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Venture Capital: Why Investors Invest

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Over the past year, my colleagues and I at Flywheel Ventures have received 494 business proposals from entrepreneurs seeking funding. We followed up with initial inquiries to 98 entrepreneurs; 23 were then invited to an initial meeting with the entire Flywheel investment team. We then pursued additional "due diligence" research on about half of the presenters. Ultimately, we invested an average of $365,000 in initial funding in each of just four new ventures.

From the initial submissions, then, we invested in just 0.8 percent. These statistics, while specific to our firm, are typical of the venture capital industry.

In any field of investment, achieving higher returns requires the acceptance of higher risk. Venture capital investors search for high-risk investments based on innovations in information technology, life sciences, and clean technologies such as renewable energy. Investments in these types of firms require an extreme tolerance for risk, uncertainty, and failure.

Most venture investors expect approximately one-third of the companies in which they invest to completely fail and lose the entire investment. In another third, we expect to effectively get our money back – a rate of return that does not nearly cover the risk taken. The final third, however, will typically provide us with five to ten times our invested capital. The financial rewards from these "home runs" easily pay for the losses of the other two-thirds that were not successful.

These "home runs" also go on to become the anchors for regional economic growth and job creation. In fact, a 2005 study showed that the "home run" companies funded by venture capital investors over the past 30 years now account for nearly ten percent of the entire GDP – Gross Domestic Product – of the United States, and nearly ten percent of all private sector employment. Even more impressive is that the total amount of all capital invested by venture investors during the same time period was less than two percent of the U.S. GDP. The high reward – and associated high risk – is what drives the unique selectivity of venture capitalists and the investment process.

Most venture investors analyze the risk associated with each new venture in four key areas: the team, the market opportunity, the product and technology, and the financial projections.

Many entrepreneurs and innovators are initially surprised to learn that almost all venture investors consider the team and the market opportunity – not the product or technology – as the most important of these factors. An ongoing industry dialogue rages over which of the top two, market opportunity or team, is triumphant, yet product and technology still falls behind in importance.

At Flywheel, our most important investment consideration is the entrepreneurial team. A famous Hollywood proverb states that "ninety percent of directing is casting," and we believe our industry is no different.

When assessing a team, we consider the usual aspects: experience, skill, passion, commitment, and a history of previous successes. Most of all, though, we care about the character of the individuals on the team and the culture they are creating as a team; these elements are the only long-term predictors of how the venture will react to the inevitable challenges and stresses associated with such high risk activity. The importance of our concern for character and culture is further underscored when one considers that the average period of time from our initial investment in a company to the achievement of liquidity is over six and one-half years – which is now longer than the average marriage in the U.S.

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