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# The most influential factors in venture capitals' exit decision: A qualitative study among Spanish venture capitalists

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## Abstract:

The objective of this research is to determine and draw the attention of venture capitals toward the most important factors that they should consider for making a proper exit decision. A list of suggested influential factors in venture capitals' exit decision was extracted from the literature. The list is refined and developed by the Delphi method through three rounds of Delphi with a Delphi group composed of 15 Spanish venture capitalists. A list of the 14 most influential factors in an exit decision is developed and is divided into four categories (venture capitals, investees, entrepreneurs and external environment). Some of the factors have been neglected in previous studies and some seldom have been studied. It is recommended that venture capitals consider a combination of the suggested factors to make an exit decision. Also when making the exit decision, venture capitals should not only pay attention to the factors regarding themselves and the investee, but also they should consider the factors regarding the entrepreneurs and external environment. The research brings together different factors in venture capitals' exit decision from different categories, refines and develops them, and produces a precise and actionable list of the most important ones.

**Keywords:** venture capital; divestment; exit decision; Delphi method; Spain

**JEL codes:** G24, G32, G33

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## 1. INTRODUCTION

The investment process of venture capitals is divided into three general steps, pre-investment, post-investment and exit (De Clercq et al., 2006). Getting out of an investment is the natural end to any venture capital deal and finally a day would come that the venture capital would decide to divest and exit the deal (Zider, 1998) by selling its shares in it, partially or fully (Cumming & MacIntosh, 2003a).

According to Wall and Smith (1997) more than 70% of venture capitals have difficulty in determining the proper time of their exit from a deal; and this problem still keeps on straining venture capitals (Hege et al., 2009; Oehler et al., 2007; Cumming & MacIntosh, 2003b).

The main question of this research is: 'What are the most important factors which influence a venture capital's exit decision?' The main objective of this research is to determine and draw the attention of venture capitals toward the most important factors that they should consider for making a proper exit decision.

This research is a qualitative and applied one. It is done based on literature review and by using the Delphi method with a panel consisting of 15 Spanish venture capitalists.

In this article, first, the literature on venture capitals' exit decision is reviewed. During the review the factors which are considered influential in venture capitals' exit decision are highlighted. After that, the research method (the Delphi method) is first introduced briefly and then how it is used for conducting this research is described. Later on, the results are reported and commented on and finally conclusions are drawn and future research opportunities are suggested.

## 2. LITERATURE REVIEW

First of all, there are two jargons which their difference needs to be clarified to prevent any misunderstanding and mix-up before moving forward. It is important to have in mind that an entrepreneur is a person who comes with a business idea. An 'investee' is a legal entity (usually in form of a company) which has been started by one or more entrepreneurs to convert a business idea into a business, and has been invested in by others such as venture capitals.

Venture capitals are one of the most important financial sources for micro-enterprises and SMEs. Venture capitals invest in those types of companies not in the hope of an instantaneous gain, but hoping that those companies would grow and consequently their investment value would grow. For this reason, venture capitals prefer to invest in companies with fast growth potential (Kaliski, 2006).

A venture capital enters a deal in hope of great return on its investment, usually 10 to 20 times of its investment; but the venture capital would be still satisfied with 3 to 5 times of it. Anything under that would be considered as a 'sideways deal' which means a low quality and an inferior deal (Berkery, 2007, p. 70). But in any case, whether the investee succeeds to achieve its promise or fails to do so; at some point, the venture capital have to divest and collect its profit or accept its loss. This process of divestment is called 'exit' (Félix et al., 2014; Nadeau, 2011; Bienz & Walz, 2010; Gladstone & Gladstone, 2004, p. 9; Zider, 1998).

Cumming (2008) says a venture capital faces many challenges while going through the exit step. For example, there usually would be disputes and confrontations between the entrepreneurs and the venture capital in evaluating the investee's value when the time of exit comes. Also, severe information asymmetry against the venture capital, would negatively affect its ability to exit a deal; it especially makes it hard to exit the deal by an IPO (Amit et al., 1998) – which is the preferred type of exit for a venture capital in terms of return on investment (Gompers, 1995).

Scholars have identified and studied different factors which affect venture capitals' exit decision. Berkery (2007, pp. 178–211) mentions five major factors which influence the exit decision of a venture capital:

- possibilities of different exit options such as IPO, stock buyback, merger and acquisition;
- the investee's life cycle stage such as seed stage, early stage, formative stage, later stage, balanced stage;
- other investment opportunities that the venture capital is facing, such as access to better deals or lack of that;
- dividends of the venture capital's current shares in the investee;
- the venture capital's strategic decision to reduce its shares in the investee.

Puri and Zarutskie (2012) show that an 'investee's life cycle stage' is a significant factor in the investee's value; hence, it plays a major role in a venture capital's exit decision. Also, when an innovative company is small and near its beginning; it is less valuable than when it matures and commercializes its innovative ideas (Chemmanur et al., 2014). As the investee grows, although it gets more valuable but also its capital needs grows too; hence, the venture capital faces several options; it could continue and invest more or invites other venture capitals for a syndicated investment or exits.

Hawkey (2002, pp. 3-52) provides eight factors which have an impact on a venture capital's exit decision, which are:

- The 'why': the reason that the venture capital is seeking to exit the deal. This factor in Hawkey's opinion is also the most important factor and would consequently determine when and how to exit the deal. For example, the venture capital could be facing another more lucrative deal and be in need of cash to invest in that, or the investee is not growing according to the expectations and the venture capital prefers to cash in on its investment as soon as possible or the venture capital could be in conflict with the entrepreneurs.
- Value: does the chosen exit option maximise the venture capital's return on investment?
- Control: how much control does the venture capital has over the chosen exit's transaction? And furthermore, does the venture capital still want to keep some degree of control over the investee after the exit?
- Risk: how risky is the chosen exit's transaction?
- Financial expectations: how much does the chosen exit option fulfil the venture capital's expected financial gain?
- Gratification and satisfaction: how much does the chosen exit option satisfy the venture capital's non-financial expectations such as reputational incentives?
- Payment certainty: The probability that the venture capital be fully paid based on what is agreed upon with the buyer(s).

- Deal flexibility: How much flexibility the chosen exit would provide for the venture capital such as suitable payment terms and possibility of future involvement in the investee.

Kuratko and Hornsby (2009, p. 220) consider ‘continuous assessment of an investee’s performance and financial status’ to be a key factor in a venture capital’s exit decision. They also suggest that venture capitals should prevent reaching an emergency situation by periodically calculating ‘Altman Z-Score’ (Altman, 1968) to monitor possibility of bankruptcy in near future; in order to take the proper exit measures before an exigency happens.

Fried and Ganor (2006) examine the relationship between use of ‘venture capitals’ preferred stock and control rights’ and their exit decision. They found out that venture capitals are practical and opt toward an exit option which maximises their financial gains; and that is not necessarily the option which has the best consequences for the entrepreneurs. On the other hand, the exit process and its consequences have more importance for entrepreneurs. Thus, in case venture capitals have preferred stock and control rights, they tend to use them for taking an exit decision which leans toward their preferred exit option.

Also, the role of ‘contractual control rights’ is important in venture capitals’ decision to exit. Those rights come from the contract between a venture capital and entrepreneurs which is the legal basis of the deal. The amount of control that a deal bestows to a venture capital over entrepreneurs eventually affects the venture capital’s exit decision (Cumming, 2008; Smith, 2005; Bascha & Walz, 2001; Hellmann, 1998).

Existence of a ‘call or put agreement’ in a deal between a venture capital and entrepreneurs is another factor in the venture capital’s exit decision (Gladstone & Gladstone, 2004, pp. 286–289; Black & Gilson, 1998). A ‘call agreement’ is an agreement which obliges the venture capital to offer a pre-determined quantity of its shares to the entrepreneurs based on a pre-agreed timetable and pricing formula. However, the entrepreneurs are not obligated to execute their option, which in this case, the venture capital could keep the shares or offer them to other parties.

On the other hand, a ‘put agreement’ is an agreement which obliges the entrepreneurs to buy a pre-determined quantity of the venture capital’s shares based on a pre-agreed timetable and pricing formula. However, the venture capital is not obligated to execute its option, which means the venture capital could keep the shares.

Wang and Zhou (2004) show an increase in the ‘number of stages that a venture capital invested in an investee’ reduces the risk of a bad exit. Besides, another factor in a venture capital’s exit decision and choosing a proper exit option is the ‘investee’s age’ (Giot & Schwienbacher, 2007).

‘Entrepreneur’s satisfaction’ is another factor which influences the performance of an investee and consequently affects the venture capital’s exit decision (Wijbenga et al., 2007; Zahra, 1996).

Other factors which affect a venture capital's exit decision are:

- NPV (Net Present Value) of the investee and its deviation from the venture capital's previous projections and current expectation (Neus & Walz, 2005; Cumming & MacIntosh, 2001; Gompers & Lerner, 2001; McGrath, 1999; Gompers, 1995);
- the ability of the buyer(s) to help the investee's growth and development in the future and by that maintaining a positive image of the venture capital and adding to its credibility (Bayar & Chemmanur, 2012);
- the venture capital's social capital, network ties and especially its relationship with financial markets' players (Lungeanu & Zajac, 2015; Ozmel, Robinson, & Stuart, 2013; Hallen & Eisenhardt, 2012; Hochberg et al., 2007);
- the buyback ability of the entrepreneurs (Cumming & Johan, 2008; Cumming et al., 2005);
- the venture capital's experience (Giot & Schwienbacher, 2007; Cumming et al., 2006).

As it is obvious different authors have focused on different factors that affect a venture capitals' exit decision. What is missing in the literature is a study which first of all gathers all those factors in one place, and secondly, specifies the most influential one so it could be of practical use for the industry. This study aims to fill this gap.

The influential factors on venture capitals' exit decision which are scattered through the literature and are identified above are used to form a raw list which this research aims to refine and develops it into a multi-dimensional and clear-cut list of the most influential factors on venture capitals' exit decision.

### 3. MATERIAL AND METHODS

To answer the main question of this research – which is: What are the most important factors which influence a venture capital's exit decision? – and also to probe how theoretical and practical influential factors on a venture capital's exit decision relate to each other, a qualitative method that is called “The Delphi Method” was employed.

The Delphi method is based on collecting and converging the views of a group of experts in the study's subject (The Delphi Group) which is led and handled by a coordinator. The aim is to reach a consensus among the experts over the subject.

Consensus is achieved by going through a systematic process. The process starts with defining the problem by the coordinator and guiding the Delphi group's discussion, and continues by receiving the comments and views of the Delphi group members. The discussion is summarized by the coordinator.

Afterwards, the synopsis of the discussion and the comments is fed back to the Delphi group by the coordinator. This procedure of discussion, summarizing

and feeding back is called a “Round of Delphi”. The rounds of Delphi usually continue until there is a consensus among at least two-thirds of the Delphi group members on the subject at hand.

It should be mentioned that the quality of the Delphi method directly depends on the quality of the assembled Delphi group. Also, it is recommended to have at least 15 members in the Delphi group and with larger groups it gives better results (Hsu & Sandford, 2007; Linstone & Turoff, 1975; Dalkey, 1969). There are several weaknesses associated with the Delphi method such as being time consuming and possibility of getting more general answers than specific ones (Hsu & Sandford, 2007).

For this study, primarily a group consisting of three high-ranking Spanish venture capitalists were formed (High-ranking means that they were head of a venture capital firm or a senior manager in one). Then, they each were asked to introduce four more expert venture capitalists; and by adding those experts, the Delphi group with 15 members was formed. The researcher took the role of the coordinator.

First, the coordinator – based on the literature – made a list of influential factors in a venture capital’s exit decision. The coordinator then briefed the Delphi group on the research’s objective and main question; and then, they were asked to comment on the factors list. By applying the comments and suggestions, a primary list of factors were formed to start the rounds of Delphi with.

During each round of Delphi, first, the experts discussed the factors list and then graded them by assigning a mark (0 to 100) to each one of the factors. Also, they could suggest corrections or new factors. Those suggestions would be put to vote and the chosen ones would be applied to the list for the next round.

#### 4. RESULTS AND DISCUSSION

The finishing criterion of the rounds of Delphi was set to reach to a minimum of two-third consensus among the Delphi group members and absence of new suggestions; which by the end of the third round both conditions were achieved. A final list of 14 factors was agreed upon with a 73.1% average mark and also valuable commentary on them was accumulated during the rounds of Delphi. Table 1 summarizes those three rounds of Delphi.

**Table 1.** Statistics of the rounds of Delphi on influential factors in a venture capital’s exit decision

Indicator	First Round	Second Round	Third Round
Number of suggested addition / correction to apply for the next round	5	2	0
Final number of factors	7	12	14
Average mark	41.3	62.6	73.1
Changes in the average mark	-	+21.3	+10.5

Source: own study.

The final list of the 14 most influential factors in a venture capital's exit decision has been further distributed in four key categories which demonstrate different dimensions of the exit decision (Table 2).

The first noticeable point in the results is that venture capitals have detailed factors when it comes to making an exit decision. It is in the contrast with major part of the factors that are mentioned in the literature which are mostly pointing toward general factors. The results are not contradictory with the factors offered by the literature, but they are finer, more detailed and practical while the factors mentioned in the literature are general, conceptual and in some cases vague.

**Table 2.** Final list of the 14 most influential factors in a venture capital's exit decision

Factors' Category	Factors List
Factors regarding investees	<ul style="list-style-type: none"> <li>- NPV (Net Present Value) of the investee and its deviation from the venture capital's previous projections and current expectation (mark: 87),</li> <li>- the investee's life cycle stage and if it is passed its fast-growth stage (mark: 84),</li> <li>- comparison of the investee's performance with its updated business plan (mark: 72),</li> <li>- comparison of the investee's performance with the venture capital's quantitative and qualitative performance criteria (mark: 69),</li> <li>- assessment of the investee's financial status and it's Altman Z-Score (mark: 68).</li> </ul>
Factors regarding venture capitals	<ul style="list-style-type: none"> <li>- attractiveness of the venture capital's alternative investment opportunities in comparison with keeping the current investment (mark: 79),</li> <li>- the venture capital's access to financial resources and its cache requirements (mark: 74),</li> <li>- the venture capital's contractual control rights and existence of a put agreement (mark: 70),</li> <li>- availability of buyers who are interested in the investee (mark: 68).</li> </ul>
Factors regarding entrepreneurs	<ul style="list-style-type: none"> <li>- the buyback ability of the entrepreneurs and existence of a call agreement (mark: 75),</li> <li>- the entrepreneurs' potential in attracting more funds and their previous records (mark: 71).</li> </ul>
Factors regarding external environment	<ul style="list-style-type: none"> <li>- priorities and preferences of the venture capital's fund providers and the capital markets (mark: 72),</li> <li>- financial legal system (mark: 68),</li> <li>- changes in the market of the investee's products/services (mark: 67).</li> </ul>

Source: own study.

As it is shown in table 2, there are five factors regarding investees. It is important to consider that those do not solely depend on the entrepreneurs or the venture capitals, but they are the result of the cooperation between the entrepreneurs and all the venture capitals and other stakeholders involved with the investee.

An interesting result – which is not discussed in any previous study – is that a venture capital updates the initial investee's business plan based on the current realities of the investee and external environment, and takes this updated version of the business plan into consideration for making an exit decision.

Also, it should be taken into account that a venture capital's quantitative and qualitative performance criteria depends on many elements especially the source of its funds. Venture capitals that have more access to governmental funds have different criteria than the ones who have limited or no access to such funds.

Venture capitals which have access to governmental funds consider the government's strategic plans and non-profit objectives into their decision making process. For example, if the government is funding an especial industry, then the profit is less important as a criterion to the government than knowledge creation.

A venture capital considers if an investee is passed the fast-growth stage in its life-cycle. In this situation if there is not much possibility of a lucrative exit in the future (such as an IPO) then the venture capital prefers to exit and invests the earning into another deal with fast-growth possibility.

In the factors regarding venture capitals, 'attractiveness of the venture capital's alternative investment opportunities in comparison with keeping the current investment' means that in the same situation depending on what alternatives a venture capital has, it may or may not keep its shares in an investee. So, if there are not any better alternatives, a venture capital prefers to keep its shares in a weak investee.

Also, in case there is not any suitable buyer, a venture capital may prefer to hold on to its shares in a weak investee. In the factors regarding entrepreneurs, an entrepreneur's potential in attracting new funds and previous record is important to a venture capital. For example, venture capitals are more tolerant and patient with serial entrepreneurs than new entrepreneurs. Also, as another example, they are more tolerant with famous entrepreneurs who could attract new funds from other sources.

In the factors regarding external environment, changes in the market of an investee's products/services is influential in a venture capitals exit decision, which has been neglected in the previous studies. Some of the Delphi group members mentioned that they had had experiences of investing in investees with attractive products which later on, foreign cheaper products took their market and they had been forced to exit the deals.

## 5. CONCLUSIONS

Choosing the timing of an exit is one of the major concerns of venture capitals (Hege *et al.*, 2009; Oehler *et al.*, 2007; Cumming & MacIntosh, 2003b; Wall & Smith, 1997). They are hopeful to do it on the right time in the right manner to maximize their profit or minimize their loss. A review of literature shows that many factors could influence a venture capital's exit decision. Additionally, most of the literature has its focus on successful exits and unsuccessful exits and early exits have been studies less.

This research composed a comprehensive list of factors extracted from the literature and discussed them with a Delphi group of Spanish venture capitalists and finally arrived to a list of the 14 most influential factors, which some of them

were neglected by the literature or have been studied rarely. The factors regarding external environment which could affect a venture capital's exit decision seldom have been studied. And the same goes for studies of call or put agreements. Also, the results show that Altman Z-Score is an important factor that could help a venture capital to make an early exit decision. Based on the results, venture capitals are advised to consider a mixture of important factors regarding four different dimensions – themselves, the investees, the entrepreneurs and external environment – to make a proper exit decision. Also, they are strongly advised to pay more attention to external environment factors.

It should be considered that although the results does not seem to be location bound and country specific but, anyhow, the Delphi group was consisted of homogeneous members in the sense that all were Spanish venture capitalists, and that may have influenced the results although there is no clear indication of that. Also, it should be taken into account that the results not only are based on the thoughts and ideas of a group of Spanish venture capitalists but they are also affected by the reality of current economic situation of the country and the continent. Thus, further researches are required to show the degree of extendibility of the results to different places, times and situations. Moreover, based on this research and for the future studies, it is suggested that scholars consider prioritizing and weighing up those 14 factors. Additionally, designing a general model based on them could be helpful and valuable.

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