as they reduce the risk of dilution and maximize returns. Thus, the staging of venture capital aligns incentives and strategically aids the venture in its growth trajectory towards exit.

- **Exit opportunities:** an important factor in the investment decisions of VCs, since the economic payoff to investors is realized only if exit is successfully accomplished. Before making any investment in the target firm, VCs take

into consideration the viability, time period, and profitability of exit routes such as initial public offerings, trade sales, secondary buyouts, recapitalizations, and share repurchase (Wright et al., 1994). The exit window, which is expected to take place in a 5- to 10-year period, is also in consonance with the constraints placed by the limited partnership structure, which is followed by VCs and is expected to result in the distribution of payoffs to limited partners (Gompers & Lerner, 1999). Among the exit routes, the most preferred route has always been the IPO, considering the high valuation and the associated benefits. It has also been reported that IPOs backed by VCs result in lower underpricing and high operating performance compared to those firms that are not backed by VCs, thus indicating the added value created by VCs before the IPO (Megginson & Weiss, 1991; Jain & Kini, 1995). However, it is also important to note that the feasibility of the entire IPO process has remained subject to market and industry conditions such as the growth momentum and size of revenues of firms (Lerner, 1994). Thus, during periods of high capital market constraints, VCs increasingly prefer trade sales because of higher and assured exit options for VCs, even if it compromises the growth potential of the entrepreneur (Petty, Beyer, & Bygrave, 1993).

The exit options also play a crucial role in selecting industries in which VCs are likely to invest, as VCs prefer industries with a higher market for M&A deals or industries with high market investment potential. The entire issue of governance structures, including control, is also subject to exit options, as VCs, considering the urgency of exit options, are likely to exert higher control through mechanisms such as equity ratchets (Wright et al, 1994).

There are various ways in which venture capital contracts provide protection for the return on investment as well as the efficiency in the distribution of exit gains. For instance, liquidation preferences provide protection in that the investors will receive a higher amount of capital, usually in multiples of the investment amount, compared to the common shareholder return (Wright et al., 1994; Leisen, 2012). In addition, the use of participating preferred stocks

provides return asymmetry in that the investors will receive the amount of the preference stock as well as participate proportionately in the remaining gains (Ewens, Nanda, & Rhodes-Kropf, 2023).

Finally, the use of anti-dilution provisions, also known as ratchets, ensures that the venture capital investors are not diluted in the later stages of financing, especially in the case of a down round (Sahlman, 1990; Leisen, 2012).

The provisions regarding control rights also facilitate exit execution. Drag-along provisions ensure that minority shareholders cannot block exit by VCs through forcing all shareholders to sell under negotiated conditions. This ensures that a viable exit opportunity is not missed. At the same time, tag-along provisions also ensure that minority shareholders are not prejudiced because they are allowed to sell under the same conditions as VCs (Leisen, 2012). Finally, redemption provisions ensure a contractual safety net is in place in case of a scenario without exit opportunities through forcing a repurchase of shares after a specified period of time (Ewens, Nanda, & Rhodes-Kropf, 2023).

Thus, exit opportunities are subject to a dual evaluation process: market-based exit opportunities form the basis of expected returns, while the enforceability of contractual provisions forms the basis of actual return realization. The higher the number of exit opportunities available, the higher the venture's attractiveness is in meeting the performance requirements of the VC model.

1.3.2. Strategic factors

They have a critical role to play in the investment decisions made by venture capitalists because they provide an estimate of whether the venture will be able to attain the required market share to create the necessary multiples to make up for the losses incurred in the investments. While financial analysis provides an estimate of whether the business will be successful in theory, strategic analysis provides an estimate of the potential for success in practice – the size of the target market, the inherent scalability of the business model itself, and the

sustainability of the competitive position. Venture capitalists use their intelligence about the market, product/market fit, as well as defensibility to make probabilistic estimates about the ability of the venture to grow exponentially to create the necessary multiples to make up for the losses in the investments (Gompers & Lerner, 1999; Baum & Silverman, 2004). These strategic dimensions are not just assessed in terms of the present situation, but also in terms of their orientation to the future, in terms of the industry's future evolution, and the ability to create barriers to entry (Christensen, 1997; Kaplan, Sensoy, & Strömberg, 2009). As such, the process of strategic analysis is also a differentiating factor in the VC screening process, whereby only those ventures are considered to have the potential for rapid scalability in growing markets and a unique value proposition, which can result in venture-level returns (Sahlman, 1990; McGrath, 2013).

- **Market opportunity:** one of the most critical factors that venture capitalists take into account when making investment decisions, as the potential economic return is intrinsically linked to the size and growth rate of the target market (Gompers & Lerner, 1999). Venture capitalists concentrate on industries that have structural growth due to changes resulting from technology, the environment, and human behavior, which offer opportunities for new entrants into the industry. When assessing the target market, venture capitalists consider a range of factors that can be used to forecast the potential for the startup to reach a size where it can deliver venture capital returns, and these factors include:
 - **Total Addressable Market (TAM):** This is defined as the maximum potential revenue that can be generated for a particular product or service, provided that there is 100 percent penetration in the market. TAM is defined as the broadest scope of the target market, and venture capitalists use this as a factor to determine the target market to ensure that the startup has a sufficiently large target market to achieve venture-level returns.

- **Serviceable Available Market (SAM):** This is a refinement of the previously defined market to specifically include that portion of the market that the startup can realistically reach based on the particularities of the product or other issues that affect the market. Investors are interested in this metric to ensure that the startup's strategic focus is rational and sufficiently large to achieve venture-level success.
- **Serviceable Obtainable Market (SOM):** This is yet another measure of refinement for determining what portion of the SAM is available for competitive acquisition by the startup. This includes measures of traction, adoption rates, etc. This is an essential measure for venture capitals to ensure that they are able to determine whether the startup has a legitimate estimate of its initial potential for revenues and whether its initial estimates are reasonable. A legitimate estimate of SOM based on actual customer behavior is a good indicator of whether the venture capital startup is likely to gain traction in the future for higher market penetration.
- **Compound Annual Growth Rate (CAGR):** While the TAM can be used to determine the size of the opportunity, the CAGR can be used to determine the rate at which this opportunity is growing. High Growth Market (15%-30% CAGR): This allows startups to grow at high rates without having to compete with existing businesses, as the growth of the market itself is creating new room. Conversely, low growth markets limit the potential of strategy and increase the level of competition. Thus, in effect, a startup in a high growth market is inherently more attractive to venture capital, as compound growth multiplies all benefits.
 - **Stage of Market Adoption:** Besides the size and growth of the market, investors are also interested in the stage at which

the market is adopted, whether it is at the early adopter phase, early majority, or whether the market is already mature.

- **Early-stage markets:** These are the most attractive but also involve the most risk.
- **Growth-stage markets:** These have good growth potential.
- **Mature markets:** These markets have little or no growth potential unless the startup shows signs of a breakthrough innovation that can compete with existing players.

All these factors will be used to assess the likelihood of this venture achieving massive scale.

However, the size of the market on its own is not sufficient. VCs also consider the accessibility of the market, which means the extent to which the startup can capture economic value. This includes analyzing the fragmentation of the competitive landscape, entry barriers, and the underlying customer pain point. For example, the size of the market, saturation, and highly competitive positioning might not have high growth potential compared to a less attractive and less mature market with exponential growth potential and low entry barriers.

Additionally, VCs consider the future potential of the market through analyzing the demand drivers of digitalization, demographic change, and sustainability, which represent the long-term growth potential of the market, thus eliminating systematic risks. Artificial intelligence, fintech, biotech, and renewable energy have high long-term acceleration potential and high levels of innovation.

Lastly, the attractiveness of the market opportunity is assessed, and this is done alongside the exit market conditions. Industries with an existing IPO market and M&A activities are likely to have attractive exit markets, which is essential in the venture capital model. This, therefore, means that the market opportunity not only defines the potential size of the venture but also defines the economic viability of the entire investment cycle (Wright, Hoskisson, Busenitz, & Dial, 2007).

- **Scalability:** This is an essential aspect of the venture capital investor's strategic decision-making process, as it allows them to assess whether the startup has the potential to scale up the exponential growth of the startup from the early growth phase. It is essential for venture capital investors to assess the inherent scalability of the startup through the assessment of whether the startup's revenue growth can scale up exponentially without proportionately increasing its marginal costs. An essential aspect of this scalability is the assessment of the unit economics of the startup, as this allows the venture capital investor to assess whether the startup's growth is creating value or destroying value. An essential aspect of this scalability is the calculation of the LTV/CAC ratio, where the startup's customer value is compared with the cost of acquisition. The startup's LTV/CAC ratio is high, representing a value greater than 3:1.

The other important factor is the gross margin expansion potential. This factor is significant in determining if the venture's margin expands as the scale grows. Ventures such as those in the software-as-a-service industry and those in the artificial intelligence tools industry have lower marginal costs as the scale grows. This implies that their gross margin expands as the scale grows. This factor is significant to venture capitalists since it allows the business to generate compound returns in the form of increased cash flow. The next factor is operational leverage. This factor is significant in determining the extent to which the venture can scale up without necessarily growing the operational costs. If the venture has high operational leverage, then it is possible for the venture to scale up without any constraints. Apart from these factors, the scalability evaluation also considers replicability of the venture's process. Ventures such as those in the software-as-a-service industry and those in the artificial intelligence tools industry, which have the ability to replicate their business model in different markets with little or no change in their product's architecture, are those which have high scalability. Lastly, the test of scalability is carried out under the scrutiny of competitive pressures. Investors look to invest in businesses that will not only increase

their competitive advantage, or moat, but will also deepen their moat as they increase in size. Startups that can achieve this are the best investment options because they are the key to reaching high market shares and hence high returns in the long term (McGrath, 2013).

- **Competitive Positioning:** This is a crucial factor in strategic decisions made by venture capitalists. This factor is crucial because it affects the capacity of a venture to maintain its position in the market in relation to its existing and potential competitors and still sustains its growth.

Venture capitalists are looking for ventures that are not only able to gain access to competitive markets but are also able to build sustainable competitive advantages that will shield them from the risk of rapid imitation and consequent loss of economic value. This is ascertained by the existence of an economic moat developed by the venture that will enable it to gain and sustain market share.

One of the key aspects of this is barriers to imitation. This could be in terms of intellectual property rights and technology know-how. This will give additional time for the startup to realize abnormal profits because of barriers to imitation. The learning curve could also be a sustaining factor for the competitive advantage of the firm if it operates in industries where knowledge is a critical factor in product and service delivery.

Another major source of competitive advantage for a firm is network effects and data accumulation. This is especially true in industries that operate platform and digital-based business models. The value of the product or service increases as the number of users increases. This is a major source of competitive defense for firms that are early movers in such industries. The higher the number of users, the higher the barriers to imitation for new entrants, and this maintains the competitive advantage of the early movers. Additionally, it could be in industries that operate on competitive advantages based on data, and the firm is using its own data to improve its product performance.

Another aspect the venture capitalists consider is strategic differentiation. This entails examining whether the startup has a well-articulated value proposition, which cannot be easily replaced. Differentiation can be based on greater user experience, cost leadership through process innovation, or serving unserved customer segments. It should also be examined whether differentiation can survive despite the presence of competition and cannot be easily challenged by existing firms with greater resources (Porter, 2008).

Lastly, positioning in terms of competition is also associated with timing and positioning. Startups that have positioned themselves in structural change are likely to have the opportunity to establish dominance before the market becomes crowded. Strategic positioning in these structural changes gives startups the opportunity to establish standards, relationships, and customer expectations, hence promoting dominance (Gompers et al., 2020).

So, in summary, venture capitalists are looking for investments in ventures where there are good competitive positions, entry barriers, differentiation defenses, and timely market opportunities. These are the types of ventures where there is likely to be good growth, where there can be good responses to competitive challenges, and where there can be good value creation.

1.3.3. Qualitative Factors

They are also very important in the investment decisions made by venture capitalists, particularly in a situation characterized by high uncertainty, imperfect information, and a fluctuating market environment. Since the ventures at this early entrepreneurial process do not have an established financial record and an established business model, venture capitalists require information on the abilities and leadership qualities of the founding team and the organizational culture and reputation that they establish. Research studies support the empirical findings that the most important predictors of venture performance and survival are qualitative factors (Kaplan, Sensoy, & Strömberg, 2009).

- **Team quality and human capital:** team quality is regarded as one of the most important investment criteria in VC investment. Venture capitalists

assess various aspects at the individual level and team level, which include team complementarity, team cohesion, and team flexibility. Teams with experience in startup and scaling are regarded as more effective in managing uncertainty, adversity, and new opportunities. Most importantly, venture capitalists assess the learning ability and coachability of the team, as this is regarded as an important aspect in order to effectively work with them (Gompers et al., 2020).

- **Leadership and execution capacity:** The quality of leadership is not only judged on the basis of the vision; rather, but it is also judged on the basis of execution capacity. Venture capitalists look for a founder who is not only able to present a strategic vision but also has the capacity to execute it. Leaders who are exceptionally good are those who have the capacity to attract the right talent and execute strategies with the right allocation of resources and focus. It is also found that leadership plays a significant role in instilling confidence among the investors, especially with regard to decisions made by the management. The role of leadership is said to mitigate agency issues through alignment with management behavior and objectives of value creation (Kaplan & Strömberg, 2004).
- **Organizational culture and values:** this factor is increasingly being recognized as a vital factor for long-term success. Venture capitalists assess the culture of the startup regarding innovation, accountability, and ethics, which have a direct bearing on the motivation of the employees. The culture of the organization facilitates coordination and reduces frictions, hence reducing the risk of execution of the venture as it grows. Furthermore, a culture of transparency facilitates information sharing between the entrepreneurs and venture capitalists, leading to trust without requiring costly monitoring mechanisms (Sapienza & Korsgaard, 1996).
- **Reputation and signaling effects:** it acts as a vital tool for venture capital markets that experience information asymmetry between entrepreneurs and venture capitalists. Entrepreneurs with positive reputations are likely to access venture capital at favorable terms. The signs of reputations reduce

risk as they are third-party assessments of venture quality and entrepreneur competence. Just like entrepreneurs, having prestigious venture capitalists as partners is likely to enhance legitimacy and thus improve access to customers and subsequent venture capital (Hsu D. H., 2004).

In the end, qualitative factors shape the investment decisions of venture capitalists because they affect their expectations in terms of execution, flexibility, and ultimate value creation. High-caliber teams, good leadership, good organizational cultures, and positive reputation-related factors offset uncertainty and agency risks, hence making the venture more attractive despite the lack of performance history. In other words, qualitative analysis enters the processes of venture capital decision-making as a vital pillar.

1.4. Comparison of Venture Capital with Other Types of Investors

Venture capital is not alone in entrepreneurial finance markets but is rather associated with other forms of private equity finance investors, specifically business angels. As much as venture capitalists and business angels are similar in that they provide equity finance for high-growth ventures, there are differences between them, particularly regarding their decision-making process, capital sources, and control mechanisms, which affect their approach and relationship with entrepreneurs.

1.4.1. Venture capital vs Business angels

- **Decision structure:** one of the major differences between venture capitalists and business angels is their decision-making processes. Venture capital firms operate in a formalized framework in which their decisions to invest in a particular venture are collectively evaluated through an investment committee and a standardization of screening, due diligence, and approval processes. These processes, while intended to ensure consistency, control, and accountability to limited partners, tend to be time-consuming and conservative in nature (Gompers & Lerner, 1999).

On the other hand, business angels are investors who make their own judgments and decisions based on their own risk-taking ability and experience. This makes the decision-making process of business angels prompt and intuitive, with great

emphasis on their own credibility and trustworthiness and little emphasis on financial evaluation. This enables business angels to invest in new and risky business ventures that have not yet become mature enough to meet the standards set by venture capital firms.

- **Source of capital:** This is one major difference between venture capitalists and business angels. Venture capital firms have the responsibility to manage capital that is sourced from different sources such as institutional investors like pension funds, insurance companies, endowment funds, and wealthy individuals. This capital is in the form of limited partnerships with a limited life span, making venture capitalists highly motivated to utilize this capital in an efficient and effective manner to achieve the anticipated financial gains for their limited partners.

On the other hand, business angels invest their own personal funds. Since they are not answerable to anyone else, business angels are less likely to experience restrictions in terms of investment period and exit strategies. This gives them the flexibility to wait for a longer period to realize their investment and to prefer non-financial motivations such as their own interest, pleasure, and satisfaction.

- **Control and governance:** naturally, the variation in capital structure and answerability translates into different models of control and governance. Venture capitalists prefer to include contractual safeguards such as board representation, veto power, staged funding, and performance-contingent equity. These are implemented to address agency costs and information asymmetry and to retain flexibility to intervene if needed (Kaplan & Strömberg, 2004).

Business angels usually have less control over the firm. Although some of them may offer strategic advice, industry connections, and operational assistance, they may have less of an institutional control and may not enter into formal contractual agreements. However, in some cases, there may exist some similarities with venture capital governance practices, particularly in cases where the angel investors invest heavily in the firm and in angel syndicates.

- **Implications for entrepreneurs:** The implications of these differences for entrepreneurs' funding decisions are critical. For very early-stage

entrepreneurial ventures, angel investors may be more appropriate since they may offer funding to very early-stage entrepreneurial ventures. In contrast, venture capitalists may be more appropriate for entrepreneurial ventures with aggressive growth strategies since they require huge funding and formal control. Thus, angel investors and venture capitalists may complement each other in the entrepreneurial finance landscape. In fact, angel investors may bridge the gap for entrepreneurial ventures to attract venture capital funding in the future.

Tech as distribution channels, technical expertise, brand reputation, or manufacturing capabilities, which can significantly accelerate commercialization and scaling.

However, such relationships also introduce potential risks. Entrepreneurs may face constraints on strategic flexibility, concerns over intellectual property appropriation, or reduced attractiveness to alternative acquirers due to perceived corporate influence. These risks can affect future financing options and exit opportunities.

1.4.2. Venture capital vs corporate venture capital

Corporate venture capital (CVC) can be defined as a special type of equity financing for entrepreneurial firms, where existing firms invest directly in new entrepreneurial firms, either through venture units or strategic venture units. Although there are some similarities in terms of financial tools and growth orientation, venture capital and independent venture capital have some fundamental differences in terms of investment goals, decision factors, governance structures, and effects on entrepreneurial firms.

- **Investment goals and strategic orientation:** the fundamental difference between venture capitalists and corporate venture capitalists is based on investment goals. Independent venture capital firms are motivated mainly on financial grounds, where the goal is to secure maximum financial returns for limited partners within a specific time period. Investment decisions are based on growth, scalability, and feasibility of high value exits like IPOs or trades (Gompers & Lerner, 1999).

On the other hand, corporate venture capitalists have a two-fold objective, where financial and strategic returns are equally important for the parent company. Strategic objectives of corporate venture capitalists may include gaining access to new technologies, gaining new market information, improving internal corporate innovation, and developing real options for acquiring new companies. Thus, corporate venture capitalists may invest in new ventures where financial returns are uncertain, as long as they receive sufficient strategic information (Chesbrough, 2002).

- **Decision-making structure and investment horizon:** Venture capital firms have a relatively autonomous decision-making process and are subject to limited partner pressure regarding fund performance and exit strategies. This allows venture capital firms to focus on achieving liquidity events over a standard 5-10 year investment horizon (Sahlman, 1990).

However, corporate venture capital decision-making processes are sometimes subject to corporate governance structures. In other words, corporate venture capital investment decisions sometimes require alignment with corporate strategy or approval at higher organizational levels. Although this process can hinder corporate venture capital decision-making speed and introduce organizational frictions, corporate venture capital can set long investment horizons, especially in cases where strategic integration and learning are prioritized over exit-oriented investment strategies. However, corporate venture capital investment programs can sometimes be subject to changes in corporate strategy, management, or economic conditions, which can abruptly change investment priorities.

- **Governance, control, and value creation:** independent venture capitalists are usually involved in governance and control and use various devices to exercise control in order to mitigate agency conflicts and align venture capitalist and entrepreneur incentives. In this regard, venture capitalists are usually involved in professionalizing management, strategic advice, and exit preparation (Kaplan & Strömberg, 2004).

Corporate venture capitalist, on the other hand, are likely to have a more selective and strategic involvement. Some corporate venture capitalists are very active in governance, while others take on a rather passive role in order to avoid potential conflicts of interest and entrepreneurial autonomy. Startups financed by venture capitalists can gain from the complementary assets of the corporation, which can be very useful in speeding up the commercialization process.

There are, however, potential risks associated with these relationships. There are risks of restrictions on entrepreneurial flexibility, risks of intellectual property appropriation, and risks of reduced attractiveness to potential acquirers.

- **Implications for entrepreneurs:** in terms of entrepreneurs, the decision to go with venture capital or corporate venture capital implies different trade-offs. While venture capital provides financial discipline, professional governance, and incentives to achieve rapid scaling and liquidity events, corporate venture capital can provide resources and industry endorsement that are hard to find anywhere else, especially in technology-driven industries. Therefore, the best investor model will depend on the strategic needs and growth trajectory of the startup as well as its willingness to be dependent on another entity strategically.

1.4.3. Venture capital vs private equity/buyout funds

Venture capital and private equity are sometimes considered together as a category of alternative investments, but they are different from one another in terms of investment focus, risk profile, governance, and value creation mechanisms. Venture capital deals are focused on new firms that have high growth potential, characterized by extreme uncertainty, while private equity, on the other hand, deals mostly with mature firms that have a stable cash flow profile and a strong market position.

- **Investment stage and risk profile:** Perhaps the most striking difference between venture capital and private equity deals is the investment stage of the target firms. Venture capitalists usually invest in new firms, which have no operating history, cash flows, or business models, and so the investment risk of venture capital is very high, offset by the prospect of very high returns, while

private equity deals are associated with lower risk because of the maturity of the target firms (Gompers & Lerner, 1999).

Unlike venture capital funds, private equity funds focus on later-stage or mature companies, and many times, leveraged buyouts (LBOs) are conducted on companies that have consistent cash flows to service debt. Therefore, the risks faced by private equity investments are more financial in nature, as compared to venture capital investments.

- **Capital Structure and Value Creation Mechanisms:** Venture capital investments are mostly equity-based, and the main source of return on investment for venture capital investors is through capital appreciation, either through an IPO or acquisition. Value creation for venture capital investments occurs through rapid growth, innovation, and expansion (Sahlman, 1990).

In contrast, private equity investments usually involve substantial leverage, which can increase the magnitude of the return, as well as the level of risk. PE funds seek to create value through improvements in operating efficiency, restructuring incentives for management, optimizing the capital structure, and implementing cost reductions and/or strategic focus. Growth, on the other hand, is generally incremental rather than exponential. Downside risk assumes greater importance.

- **Governance and control:** the nature of governance between the two types of investors varies considerably. Venture capitalists, for instance, generally hold minority positions, but hold significant control through board representation, use of staged investments, and provisions to mitigate agency problems given the high level of uncertainty (Kaplan & Strömberg, 2004).

In contrast, private equity investors generally hold majority or controlling positions in portfolio companies. This, therefore, permits PE funds to exercise direct control over key business decisions, such as management replacement, divestiture of assets, and capital allocation. In this respect, the nature of governance for PE investors is more hierarchical compared to venture capitalists.

- **Exit timing and objectives:** VCs' exits are influenced by the lifespan of the funds under management and the capital market conditions. Thus, the timing of

the exits is not certain and is highly sensitive to the market conditions (Lerner, 1994).

Exit strategies for private equity investments may be more certain and include secondary transactions such as buyouts or recapitalization strategies. Since the target companies for private equity investments are relatively more developed, the focus is not on the growth prospects but on performance improvements.

- **Implications for entrepreneurs and managers:** Venture capital investments provide a boost for the entrepreneur or company through the availability of funds and expertise at the cost of loss of control and increased scrutiny. In contrast, private equity investments are relatively more associated with the change of ownership or restructuring situations and imply a loss of control and autonomy.

Dimension	Venture Capital	Business Angels	Private Equity	Banks/Debt financing
Capital source	Institutional funds from limited partners	Personal wealth of individuals	Institutional funds	Deposits and lending capital
Investment stage	Early to growth stages	Seed and early stages	Mature, established firms	All stages, but asset-backed
Investment size	Medium to large	Small to medium	Large	Varies, based on collateral
Risk tolerance	High	Very high	Moderate	Low
Expected returns	Very high (power-law driven) ²	High	Moderate to high	Fixed interest
Decision structure	Formal, committee-based	Informal, individual	High structured	Credit-based assessment
Control and governance	Active: board seats, veto rights	Limited to moderate	Strong control	No control
Value-added role	Strategic, financial, and governance support	Mentorship. networks	Operational restructuring	None
Time horizon	Medium to long term (5-10 years)	flexible	Medium term	Fixed repayment schedule
Exit orientation	Essential (IPO, trade sale)	Opportunistic	Planned exit	Not applicable
Ownership dilution	Significant	Moderate	Significant	None

Figure 2 - Comparison of Venture Capital with Other Types of Investors

² VC performance depends disproportionately on a small number of extremely successful investments rather than on average outcomes across the portfolio.

1.5. Theoretical Perspectives on Venture Capital Decision-Making

1.5.1. Agency theory

It offers one of the most influential sets of ideas for understanding venture capital investment decisions, especially in contexts marked by great uncertainty and information asymmetry. In the context of venture capital relationships, the classic principal-agent problem manifests itself in the form of venture capitalists (principals) providing capital and entrepreneurs (agents) providing control over the firm. Given the fact that entrepreneurs have better information about the firm's prospects and operations, investors face the risk of moral hazard and adverse selection, and therefore governance issues become critical (Jensen & Meckling, 1976; Sahlman, 1990).

One of the main implications of the agency theory on the VC industry is the significance of control. Venture capitalists seek to mitigate risk by gaining formal control through various means such as holding a significant amount of equity, board representation, veto power, and contractual provisions under shareholders' agreements. This enables the venture capitalist to influence strategic decisions such as hiring key personnel, making significant expenditure decisions, changing the business model, or initiating the exit process. Venture capitalists do not wait until things go wrong; they actively intervene if performance is not meeting expectations, unlike other shareholders who do not hold a controlling stake in a public company. This is because the business is still at a relatively early stage and is considered a higher risk (Kaplan & Strömberg, 2004).

Another significant factor to consider here is monitoring. Venture capitalists use monitoring to a great extent to minimize information asymmetry and to ensure that the decisions of the management team are in accordance with the objectives of the venture capitalist. Monitoring is achieved through close association with the founders, periodic reports, and attending board meetings, among other means. Empirical studies indicate that monitoring intensity is affected by the developmental stage of the venture, technological uncertainty, and perceived

risks, with earlier-stage and more technologically uncertain ventures benefiting from more intense monitoring (Wright & Robbie, 1998).

This theory of venture capital finance also points to the significance of incentive alignment, where the contracts of venture capitalists and entrepreneurs are designed to align their interests through various means of performance-based rewards to the entrepreneurs. These means of incentive alignment include equity-based compensation, performance-contingent equity allocation, staging of finance, among other means of incentivizing the entrepreneurs to increase their performance and minimize the risks of capital misallocation, where the venture capitalist provides additional finance to the entrepreneurs upon the attainment of certain predetermined performance outcomes (Gompers, 1995).

In summary, agency theory helps to explain why the structure of VC governance is more developed compared to traditional corporate finance. This is because of the high level of uncertainty involved in venture capital deals, the lack of sufficient collateral, and the redeployability of assets to entrepreneurs. Even though agency theory does not capture the relational or trusting aspects of venture capital relationships, it serves as a starting point in understanding venture capital relationships.

1.5.2. Signaling theory

It gives a valuable complementary perspective to agency theory in that it sheds light on how startups attempt to solve the information asymmetry problem before and during the investment decision process. For venture capital markets, the entrepreneur enjoys better information about the real quality of their venture than investors, who have to make inferences based on uncertain information. Since good and bad startups coexist in the market, signals become essential to differentiate ventures and ensure efficient capital allocation.

For venture capital markets, signals are valuable if they are costly to imitate and therefore credible. One of the most popular signals used in venture capital markets is the human capital possessed by the founder. Educational qualifications, past entrepreneurial success, industry experience, and technical

expertise possessed by entrepreneurs act as signals to investors that the entrepreneur is capable of executing the business plan and coping with uncertainty. Empirical research suggests that ventures run by experienced or previously successful entrepreneurs are more likely to attract venture capital financing at higher valuations because past success acts as a credible indicator of future success (Hsu D. H., 2007).

Another key signaling mechanism for venture legitimacy is third-party endorsement. For instance, a strategic alliance with a reputable firm, early adoption by a well-known customer, or prior investment by a high-quality venture capital firm can be a signal of venture legitimacy and lower the risk perception of the venture. In other words, third-party endorsement acts like a certification device, which sends a message of the endorsement of the venture's technology, market, or governance quality by a third party.

Financial and contractual signals are also a means of reducing information asymmetry between the entrepreneur and the venture capitalist. For example, the entrepreneur can signal his or her confidence in the venture by agreeing to staged financing, performance-contingent equity, or a vesting schedule for founders, which subjects the entrepreneur to downside risk if the venture does not perform well. Such signals suggest the entrepreneur's willingness to share risk with the venture capitalist, which increases credibility (Admati & Pfleiderer, 1994).

Lastly, early market traction is a strong signal of the quality of a venture. This is because customer growth, retention rates, pilot contracts, and/or revenue are all quantifiable measures of a venture's performance. While revenue is limited, a positive signal helps alleviate uncertainty by indicating that the value proposition of the venture is indeed resonating with the market.

In conclusion, signaling theory helps to illustrate how a startup is able to signal strategic quality under conditions of uncertainty through observable and difficult-to-replicate signals related to human capital, third-party validation, contractual arrangements, and market performance. These signals are a key

component of VC decision-making, allowing them to reduce information asymmetry and differentiate between high-potential and lower-potential ventures.

1.5.3. Resource-based view

It offers a supplementary theoretical framework to examine VC decision-making processes, which focuses on the significance of firm-specific resources in creating sustainable competitive advantage. This theoretical framework argues that firms succeed if they have resources that are considered valuable, scarce, hard to replicate, and unsustained. In the VC industry, where new firms usually lack tangible resources and established competitive positions, there is a special focus on intangible resources like human, technological, and relational competencies. Venture capitalists, for example, assess the caliber of the founding team, their experience, and their ability to attract strategic partners, as these factors are considered to contribute to the firm's ability to execute strategies and respond to environmental changes. Research findings indicate that startups that have an advantage in human capital and knowledge resources have a higher likelihood of successful scalability and a positive exit outcome, making them worthwhile investments, even in the face of high risks. Therefore, the resource-based theory helps to explain the rationale of venture capitalists' consistent preference for business ventures that have resources that can support long-term value creation (Wright, Robbie, & Ennew, 2000).

1.6. Research gap and conceptual framework

1.6.1. What the existing literature explains well

VC literature provides an extensive insight into the determinants of investment decision-making, especially with respect to financial, strategic, and qualitative factors. Prior research has documented how expected returns, growth potential, risk assessment, and exit opportunities shape the venture capitalist's selection criteria. Also, a great quantity of studies grounded in agency theory have examined governance mechanisms such as staging, monitoring intensity, and contractual controls used to mitigate moral hazard and information asymmetry.

Other theoretical perspectives, including signaling theory and the resource-based view, explain how observable signals and intangible resources such as founder human capital, reputation, and early market traction, affect the investor's perceptions of venture quality.

1.6.2. What literature does not fully explain

Nevertheless, it should be noted that despite all the contributions, literature still remains in a fragmented state. As mentioned before, the majority of the literature tends to focus on individual aspects of financial, strategic, governance, and qualitative factors if they exist in an independent manner. However, in the case of venture capital decision-making, the factors tend to exist in a multidimensional and interdependent manner. For instance, venture capitalists do not evaluate the growth potential of a firm without simultaneously assessing other aspects of team quality, feasibility of governance, and market structure.

Moreover, the literature still lacks empirical findings regarding the manner in which venture capitalists tend to balance and trade off various factors in situations of varying levels of uncertainty, particularly in the case of early-stage venture capital investments where information tends to be incomplete, and subjective judgment tends to play an important role. The interlink between formal financial and qualitative assessment remains an unexplored area.

1.6.3. Justification of research questions

This gap serves as the motivation for the main research questions posed by this thesis. Instead of studying each determinant individually, this thesis hopes to contribute to the exploration of the interplay between financial, strategic, qualitative, and governance determinants in the context of venture capital investment decisions. Such interplay is especially relevant with regard to early-stage ventures, where conventional indicators do not reliably predict success and where the judgment of the investor is a decisive factor.

All this said, the research questions posed by this thesis seek to address the following:

- What is the way venture capitalists approach the various categories of determinants during the evaluation of investment opportunities?
- What is the way the factors influence the decision under different levels of uncertainty?
- What is the way the governance factors and signaling interplay with financial and strategic factors during the investment decisions?

By answering these questions, this thesis hopes to transcend the conventional lists of determinants and move closer to a more realistic picture of the logic of venture capital decisions.

1.6.4. Conceptual framework and integrated perspective

In order to avoid these shortcomings, this thesis proposes an integrated conceptual framework, which considers financial, strategic, qualitative, and governance factors in a single decision-making model. The venture capital investment is conceptualized as a dynamic evaluation process, where the venture capital investment decision is influenced by expected returns, risks, business opportunities, founder competence, and control. Instead of examining these factors separately, the framework emphasizes the interplay and complementarity of these factors.

Grounded on agency theory, signaling theory, and resource-based theory, the framework offers a more integrated explanation of the role of venture capitalists in uncertain business environments and ventures with growth potential. By integrating these theories, the framework extends the fragmented approach of the existing literature and offers a solid foundation for the empirical research presented in the next sections.

Chapter 2: Research methodology

This chapter presents the research methodology used for the thesis. It will include research design, data sources, criteria for selecting cases, procedures for data analysis, and the limitations of the research. The aim of this chapter will be to present an appropriate account of the procedures for addressing the research questions and justify the research

methodology used based on the nature of the research as an explanation of the venture capital investment decision-making process.

2.1. Research design and approach

This research uses qualitative, descriptive, and explanatory research design for the investigation of the determinants of the venture capital investment decision-making process. The qualitative research approach will be used because of the complexity of the venture capital investment decision-making process. The process involves making judgments regarding the potential of startups under conditions of high uncertainty and incomplete information, which makes the decision-making process difficult to model for the purposes of this research.

This is because the descriptive component is focused on systematically documenting and organizing the essential factors affecting investment decisions rather than examining casual relationships or generalizations. While there is already significant literature on individual factors affecting investment decisions, there is limited understanding of how these factors, as a whole, might shape real-world investment decisions.

Finally, the research is explanatory since it deals with an issue where existing research is fragmented. This research seeks to create room for future research through integrating financial, strategic, and qualitative factors into a single framework. This research design is appropriate since there is limited primary data on venture capital decision-making, and entrepreneurial finance is constantly evolving.

2.2. Data sources

This thesis is based on secondary data sources only, and these are perfectly suited for this research as it meets the requirements and constraints of accessing information on property venture capital. The secondary data sources are as follows:

- Industry and market reports published by venture capital firms, consulting firms, and financial institutions.
- Publicly available databases on venture capital investments and characteristics of startups.
- Press releases and announcements made by startups and venture capital firms.

- Information available on company websites and pitches.
- Academic sources on venture capital investments.

These sources provide a comprehensive and in-depth understanding of the rationale and strategic positioning of venture capital investments. Secondary data is relevant and applicable for venture capital investments as it is often not publicly disclosed and is often revealed as a form of information on making such investments.

2.3. Case selection criteria

A case study method is used to analyze venture capital investment decisions. Two cases of early-stage startups have been chosen based on several parameters.

First, these are early-stage startups where the business environment is full of uncertainties, and investment decisions are based on expectations rather than hard data. At this stage, there is greater clarity on the factors influencing investment decisions, as financial data is scarce, and expectations are high. Second, the cases have been chosen based on the fact that there is sufficient publicly available data on these cases, which is an obligatory parameter for conducting the analysis.

Lastly, the cases were selected based on their comparability and analytical utility, as opposed to statistical utility. Both operate within innovation-driven contexts and have received funding from venture capitals under normal conditions of early-stage financing. This will enable the comparison of the determinants while recognizing that the findings will not be generalizable to all venture capital investments.

2.4. Data analysis methods

The analysis will be based on a qualitative method. Relevant documents and materials will be systematically examined and grouped according to the predefined analytical categories based on the literature review. The categories include:

- Financial determinants: growth potential, risk profile, capital efficiency, etc.
- Strategic determinants: market opportunity, scalability, competitive position, etc.
- Qualitative determinants: qualitative factors, leadership, reputation, etc.

For each case, the analysis will be done individually to identify the major themes and trends. The cases will be analyzed together to identify the commonalities and contrasts with regard to the determinants used by the venture capitals for the early-stage investments. The analysis will be consistent with the theoretical framework developed in chapter 1 and the empirical findings developed in this chapter.

2.5. Research limitations

However, there are some limitations which must be recognized. First and foremost, there is a need to recognize the fact that the small number of cases limits the generalizations of the results. It is worth noting, however, that the results are only meant for analysis.

Another limitation is the fact that there is room for bias in the use of secondary data, since disclosures and investment communications are normally positive, failing to include negative information. It is also difficult to directly access venture capitalists and entrepreneurs, as well as understanding their personal motives.

Finally, there is the limitation based on the fact that venture capital investments are normally influenced by macro-economic factors, as well as personal investor tastes and constraints, which are not easily accessible through secondary data. It is, however, evident that the approach is adequate for the purpose of this thesis.

Chapter 3: Empirical findings – Case study analysis

3.1. Overview of selected VC cases

3.1.1. Sequoia Capital and Airbnb

Sequoia capital is a venture capital firm founded in 1972, which has provided venture capital funding to many of the Fortune 500 companies, including Apple, Atari, and Airbnb. It operates through the business model of developing companies from ideas into IPOs. It is recognized for its long investment duration, involvement in portfolio companies, and focus on founder quality, scalability, and leadership (Sequoia Capital, n.d.).

Airbnb was founded in 2007 in San Francisco, California, by Brian Chesky and Joe Gebbia. It operates as a platform through which people can rent out rooms or properties. With this

revolutionary concept, the founders aimed at raising the required venture capital to fuel the growth of Airbnb. In 2009, the partnership between Sequoia and Airbnb was initiated with an investment of \$585,000, where the website had 2,500 listings and 10,000 registered users. In 2010, the startup raised \$7.2 million in series A funding led by Sequoia Capital. With this venture capital, Airbnb had the required funds to expand globally and create brand awareness through marketing activities (Funderlyst, 2023; Lin, 2020).

Nevertheless, the startup had numerous challenges; however, despite all these challenges, the valuation of Airbnb was on the rise, and in 2011, after completing the series B funding, the company was worth \$1 billion.

In December 2020, Airbnb had gone public, but the COVID-19 pandemic forced the careful planning and preparation of Airbnb's IPO to give way to the harsh realities of the pandemic. On March 5th, Sequoia had published the Black Swan Memo, and until the first week of May, Airbnb had held almost weekly board meetings to assess the changing circumstances. With revenues declining by 80% as international travel and experience bookings began to disappear, Brian opened the meeting saying, "Our goal in the face of this once-in-a-generation crisis was to make sure that Airbnb would be around for future generations." Despite the numerous challenges posed by the COVID-19 pandemic, Airbnb emerged as a resilient player in the travel industry. It raised \$3.5 billion through its IPO, which was a reflection of the market's trust in the company's future potential (Lin, 2020).

Therefore, the investment decision made by Sequoia Capital can be seen as a classic example of a venture capital investment decision made with the objective of creating opportunities in an environment that was highly uncertain. After investing in Airbnb, Sequoia played an active role in its governance. For instance, there was strategic advice that enabled its expansion to international markets as well as credibility that enabled the company to raise further funds.

Overall, this case provides relevant content that can be used to analyze the decision-making process of venture capitalists in investing in new ventures, especially in the context of growth potential, risk analysis, strategic positioning, as well as the overall quality of the management team. In addition to that, it provides a classic example of the process that venture capitalists use to assess ventures that operate in high-risk environments.

3.1.2. Index Ventures and Revolut

Revolut is a mobile application created in 2015 by Nikolay Storonsky and Vlad Yatsenko, providing various digital banking services to young, tech-savvy people, such as:

- Transfer money abroad in 29 currencies
- Pre-paid debit card, which allows users to withdraw cash in 120 countries from a cash machine
- Crypto-currency exchange, which allows users to exchange their currencies into Bitcoin, Litecoin, Ethereum, Bitcoin Cash, or XRP
- Vaults, which help in budgeting and saving money
- Mobile phone and medical insurance in case of illness while abroad

It was not a bank initially, but in December 2018, Revolut announced in a statement that it had been licensed as a bank by the European Central Bank, which is responsible for issuing EU banking licenses.

Revolut's major value proposition is to solve the problems associated with traditional banking, such as high charges, slow international transactions, and a lack of transparency for consumers. Revolut has entered a market where there are high growth potential and significant institutional barriers (Russon, 2019).

Index Ventures is a renowned international venture capital firm that has been involved in technology venture investing since 1996. The objective of Index Ventures is to assist top entrepreneurial teams in the technology and life science industries to build their companies into market-defining global leaders. They specialize in investments in seed to growth stage companies like Anthropic, Discord, Adyen, Datadog, and Roblox. In June 2018, Index Ventures launched its ninth venture fund. Its fourth growth fund was also launched (Jersey Finance, n.d.).

Index Venture invested in Revolut with Martin Mignot. Martin Mignot joined Index Ventures in 2010. He is one of the investors at Index Ventures that invests in early-stage founders with transformative products in healthcare, AI, and financial services. In 2016, they joined Balderton Capital, Seedcamp, Point Nine, Venrex, and a few angels in investing \$1.45 million in Revolut. Revolut has now raised a total of \$4.8 million from several top-

tier venture capital firms. They invested in Revolut because of its ambition to build a fair, instant, and frictionless platform to manage and use money worldwide (Staff, VCJ, 2016; Martin Mignot, n.d.).

In 2017, Revolut announced that it has raised an additional \$66 million in series B investment round led by Index Ventures to fund aggressive expansion in Asia and North America (Index Ventures, 2017).

The case is relevant to venture capital decision-making as the market opportunity is high, and so are the risks involved in terms of regulation and execution. Index Ventures not only provided the necessary funds to Revolut, but their involvement was also strategic in nature, which helped them raise subsequent funds and grow their operations in foreign markets with ease. In this context, it is important to note that it is pertinent to affirm that the Index Ventures and Revolut case is an important context to examine venture capitalists' decision-making in terms of venture capital investments.

3.2. Financial determinants in practice

In fact, financial factors such as valuation logic, expected financial return, and capital efficiency are critical factors in venture capital investment decisions in practice. In the cases of Sequoia Capital and Index Ventures investment in Airbnb and revolute, respectively, venture capitalists use forward-looking financial reasoning in the context of extreme uncertainty, which is in line with the logic of elevated risk and high reward.

In the case of the investment in Airbnb, Sequoia Capital investment in the venture was not based on traditional financial measures of valuation, as the venture was in its early stages and was not generating significant revenue at the time of investment. Rather, the valuation was based on the expected expansion of the market and the rate at which the venture was expected to grow in the future. In fact, as mentioned in the registration document filed by Airbnb, "Airbnb has enabled home sharing at a global scale and created a new category of travel" (Airbnb, Inc, 2020). In fact, this aligns with the findings of Kaplan and Strömberg (2004) that venture capitals use valuation logic based on the expected growth in the future and not on current financial performance.

On the other hand, the investment in Revolut by Index Ventures was justified based on the rate at which the company was acquiring customers, its top-line performance, and the scalability of its digital banking model. Although the profitability was low at the time, the valuation of the company was based on its potential to dominate the European fintech industry in the near future. As the CEO of Revolut puts it, "Our mission has always been to simplify money for our customers, and our vision to become the world's first truly global bank is the ultimate expression of that" (Storonsky, 2025). This is in line with the venture capital model that seeks to dominate the market and generate revenue scalability, as opposed to profitability, especially in markets that are technology-driven and have a large market to tap (Gompers, Kaplan, & Mukharlyamov, 2020).

In both cases, the expected return was assessed based on the context of the power-law dynamics. With respect to Airbnb, the expected return was assessed based on the possibility of exiting at high value, which was realized in 2020 through an IPO. Operating losses, which had been on-going before the IPO, as noted by the firm itself, where it stated, "we have incurred net losses in the past and may not be able to achieve or maintain profitability," (Airbnb, Inc, 2020), were being endured based on the expected ability of the firm to attain dominance in the market and thus experience high valuation growth. This is in line with the firm's assertion that, "our ability to adapt our platform and services to evolving industry standards and local preferences and to continually innovate and improve the performance, features, and reliability of our platform and services in response to competitive offerings and the evolving demands of hosts and guests," (Airbnb, Inc, 2020). In the case of Revolut, the continued investment by Index Ventures in further funding rounds can be seen as a vote of confidence that continued high growth rates and expansion into international markets will eventually lead to another spectacular exit. Revolut's CEO, Nikolay Storonsky, explained the competitive advantage of the company in the following statement: "At the moment yes there is competition, but they are just building local banks. We are building global bank alternatives" (Storonsky N., 2018). This follows Gompers & Lerner (1999), who argued that venture capitalists invest in ventures that have the potential to provide spectacular capital gains.

A further key financial factor in both cases was that of capital efficiency. In the case of Airbnb, they demonstrated their ability to grow with additional funding in the form of rapid expansion into the global market with few fixed assets, thus increasing their attractiveness as a capital-efficient business model in a very competitive and rapidly changing environment (Airbnb, Inc., 2020). Revolut was another instance of good capital leverage as it expanded its customer base in different markets with a large digital infrastructure. In both cases, the follow-up investments were subject to the venture's ability to use the additional funds to grow at an accelerated rate rather than merely to sustain themselves, as was the investment logic analyzed in Gompers (1995) and Admati and Pfleiderer (1994).

In all the above cases, it can be seen that the financial factors in venture capital practice are constantly evolving and are subject to constant reassessment as new information comes to hand. Venture capitalists are keen to see asymmetric upside potential, scalability, and exit viability, all of which are important factors in determining whether the investment will generate the high returns that VC funds require.

3.3. Strategic determinants in practice

The strategic determinants have a major role to play in the investment decisions of the VC firms, which is reflected in the long-term competitive path that the venture will follow to become the market leader. In both cases, the strategic factors such as market opportunity, scalability, and competitive positioning were important to the initial investment decision, as well as the follow-on investments.

3.3.1. Market opportunity

In the case of Airbnb, the investment decision by Sequoia Capital was heavily driven by the size and disorganized nature of the hospitality market worldwide. The traditional hospitality market had challenges, such as physical limitations, but Airbnb offered a platform that could potentially solve the problem of inefficiency in the total addressable market worldwide. This is because, as stated by the company in its registration form, "Airbnb has enabled home sharing at a global scale and created a new category of travel" (Airbnb, Inc, 2020). The creation of this new category has provided the environment that has led to the widespread adoption of the platform across the world. This has been demonstrated by the

company's claim that "the COVID-19 pandemic reinforced that travel is an enduring human desire, even in the face of challenges" (Airbnb, Inc, 2020).

Likewise, the rationale for Index Ventures' investment decision in Revolut rested on the identification of the structural problems plaguing the banking industry in Europe, which included high fees, slow innovation, and poor cross-border services. The rationale for the investment decision was also informed by the magnitude of the investment, as it can be deduced from the fact that "Revolut raised \$250 million bringing its valuation to \$1.7 billion" (Storonsky N., 2018). The problems identified were directly addressed by the value proposition of the business, which rested on the fact that the business operated within a vast market with high demand for the services it offered.

3.3.2. Scalability

Airbnb's platform-based business model enabled it to go global without the capital intensity that is associated with the capital costs of owning a hotel. The fact that it went global is acknowledged by the company when it says, "As we operate a global platform, the timing and implementation of these measures will vary across geographies" (Airbnb, Inc, 2020). The supply side growth was driven by the increasing number of hosts joining the platform, while the demand side growth occurred as more and more people started to use the platform. The business model therefore enabled the company to achieve revenue growth with minimal cost increase, which suits the investment strategy of Sequoia. For Revolut, scalability was built into their technology. As a fintech company, Revolut could onboard consumers around the world without having to build physical branch networks. Index Ventures recognized this technological scalability as a major factor in Revolut's ability to scale geographically and diversify their offerings, allowing them to scale worldwide at a relatively low marginal cost. As can be seen, in both cases, scalability was not just operational but also strategic, allowing for high growth and reinforcing the investor's confidence in the growth paths taken by these ventures.

3.3.3. Competitive positioning and defensibility

Airbnb had created a first-mover advantage, and its brand and network effects had created a significant barrier for new entrants. As more people were joining Airbnb, its network effects were increasing, making it difficult for new entrants to compete. For Sequoia, these

were signs of sustainable market positions for Airbnb. Additionally, Revolut differentiated itself as a competitive force through its product development capabilities. Revolut offered its users a suite of financial products, including foreign exchange, cryptocurrency exchange, and budgeting services. This differentiated approach helped create customer engagement and retention, making it difficult for new entrants to use their products as a way of gaining market share. Index Venture helped Revolut view itself as a way of creating a defensible fintech company and not a one-product company.

Apart from these factors, strategic coherence was also very important in these cases. For example, the alignment of Airbnb with respect to product design, platform economics, and global travel trends was very important in terms of scalability and sustainability. On the other side, the alignment of Revolut with respect to technology, regulation, and consumer trends in digital banking was also very important. It can be seen in these cases that venture capitalists did not consider these factors in isolation but as a system, which was very important in terms of determining whether the firm was able to achieve dominance. Overall, these cases indicate that the strategic factors are not just random evaluation factors but real drivers of venture capital investments. Large market opportunities, scalability, and positioning of the firm were very important in terms of the timing, scale, and sustainability of venture capital investments. These cases confirm that venture capitalists invest in business models, which have the potential to reshape industries and achieve dominance, rather than investing in innovative products.

3.4. Qualitative determinants in practice: team, leadership, and culture

In reality, venture capitalists tend to heavily weigh the quality of the founding team, leadership skills, organizational culture, and reputation of the founder, which directly affect the execution, adaptability, and long-term value creation. The two cases demonstrate the role played by qualitative factors in investment conviction and engagement.

For instance, in the case of Airbnb, Sequoia's investment in the company at its early stage can be said to have been highly influenced by its confidence in the founders. At the time that Sequoia invested in Airbnb in 2009, the company was still a relatively small startup with no proven track record in a highly uncertain marketplace. According to Sequoia's partners, however, the founders' persistence, creativity, and ability to iterate played a

critical role in Sequoia's decision to invest in the company. The founders' response to the funding hurdles they faced at the start can be said to have played a critical role in Sequoia's decision to invest in the company. Such determination made Sequoia have even more confidence in the founders' ability to navigate the uncertain marketplace (Lewis, 2021). Such determination was further made clear in 2020 during the global crisis, in which the founders' primary focus was to ensure that the company would have a legacy. According to the founders at that time, "our goal in the face of this once-in-a-generation crisis was to make sure that Airbnb would be around for future generations" (Lin, 2020).

Leadership quality was also an essential issue for Sequoia's evaluation process. Chesky's capability of leading a global organization is considered an important criterion for assessing adaptability in leadership quality. Developing leadership capabilities is considered an essential issue for venture capitalists, and Sequoia helped its leaders through board engagement and mentorship. This is because leadership quality is considered not only a selection criterion but also a capability for venture capitalists (Gallagher, 2017). This is totally aligned with VC logic, where founders who can learn, delegate, and build teams are more likely to succeed with scaling complex organizations (Kaplan & Strömberg, 2004). In the case of Index Ventures, it is evident that investment decisions regarding Revolut were based on qualitative decisions regarding the founder's capability and ambition. Storonsky's background and capabilities in finance and technology were considered essential for developing a digital banking platform. Martin Mignot emphasized the intensity and speed of execution and obsession for product quality as one of the key reasons for investing in Revolut at an early stage (Storonsky N., 2024).

Early traction and execution capacity was an essential aspect in the qualitative judgment of Revolut, as perceived by Index Ventures. From the early days, Revolut has been able to experience rapid user growth, high rates of innovation, and rapid internationalization. Revolut's ability to rapidly scale up in Europe, launch new products, and attract users at an early stage are all manifestations of successful management and execution capacity (Index Ventures, 2017). Based on the above, the investment in Revolut can be seen as a reflection of venture capitals' affinity towards teams with high technical capabilities.

On the cultural front, Airbnb's design-driven and belonging-oriented culture has been a major contributor to the establishment of significant network effects and consumer loyalty. As the company puts it, "Our culture is one of the main things that attracts people to work at Airbnb, and it is a key ingredient to our success" (Airbnb, Inc, 2020). This was also perceived as a key strength by Sequoia, as it differentiated the company from its competitors and helped reinforce the brand globally. Revolut, on the other hand, has a more performance-driven, data-driven, and execution-driven culture, which attracted Martin Mignot's attention in terms of the company's ability to compete in such a fluid fintech environment, where speed and innovation are key success factors.

In conclusion, both cases highlight the fact that qualitative factors are key pillars in VC decision-making, as they validate what theory suggests in terms of the role of human capital and organizational factors in terms of providing sustainable sources of competitive advantage. The reality is that VC firms are not investing in ideas but in people and organizations who can execute those ideas to establish significant market positions.

3.5. Cross-case comparison

From a financial perspective, both venture capitals were attracted by the prospect of making high returns due to the massive market size. For Airbnb, Sequoia was attracted by the prospect of disrupting the global hospital industry using a highly scalable digital platform. The same case was true for Index Ventures' investment in Revolut, based on their vision of disrupting the retail banking industry in Europe and globally, targeting the massive and inefficient financial services industry. In both cases, the financial performance was not as significant as the growth potential, scalability, and possibility of attaining leadership, thus confirming the VC logic.

On the risk assessment side, both investments had high risks at entry. In the case of Airbnb, there was the risk of regulation, trust between strangers, and the unproven concept of a peer-to-peer model. In the case of Revolut, there was the heavily regulated environment and the high level of competition in the industry. However, in both cases, the VCs managed to mitigate the risks by considering the founder team and their capabilities. The fact that they were willing to make compromises despite the risks shows their level of comfort with uncertainty as long as the potential reward is sufficiently high.

Considering the strategic factors, the major similarity between the two cases lies in the market opportunity and scalability. For Airbnb, the network effects were strong, which means that the more people joined, the higher the value that could be created. For Revolut, scalability was demonstrated by the ease with which the company attracted users across different countries. However, the major difference between the two cases lies in the competitive positioning, with Airbnb successfully positioning itself as a category-defining company, while Revolut had to differentiate itself in the crowded fintech market. This demonstrates how venture capitals change their strategic assessment depending on the market that the startup operates in, whether it is a new market or not.

From the perspective of the qualitative analysis, we can note the role of the founding team in the same way. Thus, Sequoia chose to invest in Airbnb, despite the difficulties at the very beginning, because they saw the potential of the team, including their ability to be resilient, flexible, and have a very good vision. When looking at the second example, on the side of Index, there was the same level of confidence in the founder of Revolut, his technical skills, and his ability to be very aggressive in a very complex environment. While leadership was an essential aspect in both cases, there was a very big difference in terms of style. Thus, while Airbnb was very focused on the importance of the community and brand, Revolut was very focused on speed, product development, and operational intensity. This underlines the fact that VCs are not looking for a specific founder profile, but rather the alignment of the leadership style with the business model.

Going back to governance and investor engagement, it is noticeable that both venture capitals were actively involved in Airbnb and Revolut. For Airbnb, they were supported by Sequoia during the financial crisis of 2008. For Revolut, Index showed its support for Revolut during its international expansion and subsequent funding rounds. However, it is noticeable that there is a difference in the way these venture capitals were supportive of these companies. For Airbnb, it needed brand trust and legitimacy for its growth, whereas for Revolut, it needed regulation and scaling. This is a reminder that, although it is a common practice for venture capitals to be actively involved, it is based on the environment of the industry.

Finally, in terms of exit expectations, it is evident that both investments were driven by expectations of high value exits. For Airbnb, this meant a potential massive IPO in the future, which did occur subsequently. For Revolut, it meant a massive IPO or acquisition in the future, and this is still on the cards. Thus, it is evident that exit potential is part of the initial investment rationale and therefore supports the argument that venture capital decision-making is linked to future exit potential. However, it is also evident that the exit route and timing are subject to market conditions and maturity of firms.

In conclusion, it is evident that there is significant convergence between the venture capital decision criteria of the two firms. However, it is also evident that such decision criteria are subject to different interpretations based on market conditions and competitive dynamics. This analysis supports the argument that venture capital decision-making is subject to a logic but is flexible in terms of adapting to specific strategic and operational realities of each case.

Dimension	Sequoia - Airbnb	Index Ventures - Revolut
Industry context	Hospitality / Sharing economy	Fintech / Digital banking
Core investment thesis	Global platform with strong network effects and asset-light scalability	Technology-driven disruption of retail banking and payments
Main risk factors	Regulatory uncertainty, trust between users, untested model	Regulatory compliance, competition with incumbents
Growth logic	International expansion fueled by network effects	Rapid user acquisition and product expansion across markets
Capital strategy	Staged funding tied to scaling and market validation	Staged investments to support growth and regulatory milestones
VC value added	Strategic guidance and governance support during scaling	Support in internationalization, governance, and later-stage positioning
Expected exit	IPO as primary realization route	IPO or strategic exit depending on market conditions

Figure 3 - Comparative table: VC determinants across cases

Chapter 4: Discussion

4.1. Synthesis of Empirical Findings with Theoretical Frameworks

This section of the thesis attempts to analyze the empirical results in light of the theories identified in the literature review. The aim is to assess the validity of real-world investment practices at Sequoia and Index in light of the core economic and organizational theories presented in the literature review.

4.1.1. Agency theory: From control to partnership

The agency theory is a comprehensive approach to understanding the relationship between venture capitalists and entrepreneurs. Because of information asymmetry and moral hazard involved in venture capital deals, sophisticated corporate governance is needed to align interests between VCs and entrepreneurs (Gompers, 1995).

- **Mitigating Adverse Selection via Pre-Investment Screening:** The literature on venture capital suggests that venture capitalists are vulnerable to adverse selection risk because of information asymmetry between VCs and entrepreneurs. Venture capitalists risk investing in entrepreneurs with lower-than-average talent. Sequoia Capital mitigated this risk with Airbnb entrepreneurs by heavily investing in entrepreneurs' grit during early rejection stages of funding. The entrepreneurs' persistence served as evidence of their competence in managing the venture.
 - **How Sequoia screened for "Grit":** The partners at Sequoia checked the founders' response to initial funding issues, assuming their decision not to give up indicated their high commitment level (Gallagher, 2017).
 - **Verifying their capability by iterating:** The firm also checked for their willingness to iterate, which indicated their ability to receive feedback and alter their strategy in response to market feedback.
 - **Assessing their execution and creativity:** The firm also placed emphasis on the founders' creativity as a key factor, considering it essential in coping with the high uncertainty in the untested market.

- **Minimizing risk by evaluating leadership:** The firm also verified the founders' leadership by considering their ability to build a vision and attract talent, considering them small and untested.

Index Ventures also employed a behavioral screening process but emphasized technical excellence and speed.

- **How Index Ventures screened for 'Intensity':** Mignot found the intensity of the founders and the team's obsession with product quality as the major reason behind investing in the team at an early stage (England, 2022).
- **Verifying technical excellence through background:** Index Ventures utilized Nikolay's experience in finance and technology as an advantage to verify the team's potential in developing a complex digital banking platform.
- **Assessing operational execution through traction:** Index Ventures used Revolut's ability to roll out new products at short development times and gain users at quick rates in European markets as an indication of the team's operational effectiveness.
- **Reducing risk through global ambition:** Index Ventures verifies the team's ambition required to disrupt the existing financial industry by focusing on the founders' ambition to create 'global bank alternatives'.
- **Staged financing as a risk management tool:** The use of staged investments is basic in managing uncertainty and minimizing the risks of capital misallocation. By dividing the investments into stages, the VCs can release funds incrementally while at the same time controlling the achievement of performance milestones, hence encouraging financial discipline and minimizing the chances of over-investment in unviable businesses.
 - **Airbnb's journey:**
 - **Initial investment:** Sequoia made an initial investment of \$585,000 in 2009 when Airbnb had only 2,500 listings and 10,000 users.
 - **Milestone-based investment:** It was only after the startup had shown traction and had the potential to create a "new category of travel" that Sequoia made another investment of \$7.2 million in Series A in 2010.

- **Risk reduction:** Sequoia was able to test and verify the ecosystem of trust and the founders' capacity for iteration before investing larger capital that would be required for international growth (Gallagher, 2017).
 - **Revolut's journey:**
 - **Entry Strategy:** Index Ventures created a \$1.45 million capital increase with other investors to assess the feasibility of the venture.
 - **Updating beliefs:** This helped Index Ventures assess and verify Revolut's capacity for product releases and rapid user acquisition in different European markets before investing additional capital in the venture.
 - **High growth commitment:** After verifying Revolut's capacity for rapid growth and innovation, Index Ventures made a further capital commitment of \$66 million in Series B funding for aggressive global growth.
 - **Information asymmetry:** Through staging, Index Ventures updated its beliefs about the firm's potential and thus enabled a more accurate valuation of the firm in subsequent funding rounds (England, 2022).
 - **Active governance and oversight role:** unlike passive shareholders, VC firms take an active role in addressing information asymmetry and professionalize the firm.
 - **Sequoia's intervention:**
 - **Strategic survival:** During the 2020 COVID-19 crisis, when there was an 80% decline in Airbnb's revenues because of the decline of international travel, Sequoia had to move from monitoring mode to survival mode for Airbnb.
 - **The Black Swan Memo:** This was released as a guide, and it served tea for the management. However, it was a sign for them to pivot from growth to financial survival.
 - **Severe monitoring:** These two firms had almost weekly board meetings from March to May 2020, monitoring the environment for its rapid changes. This is a classical way of mitigating agency risks.

- **Alignment of vision:** Sequoia and Airbnb shared their long-term goals by setting the objective of making Airbnb survive for generations, thus eliminating the need for myopic decision-making, which is very prevalent during financial distress (Sequoia Capital, 2020).
- **Index Ventures' oversight:**
 - **Regulatory navigation:** since Revolut is in a market characterized by significant institutional barriers and high regulatory risks, Index Ventures' role was critical in providing credibility.
 - **Institutional signaling:** Index Ventures' signaling effects were critical in enabling Revolut to acquire an EU banking license in 2018, thus transforming them from a digital alternative to a regulated financial institution.
 - **Ensuring strategic consistency:** Index Ventures also ensured that Revolut's rapid growth in Asia and North America was not at the expense of operational stability.
 - **Value added support:** apart from capital, Index Ventures also offered Revolut strategic guidance, which was critical in enabling the firm to cope with the complexities associated with providing a range of diversified financial services, such as cryptocurrency exchange, medical insurance, and saving vaults (Storonsky N., 2018).

4.1.2. Signaling theory: reducing information asymmetry

Signaling theory is a theory that complements agency theory in that it provides an explanation of how startup firms convey their quality to investors in the context of high uncertainty. In the context of the VC market, the founder sends observable and costly-to-imitate signals to differentiate their high-potential venture from those that are less promising. In both cases, the venture capitals looked for signals that the “low-quality” founders could not possibly imitate (Svetek, 2022)

- **Signals of human capital and founder reputation:**
 - **Index Ventures and Revolut: professional background and financial commitment**

Revolut's founder sent out strong quality signals based on the founders' professional backgrounds and their own financial commitment. For instance, the fact that the founder, Alex Storonsky, had worked at Lehman Brothers and Credit Suisse sent out a signal that he was capable of working in a challenging and data-driven financial industry. This was also reinforced by the fact that the second founder, Vlad Yatsenko, had also worked at Deutsche Bank, which sent out a signal of technical capability as well as competence in the financial industry. The quality signal therefore reduced the execution risk for Index Ventures at the early stage (England, 2022).

Additionally, the fact that Alex Storonsky had invested £300k of his own savings to develop the first prototype for Revolut sent out a costly signal of commitment for the venture. According to the signaling theory, it would be difficult for someone to imitate the investment of their own savings and therefore sent out a signal of commitment and belief in the venture for the long term. Index Ventures recognized this as a signal that the founders were committed to the venture and shared the same interest as the investors (Kostyuchenko).

- **Sequoia and Airbnb: Behavioral Resilience as a Quality Signal**

Airbnb's founders signaled quality to Sequoia Capital through their behavioral responses to adversity, such as the ability to raise funds after the initial rejections and limitations. The founders managed to raise around \$30k after selling themed cereal boxes, which showed creativity, persistence, and the ability to raise funds after the initial rejections by investors. This signaled to Sequoia that the founders could persevere in challenging circumstances. According to the literature, investors seek founders who show the ability to survive challenging circumstances (Gallagher, 2017).

Besides resilience, coachability was also evident in the founders' ability and willingness to quickly change and improve their business model. The choice of relocating temporarily to New York and improving the quality of property listings on a personal level is also indicative of a practical and hands-on approach to solving issues and challenges. Sequoia saw this as coachability,

which is “the capacity to marry a long-term vision with a desire for feedback and a willingness to change course when needed.” These are key qualities that venture capitalists look for in early-stage companies that are under high uncertainty conditions (Gallagher, 2017).

- **Third party certification and institutional legitimacy:** VC literature emphasizes that the identity of investors or approving institutions can be more important than the amount of capital. Third-party certification helps to reduce information asymmetry because it provides external validation that can aid in the transition of a venture from a high-risk entrant to a legitimate market participant (Megginson & Weiss, 1991).
 - **Revolut’s regulatory signal:** from early stage fintech to institutional credibility: For fintech startups, the greatest information asymmetry is between the firm and the regulatory authorities. Revolut received an EU banking license from the ECB in 2018. In this context, Revolut signaled that they have reached a higher level of maturity in terms of organizational maturity (Storonsky N., 2018). This license served the additional purpose of certification because it demonstrated to later-stage VCs that Revolut’s internal controls, capital requirements, and anti-money laundry practices are aligned with the elite standards in Europe, thus reducing the regulatory risks associated with the business. Furthermore, the license served the additional purpose of legitimacy because Revolut could assure their clients that their money is safe with them, given that the company offered protected deposits, thus demonstrating that their money is safe with them, just like with other conventional financial institutions. In this case, regulatory approval not only served the conventional purpose but also served the additional purpose of strategic importance to the business.
 - **Sequoia Capital and Airbnb: elite affiliation as a signaling mechanism:** However, when Sequoia funded Airbnb in its early funding round, it was a source of external validation that came with a reputation as a venture capitalist that specializes in finding high-growth technology companies. According to the signaling theory, support and funding from established venture capitalists

determine the perception of the venture or company by the external environment (Megginson & Weiss, 1991).

The involvement of Sequoia in funding Airbnb helped to reduce information asymmetry in the labor market because it sent a signal to potential employees about the quality of the organization. In the case of Airbnb, the support and funding of Sequoia helped to attract skilled employees and managers who may have been unsecure about joining a non-conventional venture at an early stage.

Lastly, the VC investment in the VC signaled to everyone that Airbnb was not an experimental service or a scalable and strategically important platform. This helped shape market expectations, enabling rapid international expansion and recognition as a legitimate player in the world travel industry.

- **Market traction as a “Traction signal”:** In the absence of long-term financial statements, VCs use ‘traction signals’ as an important measure of future performance. Traction signals provide evidence of progress beyond the idea phase and evidence of creating market value for the venture, thus reducing the risk of failure of the business model (Gompers & Lerner, 2001).

- **Revolut:** Speed and agility as signals of execution capacity: Index Ventures was impressed by Revolut’s execution capabilities. Revolut was able to execute quickly relative to traditional banks, where there is often a lengthy process of developing and implementing financial products. Revolut was able to roll out new financial products quickly, and its introduction of services such as cryptocurrency trading, insurance, and currency exchange showed its execution capabilities.

In the case of Index Ventures, this level of iteration speed was a clear sign that the founding team was able to manage the pressures of competition effectively. This was important in reducing the execution risk and increasing the confidence in their ability to grow in a very competitive environment.

It is worth noting that the traction was not just based on the number of users gained. In fact, the expansion of services per user by Revolut was a clear sign that they had the potential to increase their level of value creation in the future. This was important in making the company more attractive to a VC perspective

in terms of their ability to increase their customer base and the number of services offered to them.

- **Airbnb: network effect and the validation of market adoption:** For Airbnb, the early signs of traction helped solve one of the biggest challenges facing the startup, which was trust in the peer-to-peer accommodation business. However, the growth in users and transactions was an indication that people were willing to use the platform, thus showing that the biggest social and behavioral challenges could be surmounted (Gallagher, 2017).

From the perspective of Sequoia, the growth in the number of listings and transactions was an indication of the development of network effects. This was because, as the number of users on the platform grew, the platform became increasingly attractive, thus ensuring further growth. The fact that the growth was steadily increasing showed that Airbnb was on the verge of reaching the point where growth was likely to be self-sustaining.

This was, therefore, one of the main reasons why Sequoia Capital decided to lead the Series A investment in Airbnb.

- **The resource-based view: intangible assets as sources of advantage**

According to the Resource-Based View (RBV), "the firm can gain sustainable competitive advantage by developing resources that are valuable, rare, difficult to imitate, and hard to substitute" (Barney, 1991). In the VC context of young start-ups without physical resources or stable financial performance, there is a strong emphasis on intangible resources as sources of competitive advantage.

- **Organizational culture as difficult to imitate resource:**

- **The Sequoia-Airbnb case:** In this instance, organizational culture played an important strategic role. For instance, their design-driven and community-centric culture was identified by Sequoia as an important factor that enabled Airbnb to build its brand identity and customer loyalty that the hotel chains simply couldn't replicate (Gallagher, 2017).

Given that this culture was embedded in the DNA of the company, it served as a barrier to entry for its competitors because they could replicate the software but not the trust and identity of the community.

From the perspective of the RBV theory, this cultural asset enabled Airbnb to attain strategic differentiation. The social complexity in developing this host community made this asset difficult to imitate, thus giving it a competitive advantage (Barney, 1991).

- **The Index Ventures-Revolut case:** Unlike Airbnb, which emphasized a culture of community, Revolut had a high-performance culture. This culture was seen as a source of sustainable competitive advantage, where the company was able to compete favorably with conventional financial institutions. (England, 2022). Revolut's culture, from an operational perspective, is based on radical transparency. Although the company has been criticized for having an intense culture, from an RBV perspective, this can be seen as a way of ensuring the organization can attract and retain the best talent in the fintech industry. This way, the organization can ensure that there is alignment in terms of culture and strategy, which enabled the organization to innovate and execute.

This culture is hard to replicate, especially for conventional financial institutions. This is because conventional financial institutions have existing structures which are difficult to change. Changing the way conventional financial institutions operate, especially in terms of decision-making, is hard. This is because changing the way these organizations operate can have serious implications on the existing systems. Therefore, Revolut's culture can be seen as a rare resource, which enables the organization to innovate rapidly. (Barney, 1991).

- **Human capital and execution velocity as rare capabilities:**

- **Index Ventures-Revolut case:** According to the RBV theory, human capital is considered to be one of the most important sources of competitive advantage in the high-tech environment. In the case of Revolut, the investment decision was heavily driven by the expertise that the founding team brought, which created a rare combination of financial and technical expertise, which could support the creation of a high-tech digital banking platform.

The ability to maintain high velocity in execution has become a firm-specific capability. It has already been discussed that the competitors faced difficulties in

replicating the high velocity in the market because this velocity is associated with the organizational structure and the high intensity driven talent pool that the company had. This is considered to be a causal ambiguity, which means that the exact link between the resources and the outcomes is not clear (Barney, 1991).

- **Sequoia Capital-Airbnb case:** Airbnb's founding team brought a unique kind of human capital to the table, given that the tech world is dominated by engineers, but Brian Chesky and Joe Gebbia are industrial designers by background. This has affected the way the company has approached some of the challenges, such as the need to create trust in a peer-to-peer accommodation market, which they define not as a technical problem but a design problem, emphasizing the importance of user experience, visual, and emotional connections. This, according to Gallagher (2017), is a rare kind of capability in the startup world that Sequoia saw strategically.

The ability of the founders to empathize with the users personally created a socially complex resource. The fact that the founders chose to engage in close interaction with the hosts in order to improve the way in which the listing is presented demonstrates the empathetic approach to the creation of the platform. According to the RBV, this knowledge is difficult to codify and therefore difficult to imitate by competitors. The framework also suggests that brand identity, which is created as a result of trust built from repeated interactions, is an inimitable resource (Barney, 1991).

- **Network effects and platform dynamics:**

From the perspective of the RBV theory, the user base of the platform could be considered a valuable resource, especially if the usefulness of the platform increases with the number of users.

In the case of Airbnb, Sequoia understood that the two-sided network that Airbnb had created was a key strategic asset, especially because the usefulness of the platform increased with the number of users, so that the more users the platform had, the more useful it became to the other users, making it harder for competitors to keep up with the

activity generated on the platform. Thus, the platform evolved from a service that offered accommodation to become a large digital market with high market share.

In the case of Revolut, the company created an integrated platform that offered its users a series of financial services, which not only led to higher engagement with the platform but also to a situation in which the users were less likely to switch to competitors. From the perspective of the RBV theory, this situation contributed to a more sustainable competitive position with respect to traditional financial institutions (England, 2022).

4.2. The interdependence of decision-making determinants

The research findings indicate that venture capital investment decisions are not likely to be based on one single factor. However, investment conviction is likely to result from a combination of financial, strategic, and qualitative factors. These factors are not mutually exclusive and are likely to impact and complement each other throughout the process of making decisions.

This section of the report is based on balancing trade-offs and complementarities of these factors for Sequoia Capital and Index Ventures.

4.2.1. Trade-offs between financial risks and qualitative strengths

For example, in early-stage investment, where financial performance indicators may not exist, qualitative factors may often offset financial uncertainty. The cases discussed above highlight the balance between financial risk and non-financial strengths, which is essential in the investment decision-making process.

Both VCs demonstrated high tolerance for negative cash flows and operating losses. Instead, these VCs perceived negative financial performance in the early stages as common in high-growth and disruptive industries, which demand high capital expenditure for rapid growth.

- **Airbnb-Sequoia:** in the case of Airbnb, Sequoia VC accepted negative financial performance, considering the resilience of the founders, which acted as a mitigating factor. The creativity and innovative ideas of the founders in seeking funding in the early days acted as a testament to their ability to cope with financial stress.

Although there was a clear message that profitability was uncertain, this did not deter Sequoia from investing in the venture. It was not the profitability that was important to the investors, as they were more concerned with the founders' ability to improve and make changes to the venture.

- **Revolut-Index Ventures:** In the case of Revolut, Index Ventures was willing to overlook the fact that the venture was capital-intensive because of the founders' professional background. Although this venture was in the financial industry, the fact that the founders had experience in major financial institutions worked in their favor. In addition to this, the fact that Storonsky had personally invested in the venture meant that there was a level of alignment in terms of risk and reward between the founder and the VC.

Overall, what can be seen in the above cases is that venture capitalists do not remove financial risks, as this is not possible, but they offset them by placing more emphasis on other factors that increase their level of confidence in terms of execution and flexibility.

4.2.2. Market opportunity vs regulatory constraints

In highly regulated and disruptive sectors such as fintech and the sharing economy, large market opportunities can override significant regulatory barriers. Both cases show how venture capitalists assess regulatory risks in relation to long-term strategic potential.

Sequoia and Index Ventures recognized that the total addressable markets in their respective sectors were extremely large. As a result, regulatory challenges were viewed as operational obstacles that needed to be managed, rather than fundamental reasons to avoid investment.

- **Revolut's case:** Index Ventures supported the company's ambition to build a global alternative to traditional banks despite the heavy regulatory environment. They believed that gaining a strong position in such a large market would make the high regulatory and compliance costs worthwhile. Revolut's acquisition of an EU banking license strengthened this position. The license provided institutional legitimacy and signaled regulatory compliance, reducing

uncertainty for later-stage investors and reinforcing confidence in company's long-term viability.

- **Airbnb's case:** Sequoia Capital remained committed to Airbnb despite the regulatory issues faced by the company and the challenges posed by the COVID-19 pandemic. This demonstrates the confidence that the venture capital investors had in the business model, which they believed to be a long-term demand with the rise in global travel. The above case studies demonstrate that venture capital investors consider regulatory issues in the context of the market size and the strategic positioning of the business model, and hence, if the opportunity is worth the investment, regulatory issues are factored into the business model's growth strategy.

4.2.3. Synergies: how determinants reinforce each other

The relationship between financial, strategic, and qualitative determinants is such that it is a reinforcing relationship. The determinants are not independent of each other; rather, they reinforce each other and collectively build up investment conviction.

- **Qualitative → Strategic:** In the case of Airbnb, it was not the personal qualities of the founders that were relevant but rather how it could be leveraged as a strategic advantage. The fact that they were design-oriented helped them address the initial trust issue that was one of the biggest challenges in scaling up a platform like home-sharing. By improving user experience, photography, and brand design, they made it socially acceptable and desirable. Thus, founder competence as a qualitative determinant directly enhanced market scalability as a strategic determinant.
- **Financial → Agency:** financial structure reinforced agency mechanisms. With the help of financial structuring, both VCs could minimize risk by providing capital in stages. Each round was dependent upon the company's achievement of certain goals, such as growing their user base, attaining regulatory approvals, or expanding their products. This financial structure enabled the investors to monitor performance and adjust agency mechanisms accordingly. As more information became available, valuation became more accurate and less speculative.
- **Signaling → Resource-Based View:** when Sequoia invested in Airbnb, their reputation became a powerful signaling mechanism. This halo effect created greater trust among

consumers, regulators, and in the labor market. As such, Airbnb was able to attract high quality talent, which in turn enhanced their internal culture and thus their intangible resources. As such, signaling, from a Resource-Based View, enhanced the firm's valuable and difficult-to-imitate resources.

- **Signaling → Financial:** In both cases, the strong strategic position provided a boost to investors' confidence in financial returns. After scalability was identified, the business was considered less risky. Consequently, higher valuation and continued investments were achieved.

Overall, the cases have demonstrated that the VC decision-making process does not take place based on isolated factors. In fact, the factors interact with each other in a mutually reinforcing process in which qualitative factors support strategic position, strategic position bolsters financial confidence, and financial signs bolster long-term benefits. As the factors converge, investors' confidence grows gradually.

4.3. Decision logic under high uncertainty

Under conditions of extreme uncertainty, the investment decision shifts from a reliance on historical financial data to a forward-looking judgement-based evaluation of potential. In environments that are in the early stage of development, the absence of stable revenues, cash flows, and business models forces investors to rely on alternative evaluation mechanisms. Rather than eliminating uncertainty, VCs design their decision process to manage it.

4.3.1. The shift from static metrics to dynamic judgments

The conventional approach taken in corporate finance is based on different valuation mechanisms such as the Discounted Cash Flow model and financial statements, which can be used to measure the valuation of firms. However, in the case of startups, especially in their early growth period, such approaches can only provide partial information since there is no financial history, and the growth pattern is not predictable in the future. The case of Airbnb can be taken as a typical example in this context. At the seed growth period, the firm was making very little revenues, and the market was also in an undefined state. The application of the conventional Discounted Cash Flow model would have forced one to

take assumptions regarding the future cash flows, which would have been unrealistic. The valuation in such cases is based on the scalability and transformation potential in the market.

Under these circumstances, it is essential to highlight the role of qualitative indicators in investment judgment. Venture capitalists focus on other indicators, namely founder-product match, industry experience, and execution ability. This is precisely what is observed in the judgment of Index Ventures regarding Revolut. Great attention is paid to the match between founders' professional experience and the complexity of the fintech industry. This is considered a reliable way of judging the growth potential of the company rather than focusing on financial performance, which is highly volatile at this point.

There are some characteristics of the decision-making process of venture capital investments that can be related to the framework of the real options approach. Venture capitalists usually do not make a single investment and use linear financial projections. In contrast, venture capitalists make investments step by step. The first investment is more of a tentative investment, and they can easily monitor the performance and update their expectations. Both Sequoia and Index Ventures followed a stepwise investment approach, where subsequent investments are subject to specific milestones. Thus, risk is assessed stepwise rather than trying to avoid uncertainty. Venture capitalists tried to manage uncertainty dynamically rather than trying to avoid it.

4.3.2. Strategic resilience and post-investment involvement

The logic of managing uncertainty is not limited to the investment decision and continues beyond it. For VC, signing the investment agreement is not the end but rather the beginning of a governance relationship. The post-investment period is a key mechanism for managing uncertainty in high uncertainty contexts.

Unlike public investors, venture capitalists take a direct role in strategic decisions, structuring, and crises management. This process converts the uncertainty of early-stage growth into a more structured and controllable growth path. The intervention of Sequoia Capital in addressing the COVID-19 pandemic is a perfect example of the role of governance in stabilizing firms. The 'Black Swan Memo' issued by Sequoia addressed Airbnb's need to focus on maintaining liquidity, reducing costs, and structurally addressing the crisis in addressing the collapse in global travel due to the pandemic. This is a shift

from growth strategies to survival strategies. Instead of disengaging from the crisis, Sequoia directly influenced the way in which the firm addressed the pandemic, thus maintaining the enterprise value.

In addition to this, there is a role played by post-investment involvement in the process of converting regulatory risks to institutional legitimacy. Index Ventures and their support to Revolut in obtaining its banking license in the EU can be taken as an instance of this process. In order to comply with the necessary requirements, there was a need to strategically position and develop credibility and institutional expertise. By obtaining the banking license, there was a major shift in market perception, and the company was no longer perceived as a risky venture in the fintech industry but had attained legitimacy as a financial institution. However, this was not just about financial support but was accompanied by experience and endorsement as well.

Besides crisis management and regulatory issues, venture capitalists also play a role in professionalizing and growing organizations. Venture capitalists assist entrepreneurs in improving and growing organizational structures and leadership potential as well as preparing them for internationalization and exit strategies. This is a form of value-added contribution that helps entrepreneurs move from entrepreneurial growth strategies to corporate growth strategies. Venture capitalists are therefore not just passive contributors of capital; they are strategic partners in the growth trajectory of the venture.

To conclude, in a highly uncertain environment, the decision-making process in venture capital does not follow financial forecasting, but rather dynamic decision-making, which continually reassesses the venture. Investment commitment is a process that unfolds gradually, depending on the reduced uncertainty, which causes financial, strategic, and qualitative factors to converge. While risks are not reduced, they are managed through a structured process that involves strategic involvement.

4.4. Managerial implications

The research findings assist in bridging the link between theory and practice in the VC environment. Both cases presented offer useful insights to entrepreneurs in search of funding and venture capitalists in search of capital under uncertainty.

4.4.1. Recommendations for entrepreneurs: Signaling quality strategically

To venture capitalists, seeking funds from top-tier venture capital firms is not just about having a unique business idea for founders. Founders must demonstrate signs of potential and execution capacity.

Firstly, founders must demonstrate signs of flexibility and coachability. Venture capitalists like founders who are flexible and coachable because they change their business plan based on market feedback. The Airbnb story demonstrates that founders' flexibility is one of the ways of building venture capitalists' confidence in a business plan, especially in today's uncertain world.

Secondly, founders must demonstrate signs of execution capacity. For tech-driven startups, speed is of essence. Founders must demonstrate signs of making quick decisions in order to reduce venture capitalists' risk of execution capacity.

Another factor is personal commitment. Founders who are willing to commit personal resources and even sacrifice for the venture demonstrate signs of commitment and conviction for the venture and therefore aligned incentives with venture capitalists'.

Lastly, resourcefulness is an essential element of entrepreneurial quality. Founders who are able to create traction with scarce resources and/or under poor circumstances are sending a strong signal of resourcefulness, which is often understood as navigating ambiguity and dealing with future challenges.

4.4.2. Insights for venture capital funds: The value of integrated evaluation

Regarding venture capital firms, the results reinforce the need to take into account the overall picture without focusing on isolated factors. In fact, financial projections, the quality of the founders, as well as the market potential have to be considered as a whole because they are mutually influential in the overall performance of the venture.

The methodology used to analyze risks in an integrated fashion can assist venture capitalists in viewing high-risk markets as attractive investment opportunities as long as there are high execution and learning capabilities in the founding team.

Staged financing has to be considered as a learning process in managing risks rather than as a tool to manage risks. In fact, by investing in an integrated fashion, venture capitalists can reassess their perception of the venture's performance before investing again in the venture.

Besides, it should be noted that during the initial phases of the evaluation process, more emphasis should be placed on the development of intangible competitive advantages. For example, it should be noted that brand recognition, network effects, technology, and organizational culture have more impact than short-term profits.

It should also be noted that the performance of venture capital is also largely dependent on post-investment involvement. For example, as all the cases under analysis have revealed, the performance of venture capital not only depends on capital allocation, but also on strategic involvement and engagement. Therefore, the venture capitalist should be willing and ready to be involved in post-investment activities with the aim of managing the uncertainty and hence the performance.

4.5. Limitations and future research

This study provided an in-depth analysis of the determinants influencing VC decision-making. However, several limitations must be acknowledged to contextualize the findings and ensure academic rigor.

4.5.1. Research limitations

One of the major limitations associated with the research lies in the limited sample size. The research conducted in this thesis focuses on two different cases. The cases considered in this research include Airbnb and Revolut. Although both cases have provided in-depth analysis of high-growth ventures, there remains a major limitation associated with the research. The results obtained from the research conducted on both cases may not be generalized for the entire venture capital industry. In addition to this, the results may not be applicable to different ventures in different industries or regions.

Another major limitation associated with the research conducted in this thesis lies in the use of secondary research. Due to the confidential nature of venture capital negotiations and board-level discussions, the research conducted in this thesis focuses only on secondary research. Although secondary research provides reliable results for the analysis, there

remains a major limitation associated with the research. In this context, the research conducted in this thesis may not provide the actual picture of the entire scenario. The research conducted in this thesis may provide a partial view of the actual scenario.

Another relevant limitation in this research is represented by survivorship bias. Indeed, both case studies deal with extremely successful ventures that managed to reach a global scope and a good market valuation. In this sense, the research may have inadvertently highlighted some factors as particularly predictive of success, while in reality, they may simply be common characteristics among all startups, irrespective of their success or failure.

Lastly, it is necessary to analyze the macro-economic context in which the investment decisions were taken. Indeed, the cases analyzed in this research were taken in a particular market context and economic cycle. Differences in macro-economic variables, such as different availability of capital or different valuation models, can significantly affect the analysis of the determinants at hand.

4.5.2. Suggestions for future research

As can be seen from the limitations, there are several ways in which future research can build on the current findings. Perhaps the most obvious solution is through the extension of the number of cases. By conducting further research on a greater number of ventures, covering various industries, development stages, and geographic regions, including emerging markets, it might be possible to get a clearer understanding of whether the aforementioned factors are consistent in their effects.

Another way in which future research might build on the current findings is through the use of a mixed-methods approach. By using this method, it might be possible to gain further insights into whether the aforementioned factors are, in fact, statistically significant.

Another interesting area that can be explored in the same context is to carry out comparative analyses of successful and unsuccessful ventures. By studying the startups that have failed despite showing similar characteristics in their early stages, researchers can make a clearer distinction between what factors are truly determinant and what factors are common but not necessarily determinant of success.

Lastly, with the rise of artificial intelligence and data analysis in investment filters, another area that can be explored in the context of venture capital is how this technological evolution is affecting investment decisions in the industry. It will be interesting to see whether this evaluation through artificial intelligence is replacing subjective evaluation or merely supplementing it.

Chapter 5: Conclusion

This chapter will summarize the key findings of the research, its contribution to theory and practice, as well as provide some final thoughts on venture capital decision-making in an uncertain world.

5.1. Summary of findings

The primary objective of this thesis is to analyze the determinants of venture capital investment decisions in early-stage startups from a comprehensive perspective. Through analyzing Sequoia Capital's investment in Airbnb and Index Ventures' backing of Revolut, it is possible to establish some key findings regarding venture capital firms' approaches to investing in high-growth startups in uncertain contexts.

Firstly, it is evident that venture capital decision-making is a fundamentally holistic process. Investment decisions are not made solely based on financial variables; rather, they are made on the basis of financial variables and other strategic and qualitative variables that are collectively assessed and not individually. This is especially true in the context of making investment decisions in early-stage startups, as traditional financial variables such as discounted cash flow analysis are not applicable in such contexts because of the high volatility and uncertainty involved in such contexts.

Second, there is the issue of information asymmetry, which is addressed through the role of qualitative signals. Resilience, technical ability, leadership ability, and speed are some of the factors that are crucial in determining the success of investments. In the cases under review, the ability of the founders to adapt was seen as playing an important role in compensating for the lack of financial records and the high risks associated with business

operations. These are the qualities that enable investors to make projections regarding the sustainability of the business.

Third, there is the issue of resource-based theory, where there is emphasis on long-term sustainability as opposed to short-term financial performance. Organizational culture, ecosystem development, brand positioning, and network effects are some of the intangible qualities that are seen as playing an essential role in determining the sustainability of investments.

The role of governance mechanisms is also highlighted as a key factor in determining the process of investing. Tools such as staged financing and board involvement enable venture capitalists to increasingly manage risk while keeping strategic options open. Thus, venture capital firms are not merely controlling investors in a monitoring role but are strategic partners that support growth, add expertise, build networks, and constantly evaluate performance. The role of governance is thus highlighted as a dynamic risk management and value-added tool rather than a structural contractual tool.

5.2. Contributions to literature and practice

This study makes a contribution to academic literature by providing an integrated framework that incorporates agency theory, signaling theory, and the RBV perspective. Rather than presenting each theory in isolation, this study provides an example of how these theories interplay in the context of real investment decisions, providing a more complete understanding of the venture capital market.

Practically, this study provides the following implications: to attract venture capital, the entrepreneur must be able to prove not only the market opportunity but also their own credibility, flexibility, and ability to execute. Being able to prove their strength, flexibility, and strategic clarity is just as important as providing financials to the venture capital investors. At the same time, the study provides the following implications to the venture capital investors: venture capital investors may be able to achieve greater success by using an integrated model that considers market opportunity, team capability, governance, and strategic resources, rather than relying on short-term financial measures.

5.3. Concluding remarks

Venture capital investment is still fundamentally a judgment-driven activity. Even though data analytics and artificial intelligence play an increasingly important role in the screening process, the final decision ultimately rests on the ability of the venture capital investors to judge the team, the strategy, and the overall market conditions.

The cases analyzed show that the better venture capital firms not only recognize the potential of the startups they invest in but also contribute to their development and growth. In the face of such uncertainty, the cases also highlight the importance of a combination of financial discipline and informed judgment for a successful venture capital investment, thus reiterating the importance of the human factor in the evaluation process.

Statement on the Use of AI Tools

During the preparation of this thesis, generative AI tools such as ChatGPT have been used as support tools for organizing some of the theoretical sections of this thesis and also for finding relevant areas of literature that could be explored.

All academic sources that have been included in this thesis have been individually searched, selected, and verified through academic databases.

The research questions, development of theories, analysis of case studies, interpretation of results, and final conclusions are entirely developed by me.

I assume complete responsibility for this work.

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