

LESSON 19: VENTURE CAPITAL – THEORETICAL CONCEPT

Lesson Objectives

- To understand the Concept of Venture Capital,
- Types of venture capital funds, mode of operations and terminology of venture capital.

Introduction

Venture Capital has emerged as a new financial method of financing during the 20th century. Venture capital is the capital provided by firms of professionals who invest alongside management in young, rapidly growing or changing companies that have the potential for high growth. Venture capital is a form of equity financing especially designed for funding high risk and high reward projects.

There is a common perception that venture capital is a means of financing high technology projects. However, venture capital is investment of long term finance made in:

1. Ventures promoted by technically or professionally qualified but unproven entrepreneurs, or
2. Ventures seeking to harness commercially unproven technology, or
3. High risk ventures.

The term 'venture capital' represents financial investment in a highly risky project with the objective of earning a high rate of return. While the concept of venture capital is very old the recent liberalisation policy of the government appears to have given a fillip to the venture capital movement in India. In the real sense, venture capital financing is one of the most recent entrants in the Indian capital market. There is a significant scope for venture capital companies in our country because of increasing emergence of technocrat entrepreneurs who lack capital to be risked. These venture capital companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters' contribution as required by the financial institutions. In addition to providing capital, these VCFs (venture capital firms) take an active interest in guiding the assisted firms.

A young, high tech company that is in the early stage of financing and is not yet ready to make a public offer of securities may seek venture capital. Such a high risk capital is provided by venture capital funds in the form of long-term equity finance with the hope of earning a high rate of return primarily in the form of capital gain. In fact, the venture capitalist acts as a partner with the entrepreneur.

Thus, a venture capitalist (VC) may provide the seed capital for unproven ideas, products, technology oriented or start up firms. The venture capitalists may also invest in a firm that is unable to raise finance through the conventional means.

Features of Venture Capital

"Venture capital combines the qualities of a banker, stock market investor and entrepreneur in one."

The main features of venture capital can be summarised as follows:

- i. High Degrees of Risk** Venture capital represents financial investment in a highly risky project with the objective of earning a high rate of return.
- ii. Equity Participation** Venture capital financing is, invariably, an actual or potential equity participation wherein the objective of venture capitalist is to make capital gain by selling the shares once the firm becomes profitable.
- iii. Long Term Investment** Venture capital financing is a long term investment. It generally takes a long period to encash the investment in securities made by the venture capitalists.
- iv. Participation in Management** In addition to providing capital, venture capital funds take an active interest in the management of the assisted firms. Thus, the approach of venture capital firms is different from that of a traditional lender or banker. It is also different from that of an ordinary stock market investor who merely trades in the shares of a company without participating in their management. It has been rightly said, "venture capital combines the qualities of banker, stock market investor and entrepreneur in one".
- v. Achieve Social Objectives** It is different from the development capital provided by several central and state level government bodies in that the profit objective is the motive behind the financing. But venture capital projects generate employment, and balanced regional growth indirectly due to setting up of successful new business.
- vi. Investment is liquid** A venture capital is not subject to repayment on demand as with an overdraft or following a loan repayment schedule. The investment is realised only when the company is sold or achieves a stock market listing. It is lost when the company goes into liquidation.

Origin

Venture capital is a post-war phenomenon in the business world mainly developed as a sideline activity of the rich in USA. The concept, thus, originated in USA in 1950s when the capital magnets like Rockefeller Group financed the new technology companies. The concept became popular during 1960's and 1970's when several private enterprises started financing highly risky and highly rewarding projects. To denote the risk and adventure and some element of investment, the generic term "Venture Capital" was developed. The American Research and Development was formed as the first venture organisation which financed over 100 companies and made profit over 35 times its investment. Since then venture capital has grown' vastly in USA, UK, Europe and Japan and has been an important contribution in the economic development of these countries.

Of late, a new class of professional investors called venture capitalists has emerged whose specialty is to combine risk capital with entrepreneurs management and to use advanced technology to launch new products and companies in the market place. Undoubtedly, it is the venture capitalist's extraordinary skill and ability to assess and manage enormous risks and extort from them tremendous returns that has attracted more entrants. Innovative, hi-tech ideas are necessarily risky. Venture capital provides long-term start-up costs to high risk and return projects. Typically, these projects have high mortality rates and therefore are unattractive to risk averse bankers and private sector companies.

Venture capitalist finances innovation and ideas, which have potential for high growth but are unproven. This makes it a high risk, high return investment. In addition to finance, venture capitalists also provide value-added services and business and managerial support for realizing the venture's net potential.

Types of Venture Capitalists

Generally, there are three types of organized or institutional venture capital funds -

- i. Venture capital funds set up by angel investors, that is, high network individual investors
- ii. Venture capital subsidiaries of corporations - these are established by major corporations; commercial bank holding companies and other financial institutions
- iii. Private capital firms/funds-The primary institutional source of venture capital is a venture capital firm venture capitalists take high risks by investing in an early stage company with little or no history and they expect a higher return for their high-risk equity investments in the venture.

Modes of Finance by Venture Capitalists

Venture capitalists provide funds for long-term in any of the following modes

1. **Equity** - Most of the venture capital funds provide financial support to entrepreneurs in the form of equity by financing 49% of the total equity. This is to ensure that the ownership and overall control remains with the entrepreneur. Since there is a great uncertainty about the generation of cash inflows in the initial years, equity financing is the safest mode of financing. A debt instrument on the other hand requires periodical servicing of debt.
2. **Conditional loan** - From a venture capitalist~ point of view, equity is an unsecured instrument and hence a less preferable option than a secured debt instrument. A conditional loan usually involves either no interest at all or a coupon payment at nominal rate. In addition, a royalty at agreed rates is payable to the lender on the sales turnover. As the units picks up in sales levels, the interest rate are increased and royalty amounts are decreased.
3. **Convertible loans** - The convertible loan is subordinate to all other loans, which may be converted into equity if interest payments are not made within agreed time limit.

Areas of Investment

Different venture groups prefer different types of investments. Some specialize in seed capital and early expansion while others focus on exit financing. Biotechnology, medical services, communications, electronic components and software companies seem to be attracting the most attention from venture firms and receiving the most financing. Venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability.

In India, software sector has been attracting a lot of venture finance. Besides media, health and pharmaceuticals, agri-business and retailing are the other areas that are favored by a lot of venture companies.

Stages of Investment Financing

"Venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability." Venture capital firms usually recognise the following two main stages when the investment could be made in a venture namely:

A. Early Stage Financing

- i. Seed Capital & Research and Development Projects.
- ii. Start Ups
- ii. Second Round Finance

B. Later Stage Financing

- i. Development Capital
- ii. Expansion Finance
- iii. Replacement Capital
- iv. Turn Arounds
- v. Buy Outs

A. Early Stage Financing

This stage includes the following:

- I. *Seed Capital and R & D Projects*: Venture capitalists are more often interested in providing seed finance *i. e.* making provision of very small amounts for finance needed to turn into a business.

Research and development activities are required to be undertaken before a product is to be launched. External finance is often required by the entrepreneur during the development of the product. The financial risk increases progressively as the research phase moves into the development phase, where a sample of the product is tested before it is finally commercialised "venture capitalists/ firms/ funds are always ready to undertake risks and make investments in such R & D projects promising higher returns in future.

- II. *Start Ups*: The most risky aspect of venture capital is the launch of a new business after the Research and development activities are over. At this stage, the entrepreneur and his products or services are as yet untried. The finance required usually falls short of his own resources. Start-ups may include new industries / businesses set up by the experienced persons in the area in which they have knowledge. Others may result from the research bodies or large corporations, where a venture capitalist joins with an industrially experienced or corporate partner. Still other start-ups occur when a new company

with inadequate financial resources to commercialise new technology is promoted by an existing company.

III. *Second Round Financing*: It refers to the stage when product has already been launched in the market but has not earned enough profits to attract new investors. Additional funds are needed at this stage to meet the growing needs of business. Venture Capital Institutions (VCIs) provide larger funds at this stage than at other early stage financing in the form of debt. The time scale of investment is usually three to seven years.

B. Later Stage Financing

Those established businesses which require additional financial support but cannot raise capital through public issue approach venture capital funds for financing expansion, buyouts and turnarounds or for development capital.

I. *Development Capital*: It refers to the financing of an enterprise which has overcome the highly risky stage and have recorded profits but cannot go public, thus needs financial support. Funds are needed for the purchase of new equipment/ plant, expansion of marketing and distributing facilities, launching of product into new regions and so on. The time scale of investment is usually one to three years and falls in medium risk category.

II. *Expansion Finance*: Venture capitalists perceive low risk in ventures requiring finance for expansion purposes either by growth implying bigger factory, large warehouse, new factories, new products or new markets or through purchase of exiting businesses. The time frame of investment is usually from one to three years. It represents the last round of financing before a planned exit.

III. *Buy Outs*: It refers to the transfer of management control by creating a separate business by separating it from their existing owners. It may be of two types.

- i. *Management Buyouts (MBOs)*: In Management Buyouts (MBOs) venture capital institutions provide funds to enable the current operating management/ investors to acquire an existing product line/business. They represent an important part of the activity of VCIs.
- ii. *Management Buyins (MBIs)*: Management Buy-ins are funds provided to enable an outside group of manager(s) to buy an existing company. It involves three parties: a management team, a target company and an investor (i.e. Venture capital institution). MBIs are more risky than MBOs and hence are less popular because it is difficult for new management to assess the actual potential of the target company. Usually, MBIs are able to target the weaker or under-performing companies.

IV. *Replacement Capital-V CIs* another aspect of financing is to provide funds for the purchase of existing shares of owners. This may be due to a variety of reasons including personal need of finance, conflict in the family, or need for association of a well known name. *The* time scale of investment is one to three years and involve low risk.

V. *Turnarounds*-Such form of venture capital financing involves medium to high risk and a time scale of three to five years. It involves buying the control of a sick company which requires very specialised skills. It may require rescheduling of all the company's borrowings, change in management or even a change in ownership. A very active "hands on" approach is required in the initial crisis period where the venture capitalists may appoint its own chairman or nominate its directors on the board.

In nutshell, venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability. Venture capitalists evaluate technology and study potential markets besides considering the capability of the promoter to implement the project while undertaking early stage investments. In later stage investments, new markets and track record of the business/entrepreneur is closely examined.

Factors Affecting Investment Decisions

The venture capitalists usually take into account the following factors while making investments:

1. *Strong Management Team*. Venture capital firms ascertain the strength of the management team in terms of adequacy of level of skills,, commitment and motivation that creates a balance between members in area such as marketing, finance and operations, research and development, general management, personal management and legal and tax issues. Track record of promoters is also taken into account.
2. *A Viable Idea*. Before taking investment decision, venture capital firms consider the viability of project or the idea. Because a viable idea establishes the market for the product or service. Why the customers will purchase the product, who the ultimate users are, who the competition is with and the projected growth of the industry?
3. *Business Plan*. The business plan should concisely describe the nature of the business, the qualifications of the members of the management team, how well; the business has performed, and business projections and forecasts. The promoters experience in the proposed or related businesses is an important consideration. The business plan should also meet the investment objective of the venture capitalist.
4. *Project Cost and Returns* A. VCI would like to undertake investment in a venture only if future cash inflows are likely to be more than the present cash outflows. While calculating the Internal Rate of Return (IRR) the risk associated with the business proposal, the length of time his money will be tied up are taken into consideration. Project cost, scheme of financing, sources of finance, cash inflows for next five years are closely studied.
5. *Future Market Prospects*. The marketing policies adopted, marketing strategies in relation to the competitors, market research undertaken, market size, share and future market prospects are some of the considerations that affect the decision.
6. *Existing Technology*. Existing technology used and any technical collaboration agreements entered into by the promoters also to a large extent affect the investment decision.

