

Determinants of venture capital firms' preferences regarding the industry diversity and geographic scope of their investments.

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# Determinants of venture capital firms' preferences regarding the industry diversity and geographic scope of their investments

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### Abstract

Competition is intensifying in the venture capital industry in the U.S. The number of venture capital firms (VCFs) tripled from 1980 to 1989. Supplier power (in the form of institutional investors such as pension funds) continues to grow. Foreign venture capital has grown to the extent that commitments to foreign VCFs exceeded domestic commitments in both 1988 and 1989. Further, alternative sources of financing for entrepreneurs such as individual investors (‘‘angels’’), corporations, and strategic alliances are increasingly viable options.

VCFs face pressure to seek lower risk investments, improve rates of return, and provide value to new venture development. Surprisingly, few scholarly studies have begun to investigate the strategies VCFs are aiming to implement in order to deal with this

increasing pressure. Building on the premise that decisions regarding product-market scope are a key component of firm strategy (Hofer and Schendel 1978), this study examined 169 domestic VCFs in order to identify factors that might explain variations in preferences regarding the industry diversity and geographic scope of their investments. The sample, drawn from California, Massachusetts, and Texas, represented about 27% of all U.S.-based VCFs in 1987, the year in which the data were gathered. In terms of the total size of investment portfolio, the average for these 169 VCFs was \$69.8 million, which is statistically indistinguishable from the U.S. average of \$65 million.

Results indicate that (1) VCFs specializing in early stage ventures prefer less industry diversity and narrower geographic scope relative to other VCFs; (2) corporate VCFs (i.e., those owned by non-financial corporations), prefer less industry diversity but broader geographic scope relative to non-corporate VCFs; (3) larger VCFs prefer greater industry diversity and broader geographic scope than do smaller VCFs; and (4) provision of small business investment companies (SBIC) financing by the VCF has no impact on preferences regarding industry diversity but is associated with a preference for narrower geographic scope.

One implication of these results is that VCFs in the U.S. are not homogeneous as regards the intended product-market scope of their portfolios. This, in turn, holds implications, not only for VCFs, but also for their suppliers (limited partners), buyers (entrepreneurs), and policy-makers. VCFs can no longer rely on haphazard investment schemes; they need to attract investors by virtue of the benefits offered by their portfolio strategy, and they need to attract superior investments via offering value-added services and know-how.

Potential investors in venture capital will want to examine, for example, the impact on risk and return of investing smaller amounts in several VCFs at one extreme versus making one large investment in a very diversified VCF at the other extreme. The results of this and other studies suggest that outcomes (timing, magnitude, and riskiness of returns) of choosing such alternatives will vary widely and will depend in great part on the strategies of the VCFs involved. It will not be possible for investors to make wise choices without a full examination of their own objectives and of the profiles of VCFs.

Entrepreneurs with the most attractive ventures have alternative sources of financing to consider and should weigh the benefits of being financed and supported by various VCFs as part of the VCFs' portfolios. Knowing a VCF's preferences regarding product-market scope improves their chances of approaching and selecting the right fit and, for those

entrepreneurs with a narrower set of options, such knowledge may make the difference between receiving and not receiving financing in a timely manner.

Finally, policy-makers may be able to make use of knowledge of the forces that influence the investment strategies of VCFs. Presently, concerns for policy-makers may include the gap in seed capital, increased foreign presence in the U.S. market, and the export of promising innovative technology via alliances with foreign firms. All of these factors are influenced by the strategies pursued by VCFs as they jockey for position in the increasingly competitive venture capital market.



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