

The venture capital landscape is changing, and perhaps not for the better

October 11 2022, by Gregory Muraski



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Startup companies have traditionally looked for the most experienced venture capitalists (VC) they could find to get their businesses off the ground and support their growth. That's not always the case anymore,

according to a study by University of Maryland Robert H. Smith School Associate Professor Rich Mathews and his co-author Naveen Khanna of Michigan State University. They argue that startups straight out of the gate are often deciding to work with new venture capitalists rather than established ones.

The research shows there are two important qualities entrepreneurs are looking for in a VC. The first is skill at providing services like mentoring and the second is reliability, which refers to the VC sticking with the startup through several rounds of financing. "Even though the expertise of new VCs is unknown, their stronger incentives to stay committed and their willingness to provide good terms to attract entrepreneurs—to in some sense share the value of the reputation they (the VCs) are trying to build—makes them attractive," says Mathews.

Because unestablished venture capitalists are trying to build a reputation, they are tough competition for established VCs, often accepting less equity in a new company in exchange for their services than a more seasoned VC would. At the same time, demand for established VCs is also an obstacle to them snagging startups. New companies must get in line to get their attention, and many new startups aren't interested in waiting.

The study, "Skill Versus Reliability in Venture Capital" in the *Journal of Financial Economics*, finds this new way of doing things in the VC orbit results in the crowding out of skill, a decrease in the value of reputation and a loss in social welfare. Mathews says, "a good startup ecosystem is essential to the culture of innovation that leads to the types of breakthrough products that change people's lives for the better. Our research hints at a [potential threat](#) to this ecosystem that could reduce the pace of innovation if the traditional long-term VC/[startup](#) relationship cycle is disrupted."

Established VCs getting edged out by new VCs for investing opportunities with startups is, to some extent, turning tradition on its head. However, Mathews indicates all is not lost for experienced VCs. He says they'll still be able to find good deals, but "the terms will not be as attractive as they might like, and they might have to shift strategies to maintain an advantage."

More information: Naveen Khanna et al, Skill versus reliability in venture capital, *Journal of Financial Economics* (2021). [DOI: 10.1016/j.jfineco.2021.07.007](https://doi.org/10.1016/j.jfineco.2021.07.007)

Provided by University of Maryland

Citation: The venture capital landscape is changing, and perhaps not for the better (2022, October 11) retrieved 20 June 2024 from <https://phys.org/news/2022-10-venture-capital-landscape.html>

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