Role of Startup Rating Agencies in Improving Venture Investment Decisions

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Abstract

The startup ecosystem is characterized by high uncertainty, severe information asymmetry, and increasing competition for scarce venture capital. Startup rating agencies (SRAs) have emerged to address these challenges by providing independent evaluations of new ventures, typically compensated through fixed fees or equity stakes. This paper develops a formal model of the investor's decision whether to obtain an SRA rating under these two payment schemes. We identify the conditions under which ratings improve investment outcomes and compare the relative attractiveness of fixed versus equity fee arrangements. The analysis reveals that ratings are most valuable when public information is not decisively conclusive, with small equity investors benefiting more under favorable signals and large equity investors gaining under unfavorable signals. When comparing schemes, investors with larger stakes prefer fixed fees, while those with smaller stakes may benefit from equity-based fees. The preference for fixed fees is stronger when public information initially advises against investing. These results provide actionable insights for investors seeking to optimize due diligence strategies and for SRAs in designing compensation models that align with investor needs.

Keywords

Startup investment, startup rating agencies, information asymmetry, entrepreneurial finance, investment decision, fee structures, venture evaluation.