INVESTOR CRITERIA OF EARLY STAGE VENTURES *in New Zealand*

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This study seeks to inform New Zealand entrepreneurs on the needs and wants of New Zealand investors looking to invest in early stage ventures, potentially enabling entrepreneurs to improve the effectiveness of their capital-raising efforts. The study compares investor criteria of early stage ventures in New Zealand with those in the United States. Our findings show significant differences between the New Zealand venture capital market and developed markets, such as the US, with New Zealand investors having a relatively short-term focus and valuing different factors in their investment criteria. These differences are likely due to the relatively young age and small size of the New Zealand market.

While New Zealand has a shared heritage with other English-speaking countries, its history and environment are quite different, particularly in terms of its small size and isolation from the rest of the world. Research by Weber and Hsee (1998) confirms that culture shapes our perception of risk. Investing in the early stage ventures market (start-ups) is a high-risk activity. This study investigates the criteria of investors in early stage ventures in New Zealand using interviews with industry leaders, a survey and focus group discussion, with the results being compared to investor criteria previously identified in the United States. We make this comparison because the US has a well-developed venture capital industry, and although there are significant differences from New Zealand in relation to geographic size and age, the two countries have much in common in terms of their political, economic and legal systems.[2]

If entrepreneurs have a better understanding of how to present start-ups these may become more attractive to New Zealand investors. Obvious differences in domestic market characteristics, limited viable investment opportunities, little specialised labour and a general scarcity of investment capital suggest that the environment for New Zealand investors may be different from that for US investors who have a longer history of involvement in venture capital. Many US investors who invest in start-ups are successful entrepreneurs in their own right and tend to invest in industries where they have experience and expertise. They invest in ventures close to where they live, so they can be more involved with the operations of the company and visit the company offices (Benjamin and Margulis 2001). US investors want transparency in business dealings and have a preference for being involved in company operations (Bruton and Ahlstrom 2003).

Until now there has been no data on the behaviour of New Zealand investors or on how the New Zealand culture affects investor criteria in early stage ventures. The closest was a small study conducted in Australia by Hindle and Wenban (1999), based on just 36 respondents, which speculated that the informal venture capital market was a lot larger than the formal market. It suggested Australian investors had an affinity with accumulating more wealth and seeking financial returns, compared to the subjects of a UK study.

The objective of this study is to inform New Zealand entrepreneurs on the needs and wants of New Zealand investors looking to invest in early stage ventures, potentially enabling entrepreneurs to improve the effectiveness of their capital raising efforts. Successful entrepreneurs are seen as being of vital importance for New Zealand, as the country is dependent on selling products and services to the rest of the world. Immigration New Zealand has a special Entrepreneur Residence Category if immigrants have established a high-growth and innovative business with export potential in New Zealand (Immigration New Zealand 2017). A problem identified by the Chairman of the Angel Association of New Zealand, Marcel van den Assum, is that capital for early stage ventures is not as readily available as in larger, developed economies. He recently noted that '[d]espite all the funds being pumped into start-ups, more is needed for the country's young businesses to realize their full potential' (Pullar-Strecker 2016).

Literature and current venture capital best practice encourages entrepreneurs to match their business with appropriate investors. This enables the entrepreneur to generate more value from the relationship after the initial capital has been raised. The entrepreneur can also leverage the investor's connections and professional network to gain credibility in the industry and fast track development. Successful matching allows the entrepreneur to raise money from experienced and well-informed investors with the right connections, ensuring the best chance of success for their entrepreneurial idea.

A lack of information is a primary reason for a lack of standardisation in the investment process in New Zealand. Our research shows that New Zealand investors are more accepting of an informal approach and the industry has already identified a tendency for a lack of due diligence prior to investment. This research confirms this lack of information. While the model used to develop the findings for our conclusions has been used previously in the US, it only paints a picture of the average behaviour of investors, who have a wide diversity of approaches and behaviours when they invest.

The key prior pieces of work on which our study is based are Sudek (2006), Benjamin and Margulis (2001) and Van Osnabrugge and Robinson (2000).

Method

Van Osnabrugge and Robinson (2000), Harvard professors and angel investors, published their survey of over 300 empirical studies from the US and other countries as a guide for entrepreneurs, investors, venture capitalists and policy makers. Their call for improved funding for start-up companies was endorsed at the time by the Chairman of the US National Venture Capital Association (NVCA) and by the then Chief Economist of the US Small Business Administration. The Van Osnabrugge and Robinson (2000) book also served as a guide for a study by Sudek (2006) who looked at how angel investors in southern California prioritise their investment criteria. We used the criteria identified and ranked by Sudek (2006) to develop a survey suitable for New Zealand.

The survey was circulated by the E-centre (Massey University technology incubator), the New Zealand Venture Capital Association, the New Zealand Venture Investment Fund (NZVIF) and the Angel Association of New Zealand (Government), to their investor networks. We thereby reached out to 15 private angel networks and three venture capital funds across New Zealand. Qualified responses were received from 88 investors who had invested in New Zealand ventures in the past 48 months. The sample comprised angel investors, private investors, venture capitalists, members of crowdfunding platforms and members of professional angel groups. Insights obtained from the survey were then validated through a focus group session involving investors across different investor types. We believe this sample to be representative because the entire New Zealand venture capital ecosystem is estimated to be only between 600 and 800 investors.

The main difference between our approach and that of Sudek is that we shared the survey first and then conducted a focus group instead of the other way around. We also added an extra question to the survey to distinguish between domestic and international sales potential, reflecting the greater importance of international sales for New Zealand venture capitalists.

Results — NZ investor criteria versus US investor criteria

Ruhnka and Young (1991) identify investing in early stage ventures (start-ups) as very risky business. Investors often have limited tangible information when investing in early stage ventures and the focus is usually on the entrepreneur themselves. Multiple studies cite factors linked to the entrepreneurs' personality, such as the intelligence, enthusiasm, trustworthiness, charisma, expertise and experience of the entrepreneur and their team to be the most important criteria (along with their ideas) for investment in early stage companies (Sudek 2006; Bruton and Ahlstrom 2003; Mishra 2004; Certhoux and Perrin 2013).

Table 1 ranks the importance of each criteria to New Zealand investors compared to the criteria ranking identified by Van Osnabrugge and Robinson (2000) and using the research methodology of Sudek (2006). Respondents scored each criterion with a rank from 1 to 6. The mean and standard deviations of the scores from the 88 scores respondents are shown in Table 1, and compared to the Van Osnabrugge and Robinson (2000) results. Key differences are identified and discussed below; however, it must be recognised that while differences between the two studies are apparent, we do not have the data on the means and standard deviation of the Van Osnabrugge and Robinson (2000) study, so it is not possible to compare these differences statistically.

TABLE 1: NZ investor criteria versus US investor criteria

Investment criteria	NZ rank	Mean	Std dev	US rank
Trustworthiness of entrepreneur	1	5.53	0.68	2
Future growth potential of venture	2	5.46	0.61	6
Enthusiasm of entrepreneur	3	5.46	0.72	1
Expected return (perceived financial rewards)	4	5.05	0.94	8
International sales potential	5	5.02	1.06	–
Quality of venture products/service	6	4.82	0.93	7
Liquidity (potential exit)	7	4.71	1.29	24
Nature of competition	8	4.39	1	17
Expertise of entrepreneur	9	4.35	1.01	4
Overall competitive protection	10	4.34	1.16	21
Informal competitive protection	11	4.33	1.17	12
Investor understands venture	12	4.28	1.04	24
Track record of entrepreneur	13	4.13	1.11	10
High profit margin of venture	14	4.10	1.09	15
Size of investment	15	4.02	1.34	20
Investor liked entrepreneur on first meeting	16	4.02	1.08	5
Venture targets niche market	17	3.81	1.42	9
Presence of (potential) co-investors	18	3.77	1.48	26
Venture is local (HQ in country of investor origin)	19	3.64	1.6	23
Low initial cost to test market	20	3.61	1.21	22
Investor involvement possible (networks, skills, etc.)	21	3.54	1.46	13
Low overheads of venture	22	3.50	1.1	16
Formal protection (patents)	23	3.10	1.37	27
Low capex needed initially (fixed assets)	24	2.99	1.17	19
Further investment required to break even	25	2.98	1.46	18
Philanthropy (non-financial rewards)	26	2.88	1.25	–
Investor strength fills gaps in the venture (expertise)	27	2.79	1.36	14
Domestic sales potential of venture	28	2.76	1.31	3

Note: Table ranks the importance of each criteria to New Zealand investors compared to the criteria ranking identified by Van Osnabrugge and Robinson (2000) using the research methodology of Sudek (2006). A rank, from 1 to 6, was provided based on the average score of each response for each criterion. The mean shows how far apart criteria were between ranks while the standard deviation measures the level of disagreement among investors relating to that particular criterion with a smaller standard deviation indicating more consensus.

Entrepreneur characteristics

Not surprisingly, both surveys rank the personal characteristics of the entrepreneur highly with the New Zealand survey ranking *trustworthiness* in first place (US: 2) and enthusiasm in third place (US: 1). The entrepreneur's *track record* is ranked 13 (US: 10) while the *expertise of the entrepreneur* is ranked 9 in New Zealand (US: 4) and the *first impression of the entrepreneur* is ranked 16 (US: 5), suggesting US investors are investing more in entrepreneurs than New Zealand investors. This may reflect the fact that New Zealand is an emerging venture capital market in contrast with the highly developed US market. However, insights from the focus groups suggest New Zealand investors are more cautious when building relationships and take longer to get to know founders.

Market characteristics

Both studies rank *growth potential* highly: New Zealand investors rank this 2 (US: 6) and rank *international sales potential* 5. The Californian study doesn't rank international sales but ranks *domestic sales potential* 3 in contrast with the New Zealand rank of 28. This may reflect that New Zealand investors recognise the small size of the domestic market in contrast with the large US market in which ventures can be scaled.

The majority of capital raised in New Zealand for seed stage is concentrated in just four industries: software as a service (SaaS); biotechnology; life sciences; and pharmaceuticals (NZVIF 2016). New Zealand investors have a preference for ventures that can be scaled, a factor which may explain the concentration in just four industries. According to the NZVIF study on valuations (by deal value) of New Zealand early stage ventures, at the seed stage, software investments comprise 33 per cent of the total and pharma-biotech comprise 46 per cent. At the start-up stage, those sectors comprise 41 per cent and 20 per cent, respectively (NZVIF 2016). The report describes a similar pattern in the US with 48 per cent of angel investments being made in software and healthcare.

Investor characteristics

US investors are generally looking to invest in industries in which they have experience and expertise with *investor filling the gaps in the venture* ranked at 14 in the US compared to 28 in New Zealand. The willingness of New Zealand investors to invest in ventures in which they have little experience may reflect the small size and age of the New Zealand venture capital market. The rank of 21 (US: 13) for *investor involvement through skills and network* may also reflect this with most investors having made their initial capital in industries other than software and pharmabiotech, meaning they don't have this network. The longer track record of these industries in the US has resulted in a large pool of potential angel investors who have built their experience in those industries. This suggests that New Zealand investors frequently invest in areas (ventures) where they lack expertise and many are not able to contribute to the venture after their investments, with some investors holding portfolios in multiple start-ups across diverse industries. Moreover, the funds run by New Zealand investors are generally small, meaning that they may be operating at less than optimal scale (Cumming 2006).

The focus group suggested that many New Zealand investors are not able to commit much time to ventures they invest in. This further explains the higher ranking of the *expertise of the entrepreneur*, because New Zealand investors who are investing in fields in which they have no experience need the founders of the ventures to have that experience. In the US, investors with experience are more willing to mentor, train and coach entrepreneurs so they are less concerned about the entrepreneur's previous experience. Investors in the focus group also pointed out that successful New Zealanders are more likely to relocate overseas in pursuit of new opportunities and this reduces the number of investors in New Zealand with experience.

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Investment characteristics

Fundamental to any investment decision are risk and return trade-offs, New Zealand investors rank *expected returns* at 4 (US: 8) and *exit potential (or liquidity)* at 7 (US: 24). New Zealand investors appear less willing to risk their capital compared to US investors, and seek to invest in ventures that are more liquid than US investors. A similar picture is revealed when looking at competition with New Zealand investors ranking the *nature of competition* at 8 (US: 17) and competitive protection at 10 (US: 21). The focus group suggested that there might be a cultural difference in how the two investor groups perceive risk. Failure is often celebrated and encouraged in the US because it is seen as a stepping stone to success, while in New Zealand the 'tall poppy syndrome' still exists and investors are more cautious.

Top five characteristics

Overall there are many similarities between the two studies with both sets of participants valuing trust and enthusiasm very highly. The most significant difference in the top five criteria is the drive in New Zealand for international sales versus the US acceptance of domestic sales, though this is likely due to New Zealand investors' belief that future growth potential must come from outside New Zealand's small market.

Investor type

Survey respondents classify themselves as either angel investors (27), venture capitalists (11), private investors (41) or angel syndicate investors (9). With an overall sample of 88 respondents it was not possible to undertake meaningful statistical testing of differences among groups, but results presented below suggest there is value in a larger more robust study being undertaken.

TABLE 2: Selected rankings by investor type

Investor criteria	Angel investor	Angel syndicate	Venture capitalist	Private investor
Sample size N	27	9	11	41
Expected return (financial rewards)	6	8	1	4
Investor involvement possible	21	23	8	22
Venture is local	23	17	14	19
International sales potential	1	1	5	6
Low overheads of venture	19	15	23	21
High profit margins of venture	12	20	17	16
Size of investment required	18	5	19	15
Overall competitive protection	9	21	12	12

Note: Table reports the ranking of selected criteria for different types of New Zealand investors. The numbers of responses were too small to allow us to conduct meaningful tests for the significance of the differences.

Angel investors are very particular about investing in ventures with a strong potential for international sales. They prefer ventures with high margins and are the type of investors most concerned about overall competitive protection of the venture in which they are investing. Angel investors in groups or syndicates are most sensitive to size of investment. This is because many only co-invest as a group and are very specific about the amount they are willing to invest. Consistent with this, they are also the investors who are most concerned that the venture has low overheads.

Those who identify as venture capitalists exhibit behaviour that is closest to US investors. They wish to be more involved after the capital has been raised than other investor types. They have a preference for the venture being local so they can get more involved with the company's operations. They are the most likely category of investors that can help entrepreneurs raise smart money in New Zealand. Some venture capitalists in New Zealand invest in seed capital and Series A capital, which is uncommon in the US.

Private investors do not have extreme positions like other venture capital investors. They are the least likely to be interested in being involved with the venture after initial investment and are most concerned with the track record of the entrepreneur, preferring to invest in experienced entrepreneurs.

The desire for financial returns

The investment criteria which are related but opposites of each other, expected return and philanthropy (non-financial return) show a wide dispersion with mean scores of 5.05 and 2.88, respectively.

TABLE 3: Philanthropy versus monetary benefits

Investor type	Philanthropy		Monetary benefit	
	Mean	Std dev	Mean	Std dev
Angel syndicate (9)	3.43	0.90	5.78	0.42
Angel investor (27)	3.08	1.15	5.00	0.85
Private investor (41)	2.81	1.27	4.83	0.94
Venture capitalist (11)	2.00	0.67	4.57	1.29
All investors (88)	2.88	1.25	5.05	0.94

Note: Table reports the mean and standard deviation of criteria of expected return (monetary benefits) and philanthropy (non-financial rewards), out of 6, to demonstrate the motivations of different types of New Zealand investors.

Venture capital firms are judged solely on their expected returns whereas the firms they invest in and angel investors can have other objectives. Our survey results confirm these different objectives and incentives. Venture capital investors on the other hand rank philanthropy as least important with a mean of 2.00.

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These results suggest entrepreneurs would be wise to tailor their pitch for funding to the group of investors they are targeting. Other insights revealed by the study are that, when seeking investment, New Zealand entrepreneurs rely heavily on personal networks. A total of 27.91 per cent of investors welcome direct contact by entrepreneurs and 39.53 per cent prefer referrals from friends and trusted advisors. This is in contrast to a study in the US by Benjamin and Margulis (2001) which finds that 57 per cent of investors source their deals through personal contacts, 31 per cent locate deals through professional networks and only 12 per cent come from (direct contact) unsolicited contacts from non-family members. New Zealand entrepreneurs rely less on direct connections and more on indirect connections.

Some 75 per cent of New Zealand investors generally conduct their own due diligence with around half of these relying only on their own expertise. This implies that New Zealand investors frequently invest in ventures in which they do not have adequate knowledge or expertise and hence rely on others to help them decide where to invest. This is a way to minimise the risk of investing in ventures in which they do not have experience. The focus group noted that New Zealand culture is more cautious and not overconfident and so many would like to get a second opinion on their due diligence. It also confirms that they typically do not have standardised investment procedures. This observation from our research is consistent with Debra Hall's insights (as a member of the expert panel of the Business Intelligence Forum)[3] and suggests a cultural element. The majority of New Zealand investors are passive investors and prefer to let a minority of active investors do the heavy lifting on due diligence rather than do it themselves (Lowndes 2016).

The majority of New Zealand investors in our sample indicate they are willing to invest in any stage of the company, which is a surprising finding. The risk and return trade-off between the different stages of company operation is very significant and so is the amount of capital required to make an investment. New Zealand investors do not have consistent investment rules or preferences regarding the industries in which they want to invest, the exact amount they are willing to invest (ranked 25) or the stage of company operations at which they wish to invest. New Zealand investors are not as particular (and can be seen as less sophisticated) about their investment process as compared to US investors. New Zealand investors are more likely to take each investment opportunity on a case-by-case basis. This may limit the professionalisation of firms after venture capital involvement (Hellman and Puri 2002).

Previous studies in the US and other markets find the characteristics of the entrepreneur to be a very important determinant of the level and type of investment which is undertaken. An important finding of this study is the significance of the financial characteristics of a project with New Zealand investors ranking this at 4. The outlook for investors also differs with New Zealand investors considering a venture successful only if it has export potential, whereas US investors are content with relying on the larger US domestic market. The final difference is that US investors are looking to how they can make a non-financial contribution to the success of the venture by contributing their expertise and network of contacts. With smaller and younger tech industries in New Zealand, most investors have little tech experience as they have earnt their capital in more traditional fields such as farming and general business.

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Conclusions

The criteria identified in this report are a snapshot of New Zealand investor preferences. The findings should encourage better 'matchmaking' within the venture capital industry and promote awareness about the requirements of New Zealand investors based on facts rather than beliefs. An important finding of the study was the apparent philanthropic inclination of New Zealand angel investors who are prepared to look at non-pecuniary benefits when investing. Results from this study should assist in the country's future development by informing decision making by entrepreneurs, venture capitalists, investors and policy makers about critical aspects of the venture capital industry.

While the sample of this study is small, with only 88 responses, this reflects the limited size of the New Zealand investor base which is estimated at only 600 to 800 investors. However, our results are consistent with the views expressed in the follow-up focus group sessions as well as personal discussions with industry leaders. The size of the New Zealand market is changing with a rise in foreign investment and an influx of wealthy immigrants looking to invest (NZVIF 2016). These changes are likely to manifest themselves fairly quickly and will affect New Zealand's investor criteria in the future. It is therefore recommended that this research be updated every three to five years.

Notes

1. This paper is based on Hattaf Ansari's Master's project which he completed at Massey University's School of Economics and Finance, Albany, and as part of an internship at the Massey University E-centre. This research was supported by the Massey University E-centre.

2. Other venture capital markets, such as Australia, were considered for comparison, but studies such as that by Hindle and Wenban (1999) were considered too small for this purpose.

3. See https://www.business-intelligence.co.nz/assets/PDFs/2016-Valuable-Advice-Workshop-5.pdf

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