

# **ARE VENTURE CAPITALISTS CONSUMMATE ENTREPRENEURS? SIMILARITIES AND DIFFERENCES IN THEIR OPPORTUNITY RECOGNITION PERCEPTIONS AND BEHAVIORS**

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## **ABSTRACT**

Opportunity recognition (OR) is at the centre of the entrepreneurial process and a defining feature of the entrepreneurship domain. However, despite contributions made in generating knowledge about the sensitivity of entrepreneurs to opportunities and the cognitive processes they use, there is still much to learn, particularly about how venture capitalists (VCs) perceive OR as distinct from entrepreneurs. It is clear that understanding OR is essential to VC survival. Whereas entrepreneurs need to be able to recognize and commit to at least one opportunity (their current business venture(s)) to ensure success; VCs need to be able to recognize multiple investment opportunities to ensure the success of their current portfolio as well as to ensure financial support for their being able to

establish future VC funds. However, although VCs need to act like consummate entrepreneurs in recognizing opportunities, a comprehensive conceptualization of similarities and differences between the two groups is absent. In this research, we examine the OR behavior of VCs and entrepreneurs and use a conceptual framework developed by Hills (1995) that highlights core structures and proactive management decision processes.

The research makes a contribution in a number of ways. First, it bridges a gap in the literature by providing an entrepreneurial framework against which VC behavior can be contrasted. Second, the framework is endorsed as being useful for identifying conceptual and operational strengths and limitations evident in the two groups. Third, the research provides practical insights into the design of training programs aimed at imparting knowledge about the OR process and idealized behaviors.

The results indicate both similarities and differences in OR behavior between VCs and entrepreneurs. Both groups demonstrated similar distinctive general OR behavior types in terms of: self perceived alertness to opportunities; underlying causes of opportunities; importance of venture ideas, individualism, creativity, and sources; OR processes, deliberate search, spin-offs, and immersion; and evaluation of business opportunities. However, there were significant differences between the two groups on each of these dimensions.

## **Are Venture Capitalists Consummate Entrepreneurs? Similarities and Differences in their Opportunity Recognition Perceptions and Behaviors**

### **INTRODUCTION**

Opportunity recognition (OR) is a key component of the entrepreneurship process (Schumpeter, 1971; Kirzner, 1979; Shane & Venkataraman, 2000) and has critical theoretical importance (Lumpkin, Hills, and Shrader, 2001). Substantial research has been undertaken in the area of opportunity evaluation. OR, however, has received less attention (Hills, 1995) until only more recently (Venkataraman, 1997). As a result, less is known about how entrepreneurs recognize opportunities (Hills, Shrader, Baltrusaityte, and Izberk-Bilgin, 2002) and the literature that exists is fragmented and often appears contradictory (Lumpkin, Hills, and Shrader, 2001).

Even less, however, is known about venture capitalist (VC) OR behavior. VCs are professional investors that raise funds from others (typically financial institutions such as pension funds, insurance companies, etc.) and invest these funds in growth oriented business. "Very little is known about the sensitivity of venture capitalists to opportunities and the cognitive processes they use to identify opportunities" (Lindsay, 2004, p.1). Some insight may be gained from examining the behavior of entrepreneurs since there is evidence to suggest that VCs demonstrate an entrepreneurial orientation (Lindsay, 2004a). In addition, there may be similar OR behavior types between entrepreneurs and private equity financiers such as VCs (Lindsay & Craig, 2002).

Motivation for this research, therefore, is driven by a need to address a gap in the literature by building upon our understanding of OR for entrepreneurs and to extend this

to VCs. In so doing, we can better understand more about how VCs recognize opportunities and whether there are similarities and differences with entrepreneurs on this construct. Thus, the aim of this research is to compare and contrast OR behaviors of VCs and entrepreneurs with a view to better understanding VC OR behavior. In doing so, the research makes a contribution to the literature by contributing to entrepreneurship theory. In addition, it benefits practitioners (such as consultants and trainers) by providing insights into VC behaviors that may be useful in developing training programs for them.

## THEORY AND HYPOTHESES

Considerable effort has been devoted to developing an understanding of the fundamental OR behaviors of entrepreneurs (Hills, 1995; Hills, Lumpkin, and Singh, 1997; and Hills and Shrader, 1988) and to providing insights into the OR process as being inherently creative (Hills, Shrader, and Lumpkin, 1999; Lumpkin, Shrader, and Hills, 2001). There are a number of behaviors that underlie OR (Hills, 1995; Hills, Lumpkin, and Singh, 1997; and Hills and Shrader, 1988). These include: self perceived alertness to opportunities; underlying causes of opportunities; importance of venture ideas, individualism, creativity, and sources; OR processes, deliberate search, spin-offs, and immersion; and evaluation of business opportunities.

The following discussion builds upon the findings of Hills (1995), Hills, Lumpkin, and Singh (1997), and Hills and Shrader (1988) who focused on OR for entrepreneurs. From this, hypotheses are developed that focus on OR behavior similarities and differences between entrepreneurs and VCs.

As there is support to suggest that VCs may act in an entrepreneurial manner (Lindsay, 2004, 2004a), it is expected that VCs will also demonstrate OR behavior types similar to those identified in entrepreneurs (Hills, 1995; Hills, Lumpkin, and Singh, 1997; Hills and Shrader, 1988). As such,

H<sub>1</sub>: VCs will demonstrate similar OR behavior types as entrepreneurs.

*Self perceived alertness*: Entrepreneurs see themselves as being alert to opportunities. They believe that it is natural for them to identify opportunities and that they enjoy thinking of opportunities (Hills, 1995; Hills, Lumpkin, and Singh, 1997; and Hills and Shrader, 1988). Venture capitalists also need to be alert to opportunities. They are professional investors. They are in the business of recognizing opportunities. As such, because this is what venture capitalists do, they will have a perception that they are opportunity aware and that they have an innate ability to recognize opportunities. Because VCs spend their work life looking for and evaluating opportunities, they will have a greater perception that they are better at recognizing opportunities than to entrepreneurs. As such,

H<sub>2</sub>: There will be differences between VCs and entrepreneurs in terms of self perceived alertness to opportunities behavior.

*Opportunity causes*: Experienced entrepreneurs appreciate that opportunities are grounded in adversity and problems that people face and that they also arise through market changes and customers and, to a lesser extent, through technology (Hills, 1995; Hills, Lumpkin, and Singh, 1997; and Hills and Shrader, 1988).

VCs see many deals. Most of them they do not invest in for a range of reasons including not being investment ready and not being suitable for VC investment. VCs do not always “pick winners”. Sometimes they invest when they should not have. Lindsay (2004, 2004a) refers to this as Type I error. Through experiential learning in picking winners and losers, VCs develop an appreciation of what causes opportunities and what does not. Because they have more experience of this than entrepreneurs, they will be better skilled at understanding opportunity causes. As such,

H<sub>3</sub>: There will be differences between VCs and entrepreneurs in terms of opportunity causes behavior.

*Ideas, individualism, and creativity:* Many entrepreneurs appreciate that ideas are not the same as opportunities and that value needs to be created in ideas to turn them into opportunities. This is where creativity plays a role and many entrepreneurs see themselves as being creative. Some entrepreneurs, however, believe that getting capital and other necessary resources is more important than the idea itself.

In terms of the latter point, VCs appreciate that there is an abundance of finance for entrepreneurial firms. This is not the problem. What they believe is lacking is a suitable stream of investment ready entrepreneurial firms (Mason and Harrison, 2001). As such,

H<sub>4</sub>: There will be differences between VCs and entrepreneurs in terms of ideas, individualism, and creativity behavior.

*Processes, deliberate search, spin-offs, and immersion:* OR is a process comprised of a number of steps. Many entrepreneurs engage in a deliberate search strategy for opportunities but appreciate that one opportunity can lead to another. In addition, they appreciate that although undertaking market research is important, there is no substitute for immersion in the market.

Although there will be similarities between VCs and entrepreneurs on this behavior, there will also be a major difference. Although VCs engage in a deliberate search process for opportunities; their opportunity search approach is different than for entrepreneurs. VCs tend to be sought by entrepreneurs looking for finance – some entrepreneurial opportunities are presented to VCs. This will not preclude VCs from scanning the environment for opportunities and/or utilizing their networks; however, they will demonstrate a different opportunity search behavior than entrepreneurs. As such,

H<sub>5</sub>: There will be differences between VCs and entrepreneurs in terms of processes, deliberate search, spin-offs, and immersion behavior.

*Opportunity evaluation:* Entrepreneurs consider gut feel to be an important part of evaluating opportunities. Although VCs will also believe in gut feel, they will more likely be inclined to back their gut feel up with formal research into the viability of the product/technology, market, and commercial operations of the business. As such,

H<sub>6</sub>: There will be differences between VCs and entrepreneurs in terms of opportunity evaluation behavior.

# RESEARCH DESIGN

## Participants

Both groups of participants (venture capitalists and entrepreneurs) were from Australia. Venture capitalist participants in the survey were identified using a venture capitalist directory as well as by accessing industry contacts to identify firms not appearing in the directory. Firms were contacted and their permission sought for decision makers in these firms to participate in the study. Responses were received from 39 Australian participants which represented a 31% response rate.

A list of potential entrepreneur respondents was developed through a database that identified firms with high growth. The entrepreneurs behind these firms were contacted. The research team contacted participants to gauge their willingness to participate in the survey. For those participants that were slow in responding, a subsequent follow up was made. In total, there were 129 entrepreneur participants which represented a 26% response rate. Demographics on the participants appear in Table 1.

**Table 1 - Respondent Demographics**

Details		Entrepreneur Frequency	Entrepreneur %	Venture Capitalist Frequency	Venture Capitalist %	
Gender	Male	89	69%	39	93%	
	Female	40	31%	3	7%	
Age	30 years or less	42	33%	5	12%	
	31 years to 40 years	37	28%	23	55%	
	41 years to 50 years	32	25%	4	9%	
	51 years to 60 years	18	14%	10	24%	
Highest Education Achieved	Primary School	1	1%	0	0%	
	Secondary School	45	35%	2	5%	
	Technical Qualification	26	20%	1	2%	
	Undergraduate Degree	45	35%	9	21%	
	Postgraduate Degree	10	8%	30	72%	
Other Qualification	Other Qualification	2	1%	0	0%	
	Have you ever started your own business previously?	Yes	46	36%	19	45%
	No	81	63%	23	55%	
Missing Data	2	2%	0	0%		

Were you a founder of the firm?	Yes	38	30%	22	52%
	No	89	69%	20	48%
	Missing Data	2	2%	0	0%

## MEASURES

A questionnaire was used to gather information from participants. The questionnaire asked participants for demographic information including personal information and business-related activities. It contained several sections including measures for opportunity recognition.

The instrument adopted in the research used a modified version of a questionnaire originally developed by Hills (1995). Versions of the questionnaire have been used by others (for example, Hills, Lumpkin, and Singh (1997) and Hills and Shrader (1998)). It has been extensively pre-tested and modified where appropriate (Hills & Shrader, 1998). The instrument identifies a number of underlying dimensions associated with OR. These were adopted in this research: self perceived alertness to opportunities ( $\alpha_{\text{entrepreneurs}} = 0.766$  and  $\alpha_{\text{Venture Capitalists}} = 0.744$ ); underlying causes of opportunities ( $\alpha_{\text{entrepreneurs}} = 0.734$  and  $\alpha_{\text{Venture Capitalists}} = 0.732$ ); importance of venture ideas, individualism, creativity, and sources ( $\alpha_{\text{entrepreneurs}} = 0.820$  and  $\alpha_{\text{Venture Capitalists}} = 0.702$ ); OR processes, deliberate search, spin-offs, and immersion ( $\alpha_{\text{entrepreneurs}} = 0.845$  and  $\alpha_{\text{Venture Capitalists}} = 0.705$ ); and evaluation of business opportunities ( $\alpha_{\text{entrepreneurs}} = 0.867$  and  $\alpha_{\text{Venture Capitalists}} = 0.701$ ). Each of these items is scored on a 5 point Likert scale ranging from "1 = Strongly Agree" to "5 = Strongly Disagree".

## RESULTS

Tables 2 and 3 provide the results of the entrepreneur and venture capitalist participant self perceived OR behaviors. These are defined in terms of the frequencies associated with participant responses on the 5-point Likert scale for each OR behavior. VCs adopted similar OR behavior types as entrepreneurs (that is, they demonstrated the following OR behaviors: self perceived alertness to opportunities; underlying causes of opportunities; importance of venture ideas, individualism, creativity, and sources; OR processes, deliberate search, spin-offs, and immersion; and evaluation of business opportunities). As such,  $H_1$  was confirmed.

In addition, an independent samples t-test was conducted to compare the OR behaviors of each group. Significant OR differences between each group were found on all OR behaviors: alertness ( $t(169) = 1.971$ ,  $p = 0.050$ ); causes ( $t(169) = 4.055$ ,  $p = 0.000$ ); ideas ( $t(169) = 2.068$ ,  $p = 0.040$ ); search ( $t(169) = 1.958$ ,  $p = 0.052$ ); evaluation ( $t(169) = 2.134$ ,  $p = 0.034$ ). As such,  $H_2$  to  $H_6$  were confirmed.

**Table 2 - Frequencies: Entrepreneurs**

Measure	Mean (s.d.)	1 SA	2	3	4	5 SD
Alertness	2.31 (1.03)	27 21%	40 31%	41 32%	15 12%	6 5%
Causes	2.61 (0.704)	5 4%	50 38%	56 44%	17 13%	1 1%
Ideas	2.92 (0.814)	2 2%	30 23%	79 61%%	7 6%	11 8%
Search	2.95 (0.826)	3 2%	32 25%	70 54%	13 10%	11 9%
Evaluation	2.98 (0.980)	1 1%	38 29%	64 50%	6 5%	20 15%

**Table 3 - Frequencies: Venture Capitalists**

Measure	Mean (s.d.)	1 SA	2	3	4	5 SD
Alertness	1.95 (0.942)	11 26%	19 45%	8 19%	2 5%	2 5%
Causes	2.11 (0.683)	7 17%	22 52%	11 26%	1 2%	1 2%
Ideas	2.64 (0.609)	0 0%	16 38%	22 52%	4 10%	0 0%
Search	2.67 (0.642)	2 5%	16 38%	21 50%	3 7%	0 0%
Evaluation	2.63 (0.730)	4 10%	8 19%	26 62%	4 9%	0 0%

## DISCUSSION

The results suggest that in terms of recognizing opportunities, VCs demonstrate behaviors similar to entrepreneurs. However, although demonstrating OR behaviors, they demonstrate significant differences within behavior types in terms of the means or weightings placed on these behaviors as compared to entrepreneurs.

One possible explanation for this is that whereas entrepreneurs need to be able to recognize and commit to at least one opportunity (their current business venture(s)) to ensure success; VCs need to be able to recognize multiple investment opportunities to ensure the success of their current portfolio as well as to ensure financial support for their being able to establish future VC funds. Thus, VCs become more experienced in OR than entrepreneurs because they undertake OR more frequently than entrepreneurs. Entrepreneurs may see a range of potential opportunities but they may not necessarily have the time, inclination, or resources to invest in these. VCs on the other hand are in the business of OR. They must recognize opportunities and invest in them if they are to satisfy their investors that they are doing their job. As such, not only do VCs get to practice at recognizing opportunities, they also are required to back their decisions with hard cash. Because VCs tend to use investor's money in their investments, they do not have an emotional attachment to the funds they invest in. As such, they may be more objective in learning from their investment decisions than entrepreneurs who will have personal assets at stake.

## **IMPLICATIONS**

OR is not only fundamental to the entrepreneurship process, it also is fundamental to the VC investment process. Critical to VC success is whether VCs can successfully recognize opportunities. From the OR behavior perspective, VCs need to be consummate entrepreneurs. However, VCs do not always get it “right”. Sometimes they invest in deals they should not have (Type I error). Other times they may reject deals they should have invested in (Type II error). No matter how good VCs are in picking winners, with the dynamic environments they operate within, there is room for ongoing development in the OR area at the individual VC level. This can be achieved through continuing professional development courses. In terms of developing these courses, the framework developed by Hills (1995) appears to provide a good foundation.

## **RESEARCH LIMITATIONS**

There are a few limitations associated with this research. These include the following. First, only “successful” VCs were examined in the research (that is, those that were operating). There is a need in future research to examine OR behavior of non-successful firms and to determine whether OR behavior is different in these firms. Second, the sample size for VCs was relatively small; however, this is a reflection of the venture capitalist population in Australia. Third, most VC funds are closed funds (that is, they have a limited life – usually 10 years). However, some funds are open (they theoretically have an indefinite life). Future research may benefit from comparing the VC OR behaviors in closed funds versus open funds to determine to what extent organizational factors influence the OR process. Fourth, Australian VCs and entrepreneurs were used in the research. Care needs to be exercised in generalizing the results to other western countries such as the USA and the UK and to Asia.

## **SUMMARY**

This research examined the similarities and differences in OR behaviors between entrepreneurs and VCs. VCs demonstrate similar types of OR behaviors as entrepreneurs – they act like entrepreneurs in that they emulate entrepreneur OR behavior types. However, there are significant differences in the means of these OR behaviors between VCs and entrepreneurs. These differences may be explained through the skill set, knowledge, and experience that VCs acquire or develop through their entrepreneurial business dealings.

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