

Promoting Entrepreneurship: how risk capital companies and business incubators select their projects and how satisfied are they with their choices

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ABSTRACT

This communication is the partial result of a wider research project and presents an analysis of the selection criteria used by risk capital companies and business incubators in Portugal, in 2003.

In this analysis it is concluded that the criteria differ, since the risk capitals worry more about the type of opportunity in analysis, whereas the incubators attribute greater importance to the innovativeness of the project, to its growth potential and to the quality of the business plan they received.

Both believe that the profile of the entrepreneur is important, but the risk capitals worry more about the experience and the incubators with the formation of the entrepreneur.

There is also an analysis of the criteria risk capitals and incubators use to evaluate the performance of the startups they supported. While the first give greater importance to profitability and sales, the later are more concerned with market share and growth in the number of employees.

Finally, this communication evaluates and compares how happy risk capitals and business incubators are with the performance of the startups they supported. The later show a higher level of happiness.

KEYWORDS: risk capital, business incubator, entrepreneurship, selection criteria, performance, evaluation criteria.

1. INTRODUCTION

The present communication presents the results of an empirical study on the criteria used by Portuguese risk capital companies and business incubators in the choice of the projects they support.

Then we go on and ask them what criteria they use to evaluate the performance of the startups and, finally, we ask risk capitals and business incubators to evaluate that performance.

A comparison is made between how risk capitals and business incubators:

1. Select projects;
2. Evaluate the performance of startups;
3. Are happy with the performance of supported startups.

1.1 IMPORTANCE OF ENTREPRENEURSHIP

The importance of the study of entrepreneurship is developed by several authors. For Low and MacMillan (1988) and Gartner (2001), entrepreneurship must be studied, fundamentally, to explain and to ease the role of the new company in economic progress. Another reason pointed to justify investigation in this area resides in the idea that, besides explaining how the markets work, it is also necessary to realize why they work and, for that, it is crucial to understand the role of a central agent in this process: the entrepreneur (Raposo and Silva, 2000).

Lambing and Kuehl (2003) defend that this subject must be studied mainly due to the dimension that it took, and they give us an idea of this dimension through the growth of the number of new companies created in the United States of America (U.S.A.), in the last forty to fifty years. Thus, in 1955, in that country, there were 4,5 million small enterprises, in other words, 1 for each 38 inhabitants. In 1965 this ratio passed for 1/29, in 1975 for 1/26, in 1985 for 1/20 and in 1998 for 1/16, twice as much as in 1955. The pure dimension of the phenomenon of the creation of new enterprises is, according to these authors, a justification to the attention that is dedicated to it in the literature.

The importance of the entrepreneur and of the creation of new firms, mainly the small businesses, for the economical and social development of a country is pointed by the European Commission (2003) like another motive that justifies an effort of investigation on the phenomenon. The Green Paper of the European Commission (2003) points out as reasons to consider entrepreneurship's contribution important for the creation of jobs, for economical growth; to improve competitiveness, to fully use the potential of the individuals and to explore the interests of the society (protection of the environment, production of health and education services, and social security).

Reynolds (1991) offers a more global vision on the phenomenon of entrepreneurship, telling that the enterprising subsystem, while a part of the social and economical system of a society, fulfils two functions, that of arbitration between subsystems (namely between the financing, the innovation and the suppliers of productive factors), and of integrator of the economical subsystem. For fulfilling such an important role in the society, it is not surprising that the entrepreneur is a target of so much attention in the published literature.

On the other side the significant increase that has been happening in the publication of investigation on entrepreneurship is a recognition of the importance what the phenomenon assumes in the development of the economies, a fact already underlined by Schumpeter (1949) more almost sixty years ago.

This importance is recognized not only by the investigators but also by the political power, since all government underline the strategic importance of entrepreneurship for the economical and social development of their countries, independently of their political family (Raposo and Silva, 2000).

Henrekson (2002) and Coulter (2003) point three main reasons for the explanation given to this phenomenon: the creation of job, the innovation and the creation of wealth.

Reynolds, Storey and Westhead (1994) add a fourth: the constitution of the own enterprise sets itself as an important choice of career that affects the life of millions of persons in the whole world nowadays.

So, by analysing the published works, it is possible to summarize four principal reasons to justify the importance of the study of entrepreneurship:

1. The creation of jobs, including the self-employment;
2. The importance of young enterprises for the innovation in the economy;
3. The contribution of the creation of enterprises for the creation of wealth and for the development of the economy and of the society;
4. The career option for a significant part of the workforce.

An important contribution for the understanding of the relation between entrepreneurship and economical growth is offered by one of Michael Porter's conclusions:

"Invention and entrepreneurship are at the heart of national advantage." (Porter, 1990: 125)

It is to this purpose that the Nobel Prize winner Hayek (1974) presents the entrepreneur as the key to the development of the nations.

Finally, Shane and Venkataraman (2000) face this situation of the relevance of the study of entrepreneurship in a different way, when they affirm that it is necessary to study this phenomenon for three reasons:

1. This is the process for which the society converts technical information in goods and services available in the markets;
2. It is also the mechanism that discovers and moderates secular and space inefficiencies in the functioning of the markets;
3. Innovative entrepreneurship is the crucial process for the change and evolution of the economy.

All these reasons put in evidence the considerable importance of entrepreneurship for the development of a region or country, thus justifying the realization of this work.

The results of the present work study may be particularly important for the understanding of a part of the reasons that explain the low levels of entrepreneurial activity in Portugal presented by Carvalho (2003).

1.2 THE ROLE OF RISK CAPITAL AND BUSINESS INCUBATION IN THE PROMOTION OF ENTREPRENEUSHIP

The support of risk capital and business incubation (Gaspar, 2005):

- contributes positively to the increment of entrepreneurship, because it increases the probability that the entrepreneur will create its company;
- increases the odds for the survival of the start-ups, since it contributes to a better performance.

Thus, these two types of support can be considered as interesting instruments for the development of the economy and of the society, especially in these days when the

governments of the euro zone have gradually lost the possibility of using the “classic” policies to manage the economy (exchange rate, interest rate, printing bills, tax policy...). Betting on the promotion of entrepreneurship, through the use of risk capital and business incubation, to develop the economy through the supply side is therefore a political option that can be extremely important for the future.

For these reasons, it is suggested to the governments to use risk capital and business incubation as a way to develop the economy and the society, through the increment of entrepreneurship and the reduction of the start-ups’ mortality.

It is also suggested that, for the entrepreneur, the use of risk capital and/or business incubation constitutes a considerable advantage, and contributes to their decision to materialize the creation of the start-up, but also contributes to increase its’ survival probabilities.

1.3 HOW DO RISK CAPITAL COMPANIES AND BUSINESS INCUBATORS SELECT PROJECTS

In face of the importance that risk capital and business incubation can have for the increment of entrepreneurship, it becomes important to study the way both select the projects that they support and, in particular, the criteria they use in this selection.

This is the purpose of this work and, to accomplish it, primary information was obtained from the universe of the risk capitals and business incubators in activity in Portugal, in the end of 2003.

1.4 STUDYING INCUBATORS’ AND RISK CAPITAL’S SATISFACTION WITH THE PERFORMANCE OF THEIR CHOICES

In order to evaluate the results of the criteria used by risk capitals and incubators in the selection of projects, their satisfaction with the performance of the startups they supported was measured.

These measures will tell us whether incubators and risk capitals are happy with the choices they made and, therefore, if the criteria they used resulted in good choices of projects to support.

First, the importance both companies place on different criteria to evaluate performance was measured.

Then it was measured how pleased risk capitals and business incubators were with the results on these criteria.

2. ENTREPRENEURSHIP, BUSINESS INCUBATION AND RISK CAPITAL: DEFINITIONS

Before advancing with the empirical study, it is important, as Gartner (1989) points out, to clearly define the meaning of the concepts used in the work, given the difficulty that the literature reveals in arriving to consensus on the definitions of the terms entrepreneurship and entrepreneur.

Therefore, the definitions used in this study will be the following. Entrepreneurship:

“The creation of a new company, to explore a business opportunity by an entrepreneur that, through its social network, gets access to the necessary resources.”

Entrepreneur:

“An individual that, alone or with partners, creates a new company whose management he is going to assume, at least in its start-up phase.”

Risk capital:

“Investors specialized in financing entrepreneurs, acquiring a share in the start-up, with the objective to make capital gains in the long run.”

Business incubators:

“Organization where the start-ups are installed for a limited period of time, with the objective of improving their odds of growth and survival, through the supply of support services at reduced costs.”

3. METODOLOGY

This inquiry was a part of a larger project, which aimed to study the impact of the support of risk capital and business incubation to startups.

In the course of this project the present information was gathered but, in the end, it was not used, nor published.

It is this data that the present communication analyzes and presents.

4. RESULTS AND DISCUSSION

All risk capital companies and all the business incubators in activity in Portugal in 2003 were sent questionnaires. Therefore a census was made.

The total number of inquires and the percentage of answers is shown in table 1. Answers had been received from 15 risk capital companies and 18 business incubators, which corresponds to a little more than 50% of the total universe.

Table 1 - Participation in the empirical study

	Universe	Closed	Being installed	Answers	Did not answer	Participation
risk capital companies	28			15	13	53,6%
business incubators	35	3	2	18	17	51,4%
Total	63	3	2	33	30	52,4%

The inquiries used 5 points scales of importance (Kotler et al, 1996) to evaluate the weight that the risk capitals and the incubators gave to each of the selection criteria.

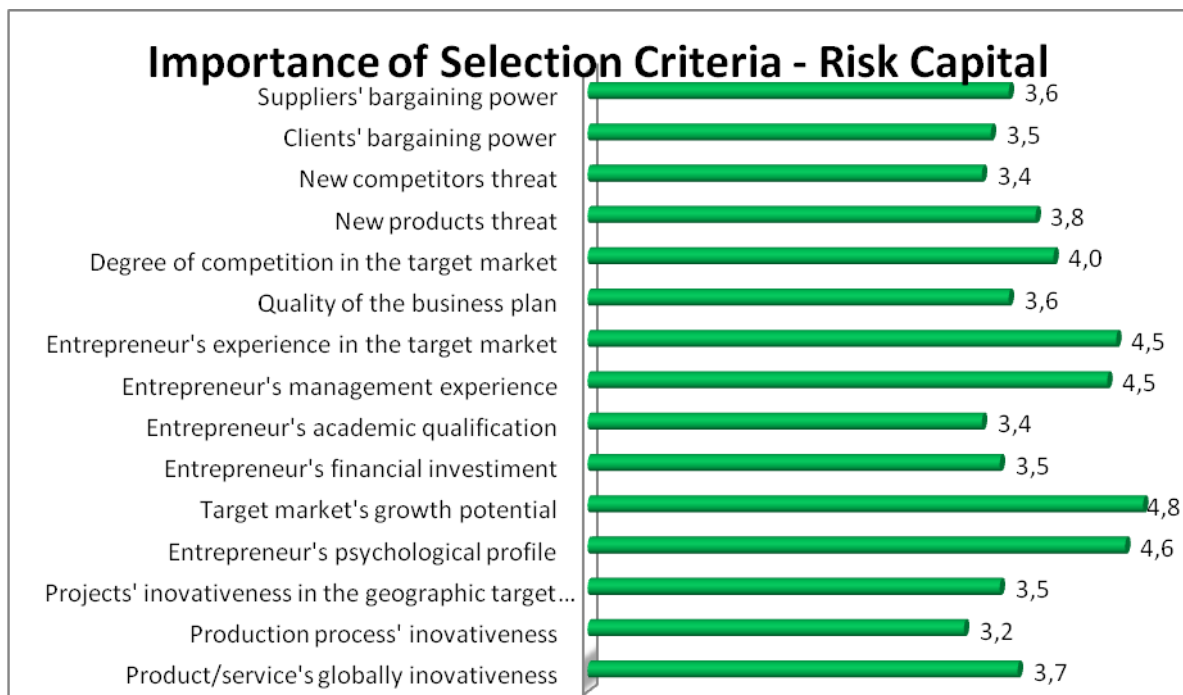
The results of the collected inquiries are presented in table 2. Averages of the importance risk capitals and business incubators place in each criterion are presented.

Table 2 - Selection criteria

Selection criteria			
	Average		
	Risk Capital Companies	Incubators	Total
Product/service's globally inovativeness	3,7	4,1	3,9
Productive process inovativeness	3,2	3,6	3,4
Projects' inovativeness in the geographic target market	3,5	4,0	3,8
Entrepreneur's psychological profile	4,6	3,9	4,3
Target market's growth potential	4,8	3,8	4,2
Entrepreneur's financial investiment	3,5	3,1	3,3
Entrepreneur's academic qualification	3,4	3,9	3,7
Entrepreneur's management experience	4,5	3,4	4,0
Entrepreneur's experience in the target market	4,5	3,5	4,0
Quality of the project's presentation file	3,6	3,8	3,7
Degree of competition in the target market	4,0	3,4	3,7
New products threat	3,8	3,3	3,5
New competitors threat	3,4	3,2	3,3
Clients' bargaining power	3,5	3,3	3,4
Suppliers' bargaining power	3,6	3,1	3,4

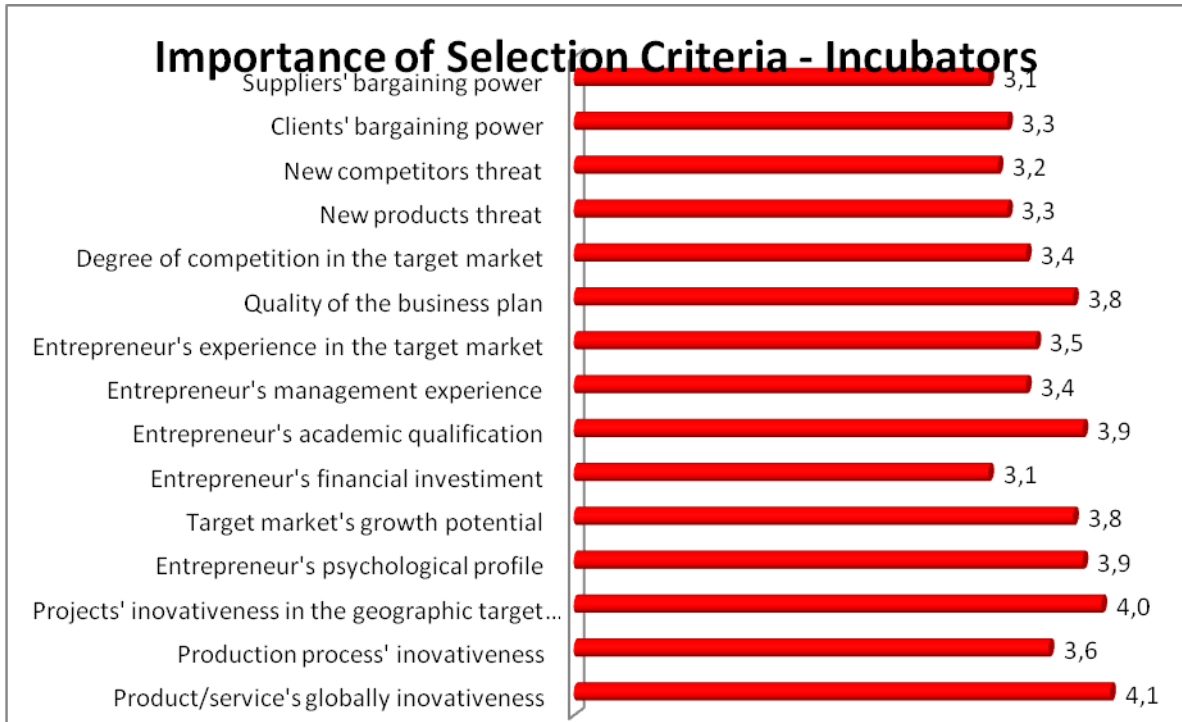
In figure 1, we can compare the importance attributed by risk capitals to each of the selection criteria. One notices that the four criteria most important for risk capitals are: the experience of the entrepreneur in the target market, his management experience, the potential of growth of the target market and the psychological profile of the entrepreneur.

Figure 1 – Selection Criteria of Risk Capitals



The answers of the incubators, presented in figure 2, point as more important factors globally innovative character of project, innovative character of the project in the target market, the psychological profile of the entrepreneur, its formation, the potential of growth of the target market and the quality of the presented dossier.

Figure 2 - Selection Criteria of Incubators



Comparing the two, we can see that the criterion “new competitors threat” worries much more risk capitals than the incubators.

This also happens with “client’s bargaining power”, also more valued by the risk capitals than by the incubators.

Risk capitals also attribute greater importance to the criteria “suppliers’ bargaining power” and “new products threat”.

The “quality of the business plan”, is a criterion more valued by incubators, the opposite of “entrepreneur’s management experience”.

Both “experience of the entrepreneur in the target market” and “degree of competition in the target market”, are more important for risk capitals.

“Entrepreneur’s academic qualification”, is valued by incubators, whereas “entrepreneur’s financial investment”, is the opposite.

“Growth potential of the target market” and “entrepreneur’s psychological profile” are both more important to risk capitals.

“Project’s inovativeness in the geographical target market” and “production process’ inovativeness” are both more valued by incubators.

Finally, the criterion “product/service’s globally inovativeness” is more important to incubators.

The data collected from risk capitals and business incubators was compared, by comparing means and variances with a standard set of Levene’s F tests and student t-tests, to check for statistically significant differences between the two samples.

Table 3 - Differences in criteria to select projects

Selection Criteria		Levene's Test for Equality of Variances		t-test for Equality of Means			
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference
Target Market Potential Growth	Equal variances not assumed	6,731	0,015	3,353	18,867	0,003	1,036
Entrepreneur's management experience	Equal variances assumed	1,739	0,199	2,728	26,000	0,011	0,928
Entrepreneur's experience in the target market	Equal variances assumed	2,761	0,109	2,910	26,000	0,007	0,938

When comparing selection criteria, only three of them showed significant differences. All of them were more important to risk capitals than business incubators. “Growth potential of the target market” (1,036 more important, in a 1 to 5 scale, with $t=3,353$, 18 degrees of freedom and $p=0,003$), “entrepreneur’s management experience” (0,928 more, $t=2,728$, 26 degrees of freedom and $p=0,011$) and “entrepreneur’s experience in the target market” (0,938 more, $t=2,91$, 26 degrees of freedom and $p=0,007$) are those three criteria.

The same comparison was performed with the criteria to evaluate the performance of the startups.

Table 4 - Importance of criteria to evaluate satisfaction with the performance of startups

Importance		Levene's Test for Equality of Variances		t-test for Equality of Means			
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference
Sales objectives are achieved	Equal variances assumed	0,309	0,579	2,496	120,000	0,014	0,260
Market share objectives are achieved	Equal variances not assumed	27,730	0,000	-1,464	45,482	0,150	-0,293
Return on investment	Equal variances assumed	0,053	0,818	4,227	120,000	0,000	0,508
Return on equity	Equal variances not assumed	5,880	0,017	3,880	59,574	0,000	0,486
Profit margin	Equal variances not assumed	19,889	0,000	5,321	53,371	0,000	0,560
Sales growth	Equal variances assumed	0,006	0,937	2,015	120,000	0,046	0,224
Growth in number of employees	Equal variances assumed	2,702	0,103	-8,617	118,000	0,000	-1,411

It turned out that the samples were quite different. Risk capitals and business incubators do judge their startups performance very differently.

Incubators showed more concern with “market share objectives being achieved” and “growth in the number of employees”, while risk capitals paid more attention to profitability (return on investment, return on equity, profit margin) and sales (sales objectives being achieved and sales growth).

Finally, the same procedure was performed with the data about the performance of the startups.

Table 5 - Differences in satisfaction with performance of startups

Satisfaction		Levene's Test for Equality of Variances		t-test for Equality of Means			
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference
Sales objectives are achieved	Equal variances assumed	2,946	0,089	-2,590	118,000	0,011	-0,579
Market share objectives are achieved	Equal variances assumed	3,470	0,065	-2,874	117,000	0,005	-0,638
Return on investment	Equal variances not assumed	6,059	0,015	-2,308	50,923	0,025	-0,600
Return on equity	Equal variances assumed	3,307	0,072	-3,724	117,000	0,000	-0,857
Return on active	Equal variances not assumed	5,462	0,021	-3,476	53,259	0,001	-0,869
Profit margin	Equal variances not assumed	9,179	0,003	-3,145	49,255	0,003	-0,786
Sales growth	Equal variances assumed	2,456	0,120	-2,692	117,000	0,008	-0,600
Growth in market share	Equal variances assumed	1,289	0,259	-4,110	117,000	0,000	-0,895
Growth in number of employees	Equal variances assumed	0,887	0,348	-5,296	117,000	0,000	-1,169

This data also showed large differences between the two samples.

Overall, business incubators were happier about their startups' performance.

On all the criteria that showed statistically significant differences (almost all), business incubators were more satisfied than risk capitals.

5. CONCLUSIONS

From the results presented in the previous section, we can conclude that risk capitals, in the selection of projects, give greater importance to:

1. Growth potential of the target market;
2. Entrepreneur's management experience;
3. Entrepreneur's experience in the target market.

Overall, there weren't that many differences between the criteria used by both industries in the selection of projects.

When evaluating their startups' performance, the two industries revealed much larger differences, giving statistically significantly different importance to most criteria.

Risk capitals put greater importance on profitability and sales indicators, while incubators give greater importance to the growth in the number of employees and to market share.

Finally, business incubators revealed themselves a whole lot happier with their startups' performances. Maybe their selection criterion allows them to have better projects from the start.

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