

PAKISTANI VENTURE CAPITALISTS' INVESTMENT CRITERIA: A COMPARATIVE LOOK

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ABSTRACT

This paper has two objectives. First, it identifies investment criteria used by Pakistani venture capitalists (VCs) in the investment evaluation process. Second, it analyses how Pakistan VCs decision policies differ from their US and Indian counterparts. It is found that among Pakistani VCs, the factors related to the entrepreneur and management team are considered predominant and decisive in making investment decisions. Pakistani VCs rely heavily on a relationship-based approach in decision policies and may gradually move to a market-based approach once the economy's formal institutions attain stability. A relationship-based approach focusing on social networks can help substitute for formal institutions such as law, regulation and enforcement, which would facilitate the process of financial and non-financial transactions in the operation of venture capital markets in emerging economies. The differences I observed among US, Indian and Pakistani VCs decision policies regarding the use of investment evaluation criteria reflect the differences in institutional contexts. Moreover, I draw on agency theory to further view my survey results regarding the venture capital market in Pakistan. The results are in line with agency theory prescriptions that a relationship-based approach may be better suited to mitigate the agency problem, particularly adverse selection and moral hazard problems, by implementing the four prescriptions proposed by Ian and Peter (1994).

Keywords: venture capital, investment criteria, emerging economies, relationship-based approach, agency theory

INTRODUCTION

The venture capital market (VCM) plays an important role in technological and economic growth through its direct involvement in the development of a wide variety of enterprises (Maier & Walker, 1987). Specifically, it has been posited as potentially providing an impetus to economic growth for developing countries (Aylward, 1998). For emerging economies such as Pakistan that are in the process of moving from traditional labour-intensive methods of production towards knowledge-based ones, the use of venture capital becomes more important than ever. Pakistan is at a threshold of achieving the status of a middle-income country, and an important factor stimulating structural change from a

low- to middle-income economy appears to be the growth in the size and scale of SMEs (Faisal, Ali & Ehsan-ul-Haque, 2005). The existence of an active VCM may further expedite this process of structural change, leading to a high-income economy, as studies find that there exists a positive relation between institutional investments, the size of the firm and the presence of venture capital funding (Mishra, 2004). The creation of an effective VCM in emerging economies requires a thorough understanding of how the VCM functions in each emerging economy. This paper, a step in this direction, focuses on the VCM in Pakistan, a major emerging economy in South Asia. The first objective of this paper is to identify investment criteria used by Pakistani VCs in an investment evaluation process. Although some studies classify the VCM as homogeneous (Fried & Hisrich, 1988), most research has found it to be heterogeneous (Bygrave & Timmons, 1992; Elango, Fried, Hisrich & Polenchek, 1995). The heterogeneity of venture capital markets, in part, depends on the stability level of the economic institutions in which they operate. In developed countries, such as the US, institutions are stable and are characterised by the rule of law, transparency, accountability, an efficient judicial system and an effective contractual enforcement mechanism. In contrast, in emerging economies such as Pakistan and India, institutions tend to be weak with overall poor and ineffective corporate governance and control. This poor legal and institutional framework in emerging economies affects the dissemination of information about market conditions and participants, thereby creating an agency problem (For more discussion, see Khanna & Palepu, 2000). Consequently, the different levels of institutional stability across countries lead VCs to construct decision policies in significantly different ways to cope with market failures caused by weak institutions. The differences that exist in the way in which VCs make decision policies across countries have been examined in various studies (Bygrave & Timmons, 1992; Elango et al., 1995; Sapienza & Timmons, 1989). In an attempt to contribute to the knowledge about such differences, the second objective of this paper is to compare the survey results of Pakistani VCs with those of the US and Indian studies in order to examine the differences in investment decision policies. For a comparison of results, the US is selected because it is the most developed VCM, the US venture capital model serves as a benchmark with which other VCMs can be compared (Andrew et al., 2007), and India is selected because it shares a relatively similar cultural and legal system with Pakistan among South Asian countries. Therefore, this comparison may further our understanding of how VCs make investment decision policies in closely related emerging economies.

This paper is structured as follows. First, I give a brief overview of the VCMs in Asia and Pakistan. Second, section describes the methodology used in this study and discusses the investment criteria used by Pakistani VCs. This is followed by the identification of the differences and similarities in investment decisions among US, Pakistani and Indian VCs. The third section takes on an agency

theory perspective to further view the results obtained in previous sections. Finally, the fourth section concludes and presents the implications of this study.

Venture Capital in Asia

The Asian venture capital pool has increased from USD33,433 million in 1995 to USD106,383 millions in 2004, implying an annual growth rate of 13.7%. Similarly, the Asian venture capital investment portfolio increased from USD17,751 million in 1995 to USD75,434 million in 2004, showing an annual growth rate of 17.4%. In 2005 and 2006, the world's leading buyout and venture firms poured into Asia to open offices, hire staff, and launch Asian-related regional funds. This brought a sense of optimism among the Asian venture community, which will certainly translate into better performance figures in the future. Some Asian countries have apparently benefited from the technology and economic fronts from the existence of viable venture capital industries in their respective countries. In the early 1970s, Japan witnessed the emergence of a technological environment and a culture of risk-taking entrepreneurs creating new business ventures. During the same period, the dynamic performance of some business ventures has been boosted by the rapid development of the venture capital industry in Japan (Dennis & Turpin, 1993). In Singapore, the report of the Subcommittee on Entrepreneurial Development clearly assigned a central role to venture capital in the entrepreneurial development process and in Singapore's economic future; here, venture capital is seen as the bridge between the technologies of the United States and Europe and the transfer of technology to Singapore (Dennis, 1991). The experience of Taiwan shows that technological innovation and the growth of venture capital markets are closely interrelated (Premus, 1985). In Korea, the government has been supporting venture capital firms since the 1980s as part of its programme to develop high-technology industries (Joondoug et al., 1994).

Venture Capital in Pakistan

Venture capital companies and venture capital funds are of recent origin in Pakistan, as their history dates back only to the early 1990s. The legal framework for the establishment of venture capital companies was set up for the first time by the Pakistani government in February 1995. This legal framework was revised in July 2000 and was made more lenient and conducive to helping venture capital activities flourish. The Securities and Exchange Commission of Pakistan under venture capital companies and funds rule defines venture capital as a "company that is engaged in financing any venture project through equity or other investments, whether convertible into equity or not, and provides managerial or technical expertise to venture projects or acts as a management company for management of venture capital funds."

The Pakistani venture capital market witnessed slower-than-expected growth during the 1990s. The government analysts attribute this slower expansion of venture capital to the overall slower economic growth during the 1990s and the lack of qualified professional venture capitalists knowledgeable about the operation of venture capital in emerging economies. It is further argued that the key hurdle to expanding Pakistan's venture capital business has been entrepreneurs' attitude, which is also expected to be a challenge in the future. That is, entrepreneurs are less motivated to raise venture capital because of their family-owned and cultural values that discourage an entrepreneur to share the part of ownership and control with outsider (e.g., venture capitalists) in return for money. Second, the business culture of Pakistan is not appreciative of the riskier efforts of an entrepreneur. If an entrepreneurial effort fails, it is very probable that the entrepreneur will lose his name and fame along with his money. Failure is an unshakable stigma. In contrast, in the US, to have failed is not an ineradicable black mark against an entrepreneur (Keith, 1991). Such failure in certain cases is treated as a positive factor towards economic development. As noted by Robert D. Hormats, Vice-Chairman of Goldman Sachs International, "an entrepreneur who has gone bankrupt with one idea can come back and get the venture capitalist to start another idea. In a period of low savings rates, high government spending and other economic problems, this stands out as big advantage" (Keith, 1991, p. 105). Therefore, there appears to be a need for an attitudinal shift towards the acceptance of a risk-oriented equity culture in our society at large. Presently, venture capital companies are mainly focused in the media and telecom sector and also prefer to invest in business process outsourcing (BPO). The Pakistan Economic Survey (2005) notes that "Venture Capital Companies and other Financial Institutions (FIs) fulfil only 18 to 21% of fund requirements of the domestic software houses. There is an emerging need for the venture capital companies to concentrate on this sector, especially in aiding the local companies in product development and marketing the IT-enabled services of local companies abroad to get any sizeable share in the global BPO market." Moreover, In Pakistan, the stringent collateral requirements of banks and other FIs limit new start-ups' as well as existing SMEs' access to financing. FIs require collateral of up to 120%–130% of the loan value (Khan, 1997). This is why SMEs mostly rely on self-financing or retained earnings (Pakistani Economic Survey, 2005). Consequently, a financing gap occurs when capital sources such as self-raised or retained earnings are exhausted. Venture capital companies could be one of the ways to bridge this financing gap in a commercial capacity. The government of Pakistan, as part of its programme to promote the venture capital industry, granted a tax exemption for venture capital investment for a period of seven years from 1 July 2000 to 30 June 2007. The further extension of the period of this tax exemption is presently on the cards with government policy makers. Venture capital activities in Pakistan have been spurred in recent years. The total assets of venture capital companies witnessed the highest one-time

annual growth of 218% from Pakistan Rupees (PRs) 1005 million in FY 2004 to PRs3,200 million in FY 2005 (Figure 1).

Table 1
Profile of respondent venture capital companies (VCCs)

Profile	Mean	Max.	Min.
The size of venture capital firms' assets (USD millions)	32	60	4
The average size of investment (USD millions)	5.2	10	0.20
The annual number of applications for venture capital received by VCCs	250	1000	50
The annual percent of applications (out of total) funded by VCCs	1.6%	2.0%	0.9%
Percent of investment in small businesses	90%	100%	80%
The annual expected return in percent that VCCs require for their investment	28%	30%	25%
The percentage of working hours in a year that VCs devote to monitoring portfolio companies	68%	75%	60%

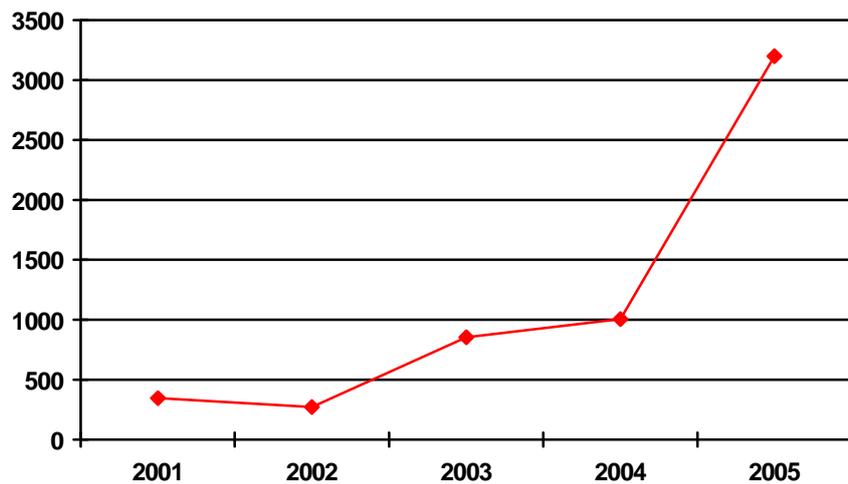


Figure 1. The pool of venture capital companies' assets in Pakistan. (Pakistan Rupees in millions)

Source: Pakistan Economic Survey (various issues).

INVESTMENT CRITERIA OF PAKISTAN VENTURE CAPITALISTS

Literature Review

There is a large body of empirical research conducted in both developed and developing countries that has focused on identifying and weighing the relative investment evaluation criteria that venture capitalists use to evaluate potential investments. Related studies in this context are conducted in the US (MacMillan, Robin & Narasimha, 1985; John & Charles, 1993; Tyebjee & Burno, 1984), Canada (Russell, 1988), Europe (Russell, 1994), the United Kingdom (Dixon, 1991; Grahame & Margaret, 1997), and Asia (Dennis & Turpin [Japan], 1993; Dennis [Singapore], 1991; Pandey & Angela [Taiwan], (1996); Joondoug, Jung & Lee [Korea], 1994; Pandey [India], 1995; Mishra [India], 2004).

The understanding of evaluation criteria and the weights attached to them by VCs are of great importance for many reasons. First, VCs are widely considered to be particularly successful in selecting and funding innovative and new growth ventures (Burno & Tyebjee, 1983; Bygrave & Timmons, 1992; Vesa & Christian, 2005). Consequently, the success rate of venture capital-backed ventures is significantly higher than the success rate of non-venture capital-backed ventures (Davis & Stetson, 1984; Dorsey, 1979; Kunkel & Hofer, 1991; Sandberg, 1986; Timmons, 1994). The survival rate for venture capital-backed ventures ranges from around 65% (Sahlman, 1990) to 85% of the VCs portfolio (Dorsey, 1979). Second, the lack of collateral and significant information asymmetries limit the ability of entrepreneurs to get financing from traditional lending institutions such as Banks. Venture capital companies, being a specialized financial intermediary, generally have the necessary expertise and skills to reduce this asymmetric information risk at the pre-investment stage by applying selective evaluation criteria.

Methodology

In order to prepare the relevant list of evaluation criteria that are expected to be used by VCs in Pakistan, I have first taken 27 well-known criteria found in the US by MacMillan et al. (1985). In a venture investment evaluation, VCs in emerging economies face some typical problems that VCs in developed countries may not encounter. For this reason, after reviewing the existing studies on evaluation criteria in the US and Asian growing-developing economies and in consultation with a venture capitalist working in Pakistan, the author has identified and assembled a list of 44-criteria. The criteria are classified into seven major categories:

- (i) The entrepreneur's personality
- (ii) The entrepreneur's experience
- (iii) Product/service characteristics
- (iv) Market characteristics
- (v) Financial characteristics
- (vi) Environment conditions
- (vii) Venture team composition

In addition, at the end of each category, the 'others' column was added for write-in respondents.

The survey questionnaire was used to collect information. The respondents were asked to weigh the importance that they attach to each criterion using the following four-point scale.

1. Irrelevant—Not a factor in the decision-making process.
2. Desirable—A factor that improves the likelihood of investment.
3. Important—A factor that must be present in order for an investment to take place, unless other factors specifically compensate for this factor's absence.
4. Essential—A factor that must be present under any circumstance in order for an investment to take place.

This four-point scale is similar to that used in US and Indian research studies by MacMillan et al. (1985) and Pandey (1995), respectively, to which the results of this study were compared. A total of six questionnaires were mailed directly to the CEO of each venture capital company 1 and fund in Pakistan listed in the Venture Capital Directory published in the Asian Venture Capital Journal (2005), and five responses were received, for a response rate of 83%, indicating a high level of interest. For some academic researchers, the sample seems too small to justify empirical analysis. Here are some reasons to mitigate the objections of our having a small sample. First, to my knowledge, this is the first study of its nature in Pakistan and is aimed to enhance the understanding of Pakistan's emerging VCM. Second, the sample is small in number but fully represents Pakistan's VCM. Third, other related research studies in contexts where the results are based on five observations are done by Dennis (1991) in Singapore and Scheela and Dinh (2004) in Vietnam. This study has all of the weaknesses of self-report study, so the results must be considered with some caution.

ANALYSIS OF RESULTS

Entrepreneur Personality and Experience

Apparently, the quality of the entrepreneur and its management team serve the most important and decisive factors in making investment decision in Pakistan. Six of the top ten most important criteria are related to the entrepreneur's personality and experience [Table 2(a)]. Specifically, integrity, commitment and enthusiasm and the capability of sustained intense effort are perceived by Pakistani VCs as highly valuable characteristics of an entrepreneur. Consequently, Pakistani VCs in their 78% deals get into contact with entrepreneur's former business associates to check his integrity and commitment (Appendix B). The managerial capability of an entrepreneur is ranked as the second most important factor when it comes to determining the quality of an entrepreneur. It implies that entrepreneurs should have necessary expertise and skills such as managing people, directing business operations and using resources judiciously to run a business. Of least concern for Pakistani VCs is a compatible personality, the ability to be articulate in discussing venture and educational background.

Product/Service and Market Characteristics

The most important product characteristic seems to be competitive advantage, which all the respondents unanimously consider to be a 'must-have' element. This implies that for the safety of the investment and for insulation against competitive attack, Pakistani VCs prefer to have a sustainable competitive advantage in the form of a functioning prototype or proprietary protection. A firm is said to have a sustained competitive advantage when it is implementing a value-creating strategy that is not simultaneously being implemented by any current or potential competitors and when these other firms are unable to duplicate the benefits of this strategy (Barney, 1991). The source of competitive advantage can be financial, physical, human, organizational, informational or relational. Furthermore, the ease of technical manpower procurement and raw material availability factors do not seem to be the part of investment evaluation process by US VCs but are considered important by Pakistani VCs, as the mean values of both factors are 3 and 3.2, respectively, on a four-point scale. It seems that such factors are especially challenging and problematic in developing countries and thus need to be considered. This finding is in line with other research studies carried out in developing nations (Joondoug et al., 1994; Pandey & Angela, 1996). Surprisingly, the need for a product to be high-tech is regarded as irrelevant by Pakistani VCs, given that venture capital is usually discussed as a high-technology-oriented industry (Florida & Kenny, 1988). Location within a large

market with high growth potential is the most critical market requirement for Pakistani VCs in investment evaluation process.

Financial Characteristics and Environment Conditions

In terms of financial characteristics, the prime concern for Pakistani VCs is the safety and liquidity of their investment. The mean of average annual expected returns required by Pakistani VCs is 28%, ranging from 25% to 30%. This is to compare with the 25% to 40% expected returns demanded in India (Mishra, 2004). However, these rates of return could mirror the US VCs' early success in posting extraordinary returns in the 1980s, returns of 40% to 80% and some as high as 318% (Huntsman & Hoban, 1980). Furthermore, a complete and sound business plan is considered as a critical requirement in the investment decision. Entrepreneurs need to develop a plan for describing the elements of a proposed investment project that would enable VCs to clearly see the plan of action and the necessary expertise and funding needed to implement it. Such a plan could be used to align the goals of VCs and entrepreneurs and thus could mitigate agency problem concerns. Moreover, VCs place emphasis on a business plan with the belief that the quality of a well conceived and organized business plan indicates the quality of the entrepreneur and its management team; as a result, VCs are apt to favour such potential investments over those with little planning (Edgar, 1995). Even in the case of Pakistan, having an incomplete plan is among the key reasons for the rejection of applications for venture funding. Among the least concerned criteria are the expectation to make subsequent investment and necessary participation in the initial round of investment. In environment-related factors, Pakistani VCs consider government regulations more important than government tax benefits, implying that government regulations are relatively more burdensome and unstable in Pakistan.

Management Team Composition

The studies relating to evaluation criteria mostly conclude that the management team is the dominant criterion in the investment evaluation process of VCs (Zopounidis, 1994). VCs invest in management rather than in products. As noted by Arthur Rock (1987), principal of Arthur Rock & Co., a San Francisco-based venture capital company that has funded such companies as Fairchild Semiconductor, Scientific Data Systems, Teledyne, Intel, and Apple Computer, "The problem with those companies (and with the ventures I choose not to take part in) is rarely one of strategy. Good ideas and good products are a dime a dozen. Good execution and good management—in a word, good people—are rare."²

Keith (1991) shows a similar concern that more than ever, the name of the game is management. If you find a company with the right horses, you back it to the hilt. Otherwise, you think twice. The finding of this study supports this view, as 80% of Pakistani VCs will not fund a venture that lacks a competent, balanced management team [Table 2(c)]. However, 20% of Pakistani VCs may still discount the requirement of balanced management team if the venture has more attractions in other factors.

Table 2(a)
Top 10 most important evaluation criteria for Pakistan VCs

No.	Evaluation criteria	Mean[SD]
1	Integrity	4.0[0]
2	Competitive advantage	4.0[0]
3	Venture can be easily made liquid (by going public or acquisition, etc.)	3.8[.45]
4	Equity stake in the venture	3.8[.45]
5	Capable of sustained intense effort	3.6[.55]
6	Managerial capabilities	3.6[.55]
7	Sound business plan	3.6[.55]
8	Commitment and enthusiasm	3.4[.55]
9	Thorough familiarity with target market	3.4[.55]
10	Demonstrated market acceptance of product	3.4[.89]

Table 2(b)
Least important evaluation criteria for Pakistan VCs

No.	Evaluation criteria	Mean[SD]
1	High-tech product	1.2[.45]
2	We will not be expected to make subsequent investment	1.4[.55]
3	We will not participate in later rounds of investment (requires our participation in initial round)	1.8[.84]
4	Government tax benefits	1.8[.84]
5	Educational background and careers	2.2[.45]

Table 2(c)
Criteria relating to management team composition

Criteria	% response
A One person relevant experience essential	0
B Team with similar experience essential	0
C Balanced team essential	80
D None is essential	20

Similarities and Differences between Pakistan and US VCs

There seem to be many similarities in the overall ratings of the evaluation criteria of Pakistan and US VCs. For the criterion capable of sustained intense effort, the

respondents from both countries have assigned a perfectly similar mean weight age of 3.6 on a four-point scale. The second significant similarity appears in criterion venture, which stimulates an existing market. This similarity shows the common concern of VCs for whether an entrepreneur's business can stimulate the existing market by better meeting consumer needs. Second, Andrew et al. (2007) argue that VCs, in their efforts to reduce the risk of making faulty investment decisions in emerging economies, prefer to follow a proven recipe by depending on the same evaluation criteria used by US venture capitalists in the evaluation of new investment proposals. However, differences mainly arise with regard to the familiarity with and the referral of the entrepreneur. For the criteria of familiarity with the entrepreneur's reputation and referral by trustworthy source, Pakistani VCs have given 1.37 and .77 more value in mean weight age, respectively, than did US VCs, indicating a significant difference. The requirement of a high-tech product is nearly an irrelevant factor for Pakistani VCs, but it is of some importance to US sources, as indicated in their mean scores. This result may show the lack of high-technology business opportunities in Pakistan. Finally, the ability to deliver an oral presentation for the venture-funding proposal is more important to US VCs (Russell, 1994) than to their counterparts in Pakistan as well as to those in India. These differences, especially in the criteria relating to the familiarity and referral issues of the entrepreneur, suggest that Pakistani VCs seem to follow the relationship-based approach rather than the market-based approach in making investment decisions. In investment decisions, the relationship-based strategy focuses on VCs personal and social ties and the venture capital firms' inter-organizational relationships since it has the potential to reduce opportunistic behaviour and agency problems in the relationship between a venture capital firm and an entrepreneur. On the other hand, the market-based strategy concentrates on competitive resources, which are independent of the firm's networks, relationships and connections (Barney, 1991). Past research suggests that emerging economies have generally underdeveloped formal institutions, such as the rule of law, accounting standards, judiciary, administrative and regulatory institutions, which are in transition to becoming more stable and developed institutions (Peng, 2003). During this transition period, there lies greater institutional uncertainty. Therefore, in such an environment, specifically for venture capitalists, to make a funding decision, the relationship-based strategy may first become most relevant. Over time, once the key formal institutions have reached a state of stability, where they can reduce the uncertainties of VCs, especially in terms of laws, regulations and enforcements, then a market-based strategy is likely to be more relevant in VC investment decisions. The adaptation of a relationship-based strategy in decision making is one of the ways to fill the institutional voids caused by weak institutional support in the emerging economies. For example, this strategy helps to settle disputes or enforce contracts in the absence of efficient formal institutions charged to promptly and cost-effectively resolve such cases. More

recently, Ahlstrom and Bruton (2006) suggest that VCs in emerging markets will migrate from a relationship-based transaction structure to a market-based structure over time. However, one can still not rule out the importance of a relationship-based strategy in VCs' funding decisions, as the focus on relations is also present to some degree in more developed economies such as the US (Shane & Cable, 2002).

Table 3(a)
Most similar criteria in mean weight age given by VCs in Pakistan and US

Evaluation criteria	Difference in means
Capable of sustained intense effort	0.00
Venture stimulates an existing market	-0.03
We will not be expected to make a subsequent investment	+0.06
Personality is compatible with mine	+0.11
Ability to evaluate and react to risk well	-0.14

Table 3(b)
Most dissimilar criteria in mean weight age given by VCs in Pakistan and US

Evaluation criteria	Difference in means
Familiarity with entrepreneur's reputation	+1.37
Demonstrated market acceptance of product	+0.95
High-tech product	-0.83
Venture creates a new market	+0.78
Referred by trustworthy source	+0.77

Notes: In Tables 3A and 3B the difference in + (-) shows Pakistani VCs are more (less) demanding than US VCs.

Similarities and Differences between Pakistan and Indian VCs

Overall, Pakistani VCs have given more weight to nearly all criteria than did Indian VCs. The most important similarity in the approaches of the VCs of both countries is that the entrepreneur should possess the ability to evaluate risk well. Generally, businesses in emerging economies are more exposed to the risk of failure, owing mainly to market- and business-related risks. The venture capital-funded firms are particularly known to be riskier ventures. Therefore, it seems that VCs operating in emerging economies perceive that entrepreneurs who are the most adept at managing risk will succeed and that others will fail. Surprisingly, the major differences between Pakistani and Indian VCs appear with regard to the entrepreneur's characteristics in terms of familiarity and referral. Pakistani respondents place more emphasis on these two factors than do their Indian counterparts, suggesting that Pakistan is more relationship-based than India. This may be explained by the fact that since 2000, India's economic growth and the openness of its institutions to the international markets have been more rapid than those of Pakistan, which drives India relatively closer to the inflection

point of a market-based economy than Pakistan's position. As institutions become more stable in the emerging economies, they disseminate information about market participants (i.e., entrepreneurs) in a relatively efficient manner. Consequently, VCs give relatively less weight to the characteristics of the entrepreneur related to familiarity and referral. There is also a significant difference in the demonstrated market acceptance of a product criterion, where Pakistani sources are more demanding than Indian and US sources. This difference may be because Pakistan's domestic market is much smaller in size than the Indian and US markets. In this regard, the market's acceptance of a product seems to be a critical element in the success of ventures in a smaller-sized domestic market before the venture finds its way in international markets.

Table 4(a)
Most similar criteria in mean weight age given by VCs in Pakistan and India

Evaluation criteria	Difference in means
Ability to evaluate and react to risk well	-0.02
Thorough familiarity with target market	+0.18
Personality compatible with mine	+0.20
Integrity	+0.22

Table 4(b)
Most dissimilar criteria in mean weight age given by VCs in Pakistan and India

Evaluation criteria	Difference in means
Familiarity with entrepreneur's reputation	+1.42
Demonstrated market acceptance of product	+1.18
Referred by a trustworthy source	+1.13
Expected return equal to at least 10 times our investment within 5-10 years	+1.13

Notes: In Tables 4A and 4B the difference in + (-) shows Pakistani VCs are more (less) demanding than Indian VCs.

AGENCY THEORY PERSPECTIVE

Venture capital is basically the product of the US; the concept was then imported to Europe and Asia. Researchers suggest that unlike production technologies, the techniques of organisation (generally referred as transaction technologies) are often strongly complementary to a country's culture and stock of institutions (Thrainn, 1994) and are therefore difficult to import. Moreover, Asian cultures are considered to be collectivist, while Western cultures are more individualistic (Liu, 2007). In collectivist societies such as that of Asia, differences are solved and consensus is reached through relationships due to weak institutional support.

On the other hand, Western culture stresses the rights of the individual and the rule of law to work out any differences through strong institutional support. Therefore, given these broader institutional differences, it is assumed that the operational mode of a venture capital market would be different in Asian economies than in Western economies, especially the US. Past studies have mostly used institutional theory to explain the difference in the operations of the VCM in different parts of the world (Bruton & Ahlstrom, 2003) and have acknowledged the influence of institutional and cultural diversity on the performance of venture capital around the globe. In this section, in order to understand this further, I take on the agency perspective to probe my survey results regarding the VCM in Pakistan. The agency theory has a wider applications and has been used by research scholars in Economics (Spence & Zeckhauser, 1971), Accounting (Demski & Feltham, 1978), Finance (Fama, 1980), Political Science (Mitnick, 1986), Marketing (Basu, Srinivasan & Staelin, 1985), Organizational Behaviour (Kosnik, 1987), Sociology (Eccles, 1985) and most importantly explaining the venture capitalist-entrepreneur (VC-E) relationships in the entrepreneurial literature (Sahlman, 1990; Sapienza & Gupta, 1994). According to agency theory, an agency problem can arise between the entrepreneur (agent) and the VC (principal) because of incongruent goals and potentially different risk preferences (Bruton, Freid & Hisrich, 1997). In essence, this theory assumes a principal-agent problem based on self-interested managerial rationality. This self-interested behaviour breeds asymmetric information, which in turn creates agency problems. Moral hazard and adverse selection comprise two forms in which agency problems takes shape (Masako & Neal, 1986). Moreover, moral hazard and adverse selection problems have a central role in institutional theory (Thrainn, 1994) and thus may have an explanatory power for the VCM. The problem of adverse selection arises from information asymmetry where the agent has more information than the principal. When adverse selection exists, agency theorists predict that the entrepreneur (agent) will act in his/her own self-interest at the expense of VCs (principal) (Paul & Adrian, 1993). Moral hazard is post-contractual opportunism that arises when an entrepreneur's action is unobservable and has a different value for the entrepreneur compared to that for the VC (Masako & Neal, 1986). VCs use selective screening and evaluation criteria to evaluate potential investment proposals to mitigate adverse selection. The researchers have found some potential mechanisms that VCs can use to deal with agency problems such as stage financing (Wang & Zhou, 2002), specialization and deal syndication with other reputable VCs (Edgar, 1995). However, Ian and Peter (1994) have comprehensively recommended four sources that can reduce the agency problem in relationship-based investing. Below, I discuss the results of my survey in light of these four sources.

1. Collecting Better Information about Managerial Ability and Value-Enhancing Changes

The heavy reliance on the relationship-approach strategy in investment decisions gives an advantage to Pakistani VCs in extracting information about entrepreneurs' managerial and other business skills, as the relation-focused strategy helps VCs to know not only the entrepreneur himself but also his/her family members, friends and former associates. Consequently, the relationship based on social trust develops between the VC and the entrepreneur. Although obtaining information from these sources and entering into a relationship with them is quite costly, it could be justified as long as the resultant reduction in potential agency problem is substantial (Ian & Peter, 1994). Moreover, other evidence also exists that working out such a relationship involves explicit research costs in an effort to lower future agency costs and current information asymmetry (Edgar, 1995).

2. Monitoring Managerial Efforts and Implementing Incentive Schemes and Implicit Contracts

VCs decide to make an investment once their goals are aligned with the investee, thereby significantly mitigating the agency problem in an ex ante evaluation process. However, it is highly likely that in an ex-post period, cracks may appear in goal alignment, which may cause moral hazard problem. For example, an entrepreneur may indulge in the activities that could bring him/her personal benefits, which may be value-destroying rather than value-enhancing to a venture, for example, using venture capital funds to purchase excessive perquisites (Jonathan & Lowell, 2003). Also, if there are private benefits from continuing a project, an entrepreneur may keep the project going even if it has negative expected profits (Wang & Zhou, 2002). Therefore, the agency theory prescribes that VCs offer incentives and utilize monitoring to align the goals of the VC and those of the entrepreneur in order to protect against or mitigate a potential agency problem (Bohren, 1998). One such incentive could be a compensation package structured to increase in value if an entrepreneur meets certain milestones and partial ownership schemes (Balkin, Markman & Gomez-Mejia, 2000; Bohren, 1998). According to a Pakistani VCs manager, his firm offers equity ownership for the core management team in portfolio firms as an incentive package. This incentive could increase the likelihood of goal alignment between the venture capitalist and the entrepreneur's management team, even in an ex post situation. Venture capital is worth more than money because it provides monitoring and counselling services to its investee. This monitoring and consulting function of VCs helps an investee firm to increase return potential, lower risk and reduce concerns over agency costs (Edgar, 1995).

3. Introducing Improvements through Informal Negotiations or Takeovers

Under the relationship-based strategy, VCs arguably have an edge over entrepreneurs in informal negotiations. This may be because VCs are well acquainted with entrepreneurs' backgrounds and the networks they belong to due to an efficient gathering of information. Ahlstrom and Bruton (2006) argue that "a founder-entrepreneur may not take advice from the VC but he or she may be willing to do so from peers or individuals seen as his or her senior. Therefore, VCs may be able to use their relationships with the network to subtly push the investee firm in the desired direction". Introducing improvements and putting the investee firm on the right path by exerting pressure on the relationship is a very familiar concept in Asia. For example, in China, this is referred to as Guanxi. This is defined as a special relationship due to the existence of particularistic ties (Tsui, Farh & Xin, 2000). Chinese VCs rely heavily on Guanxi in investment criteria to reduce uncertainties in investment decisions (Batjargal & Liu, 2004; Bruton & Ahlstrom, 2003). This also helps VCs to provide significant value to the investee firm (Bruton, & Ahlstrom, 2003) which otherwise could have been difficult. Similarly, in Russia, this relationship-based concept is referred to as Svyazi 4 (meaning relationships). There is evidence that relationships in the context of Svyazi reduce uncertainties in financial transactions (Guseva & Rona, 2001). This concept of relying on Guanxi or Svyazi relationships also pervades the business cultures of Japan, Korea and India (José & Gómez, 1998).

4. Insulating Good Mangers from Inefficient Takeover Pressures

This is most important when a takeover would disrupt long-term incentives or when the stock market is highly volatile and is likely to misprice value (Ian & Peter, 1994). The stock market in Pakistan lags behind the level of development that many other regional national markets (such as those of India, China and Singapore) have attained and therefore increases the chances of the investee firm's being mispriced in the domestic stock market. Moreover, Pakistan's stock market has played a very limited role in providing an exit mechanism via Initial Public Offerings (IPO) or Over-the-Counter (OTC) to the venture capital investment. Furthermore, the entrepreneur of a venture capital-backed firm may cave in to inefficient trade sales pressure if he or she is not able to obtain additional funding from VCs or from other conventional sources. However, in the case of Pakistani VCs seem to insulate the entrepreneur against inefficient takeover pressure, since VCs consider aiding in additional financing and in public offerings as the 4th and 6th most important activities, respectively, among the value-added services being provided to an investee firm (Khoso, 2007).

CONCLUSION AND IMPLICATIONS

The presence of an active venture capital industry in emerging economies is necessary for promoting economic, technological and entrepreneurial growth. This paper examines how VCs make investment decisions in Pakistan and then compares investment evaluation criteria used by Pakistani VCs to that of their counterparts in the US and India. It is found that the criteria related to the entrepreneur and management team (EMT) are considered predominant and decisive in making investment decisions, suggesting that Pakistani VCs prefer quality 1 (EMT) with a quality-2 business idea to having quality 2 (EMT) with a quality-1 business idea [Tables 2(a), 2(c)]. Among the factors suggested by Fried and Hisrich (1994), the entrepreneur's integrity and venture's competitive advantage are unanimously perceived by Pakistani VCs as 'must-have' factors in the investment decision. Pakistani VCs focus on (EMT), especially on the familiarity and referral side of the entrepreneur, has a greater potential to align the interests of VCs with entrepreneurs, suggesting Pakistan VCs concern for reducing agency problems in the pre-funding period. However, this difference arises mainly in activities that compensate for the lack of key formal institutions, such as having an established accounting system and providing government relations. Moreover, in this paper, I draw on agency theory to further view my survey results regarding Pakistan's VCM. The findings are in line with agency theory's proposal that the relationship-based approach may be better suited to mitigate the agency problem, particularly adverse selection and moral hazard problems, by implementing the four prescriptions outlined by Ian and Peter (1994). Formal institutions such as rule of law, judiciary, administrative and regulatory institutions are in a transition period in emerging economies; as a result, these institutions are relatively less stable in a period of transition. In such an environment, VCs adopt some different approaches in evaluating an investment proposal. For example, VCs working in emerging economies (as in the case of Pakistan) rely heavily on a relationship-based approach in the investment evaluation process and may gradually move to a market-based approach once the economy attains stability in its formal institutions. A relationship-based approach focusing on social networks can help substitute for the formal institutions such as law, regulation and enforcement (Ahlstrom & Bruton, 2006) in facilitating the process of financial and non-financial transactions in the operation of a VCM. Lending based on a relationship-based approach appears to be an efficient information collection mechanism (Berger & Udell, 1998) and therefore could have a potential to greatly reduce information asymmetry in an ex-ante and ex-post investment relationship between VCs and an entrepreneur.

However, the effects of the relationship-based approach in lending differ across emerging nations, presumably due to differences in their macroeconomic

environments in terms of the information infrastructure, business conditions, the fragility of the financial system and the regulatory regime (Berger & Udell, 1998). My findings support this notion, as Pakistan and Indian venture capitalists that are working in emerging economies differ in their reliance on the relationship-based approach in making investment decisions. The results in [Table 4(b)] show that Pakistani VCs place more weight on the relational and referral characteristics of an entrepreneur than their Indian counterparts, suggesting that Pakistan is more relationship-based than India. Emerging economies are characterized by rapid economic growth. The pace at which emerging economies grow determines in part their closeness toward a market-based economy. Since the start of the new millennium India's economic growth and the openness of its institutions to the international market have been faster than that of Pakistan, making Indian economic institutions relatively more efficient and more market-based. Consequently, Indian institutions are in a relatively better position to channel information about market participants (i.e., entrepreneurs) in a relatively efficient way, which makes Indian VCs lessen their reliance on the relational and referral factors of an entrepreneur.

The findings of this study have several implications. First, it provides a list of the investment evaluation criteria used by Pakistan's VCs community, which may help entrepreneurs seeking venture capital financing in Pakistan to better prepare their business proposals. Second, the understanding that Pakistan VCs rely heavily on a relationship-based approach in their investment decision policies and that VCs reliance on relationship-based strategy changes with respect to institutional context might help policy makers to improve the overall performance of Pakistan's VCM.

Finally, this is the first study of its nature in Pakistan and, based on a small sample size, it provides a preliminary examination of the differences in VCs' decision policies regarding investment evaluation criteria. Further research is clearly needed to undertake an in-depth comparative analysis of other important aspects of VC decision making such as deal origination, due diligence and deal structuring (across emerging economies with a larger sample) to further understand how the relationship-based strategy works in the venture capital markets of emerging economies with different institutional contexts.

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NOTES

1. According to the Securities and Exchange Commission of Pakistan (SECP), three firms are currently licensed venture capital companies in Pakistan.
2. This quote is taken from the book of Keith Schilit W. (1991). *Dream Makers and Deal Breakers*. Prentice-Hall, pp. 100–101.
3. These references are taken from the article: Kathleen M. Eisenhardt, 1989. Agency theory: An assessment and review. *The Academy of Management Review*, 14(1), 57.
4. Svyazi is sometimes referred as Blat in Russian literature.

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APPENDIX A

Evaluation Criteria Used by Venture Capitalists: A Comparative Picture

		Pakistan	US*	INDIA**
Evaluation Criteria		Mean[SD]	Mean[SD]	Mean
I. Entrepreneur's Personality				
1	Integrity	4.0[0]	n/a	3.78
2	Capable of sustained intense effort	3.6[.55]	3.60[.57]	3.11
3	Ability to evaluate and react to risk well	3.2[.45]	3.34[.73]	3.22
4	Personality compatible with mine	2.2[.84]	2.09[.81]	2.00
5	Articulate in discussing venture	2.6[.55]	3.11[.71]	2.22
6	Attends to detail	3.0[.71]	2.82[.69]	2.78
7	Technical skills vis-à-vis venture	2.6[.55]	n/a	n/a
8	Managerial capabilities	3.6[.55]	n/a	n/a
9	Insight and forecast ability	3.2[.45]	n/a	n/a
10	Commitment and enthusiasm	3.4[.55]	n/a	n/a
11	Equity stake in the venture	3.6[.89]	n/a	n/a
II. Entrepreneur's Experience				
12	Demonstrated leadership ability in past	3.2[1.1]	3.41[.67]	2.78
13	Track record relevant to venture	3.0[.71]	3.24[.69]	2.67
14	Thorough familiarity with target market	3.4[.55]	3.58[.57]	3.22
15	Familiarity with entrepreneur's reputation	3.2[.45]	1.83[.71]	1.78
16	Referred by trustworthy source	2.8[.45]	2.03[.62]	1.67
17	Educational background and careers	2.2[.45]	n/a	n/a
III. Product/ Service Characteristics				
18	Uniqueness of product	2.2[.45]	n/a	3.11
19	Demonstrated market acceptance of product	3.4[.89]	2.45[.74]	2.22
20	Proprietary or otherwise protected product	2.8[.84]	3.11[.71]	2.22
21	Product developed to the point of a functioning prototype	2.8[.50]	2.38[.90]	3.11
22	High-tech product	1.2[.45]	2.03[.96]	1.67
23	Ease of technical manpower procurement	3.0[0]	n/a	n/a
24	Raw material availability	3.2[.45]	n/a	n/a
25	Competitive advantage	4.0[0]	n/a	n/a
IV. Market Characteristics				
26	Large market size	3.0[.71]	n/a	2.00
27	High market growth potential	3.2[.45]	3.34[.64]	3.33
28	Little threat of competition during the first three years	2.6[.55]	2.33[.72]	2.22
29	Venture is in a market familiar to that of our venture capitalist firm	2.8[.84]	2.36[.78]	1.78
30	Venture creates a new market	2.6[1.1]	1.82[.83]	2.00
31	Venture stimulates an existing market	2.4[.89]	2.43[.76]	1.78
32	Access to distribution channel	2.8[.45]	n/a	n/a
V. Financial Characteristics				
33	Expected return equal to at least 10 times our investment within 5–10 years	2.8[.84]	3.42[.79]	1.67

(continued on next page)

Appendix A (continued)

		Pakistan	US*	INDIA**
34	Expected return equal to at least 10 times our investment within at least 5 years	2.2[.45]	2.34[.81]	1.78
35	Venture can be easily made liquid (by going public or acquisition, etc.)	3.8[.45]	3.17[.89]	3.33
36	Capacity to obtain complementary financing	2.8[.84]	n/a	n/a
37	We will not be expected to make subsequent investment	1.4[.55]	1.34[.52]	1.00
38	We will not participate in later rounds of investment (requires our participation in initial round)	1.8[.84]	1.20[.45]	1.00
39	Sound business plan	3.6[.55]	n/a	n/a
VI. Environment Conditions				
40	Government tax benefits	1.8[.84]	n/a	n/a
41	Government regulations	2.8[.45]	n/a	n/a

Note: Four-point scale used: 1 = irrelevant, 2 = desirable, 3 = important, 4 = essential

*Study of MacMillan et al. (1985)

**Study of Pandey I.M. (1995)

APPENDIX B

Evaluation Activities Carried Out by Venture Capitalists: A Comparative Picture

Activity	How often (%)		
	US	India	Pakistan
Interview all members of management team	100	96	92
Tour facilities	100	82	72
Contact entrepreneur's former business associates	96	97	78
Contact existing outside investors	96	75	56
Contact current customers	93	68	78
Contact potential customers	90	56	68
Investigate market value of comparable companies	86	89	67
Have informal discussions with experts about the product	84	82	96
Conduct in-depth review of pro forma financials prepared by company	84	93	80
Contact competitors	71	66	60
Contact banker	62	94	52
Solicit the opinion of managers of some of your other portfolio companies	56	92	54
Contact suppliers	53	86	64
Solicit the opinion of other venture capital firms	52	55	38
Contact accountant	47	59	64
Contact attorney	44	39	66
Conduct in-depth library research	40	52	50
Secure formal technical study of product	36	79	54
Secure formal market research study	31	91	76