**Venture capital**

**Meaning and Definition of Venture Capital**

‘Venture Capital’ is an important source of finance for those small and medium- sized firms, which have very few avenues for raising funds. Although such a business firm may possess a huge potential for earning large profits in the future and establish itself into a larger enterprise. But the common investors are generally unwilling to invest their funds in them due to risk involved in these types of investments. In order to provide financial support to such entrepreneurial talent and business skills, the concept of venture capital emerged. In a way, venture capital is a commitment of capital, or shareholdings, for the formation and setting-up of small-scale enterprises at the early stages of their lifecycle.

The term venture capital comprises of two words, namely, ‘venture’ and ‘capital’. The term venture literally means a course or proceeding, the outcome of which is uncertain but which is uncertain but which is attended by the risk of danger of ‘loss’. On the other hand, the term capital refers to the resources to start the enterprise. However, the term venture capital can be understood in two ways.

According to narrow sense, the capital which is available for financing the new business ventures is called venture capital. Generally, it involves lending finance to the growing companies.

In the broad sense, venture capital is the investment of long-term equity finance where the venture capitalist earns his returns primarily in the form of capital gain. It is under the assumption that the entrepreneur and thee venture capital would act as partners. It is a commitment of capital for the formation and setting up of small-scale enterprises specializing in new ideas or new technologies. Venture capital does not deal in financing the enterprise which is engaged in trading, broking, investment or financial services and agency or liaison work. It is generally considered as a high-risk capital. Venture capital is not an injection of funds into new firm but also an input of the skills needs to set up thee firm, design its marketing strategy, organize and then manage it.

A venture capitalist (also known as a VC) is a person or investment firm that makes venture investments, and these venture capitalists are expected to bring managerial and technical expertise as well as capital to their investments. A venture capital fund refers to a pooled investment vehicle (often an LP or LLC) that primarily invests the financial capital of third- party investors in enterprises that are too risky for the standard capital markets or bank loans.

Venture capital is also associated with job creation, the knowledge economy and used as a proxy measure of innovation within an economic sector or geography. The term Venture Capital fund is usually used to denote Mutual funds or Institutional investors. They provide equity finance or risk capital to little known, unregistered, highly risky, young and small private business, specially in technology oriented and knowledge intensive business.

Venture Capital termed as long-term funds in equity or semi- equity from to finance hi-tech investment in novel technology based projects with display potential for significant growth and financial return.”

**Features of Venture Capital**

1) **For New Entrant**: Venture Capital investment is generally made in new enterprises that use new technology to produce new products, in expectation of high gains or sometimes, spectacular returns.

2) **Continuous Involvement**: Venture capitalists continuously involve themselves with the client’s investments, either by providing loans or managerial skills or any other support.

3) **Mode of Investment**: Venture capital is basically an equity financing method, the investment being made in relatively new companies when it is too early to go to the capital market to raise funds. In addition, financing also takes the form of loan finance/ convertible debt to ensure a running yield on the portfolio of the venture capitalists.

4) **Long-term Capital**: The basic objective of a venture capitalist is to make a capital gain on equity investment at the time of exit, and regular return on debt financing. It is a long-term investment in growth- oriented small/medium firms. It is a long-term capital that is an injected to enable the business to grow at a rapid pace, mostly from the start-up stage.

5) **Hands-On Approach**: Venture capital institution take active part in providing value – added services such as providing business skills, etc., to investee firms. Thy do not interfere in the management of the firms nor do they acquire a majority / controlling interest in the investee firms. The rationale for the extension of hands- on management is that venture capital investments tend to be highly non- liquid.

6) **High risk- return Ventures**: Venture capitalists finance high risk-return ventures. Some of the ventures yield very high return in order to compensate for the heavy risks related to the ventures. Venture capitalists usually make hug capital gains at the time of exit.

7) **Source of Finance**: Venture capitalists usually finance small and medium- sized firms during the early stages of their development, until they are established and are able to raise finance from the conventional industrial finance market. Many of these firms are new, high technology- oriented companies.

8) **Liquidity**: Liquidity of venture capital investment depends on the success or otherwise of the new venture or product. Accordingly, there will be higher liquidity where the new ventures are highly successful.

**Venture Capital Funding Process**

Obtaining capital for a project through this rout is very difficult. It involves many steps, which a prospective entrepreneur has to adopt when he approaches an investor. They are:

1) **Making a Deal (Deal Origination**): A continuous flow of deals is essential for the venture capital business. Deals may originate in various ways. Referral system is an important source of deals. Deals may be referred to the VCs through their parent organizations, trade partners, industry associations, friends, etc. The venture capital industry in India has become quit proactive in its approach to generating the dal flow by encouraging individuals to come up with their business plans.

VCFs carry out initial screening of all projects on the basis of some broad criteria.

**For example** the screening process may limit projects to areas in which the venture capitalist is familiar in terms of technology, or Product, or market scope. The size of investment, geographical location and stage of financing could also be used as the broad screening criteria.

2) **Evaluation or Due Diligence**: Once a proposal has passed through initial screening, it is subjected to a detailed evaluation or due diligence process. Most ventures are new and the entrepreneurs may lack operating experience. Hence a sophisticated, formal evaluation is neither possible nor desirable. The Vcs thus rely on a subjective but comprehensive evaluation. VCFs evaluate the quality of the entrepreneur before appraising the characteristics of the product, market or technology. Most venture capitalists ask for a business plan to make an assessment of the possible risk and expected return on the venture.

3) **Investment Valuation**: The investment valuation process is aimed at ascertaining an acceptable price for the deal. The valuation process goes through the following steps.

i) Projections on future revenue and profitability.

ii) Expected market capitalization.

iii) Deciding on the ownership stake based on the return expected on the proposed investment.

iv) The pricing thus calculated is rationalized after taking into consideration various economic scenarios, demand and supply of capital, founders/ management team’s track record, innovation/unique Selling Propositions (USPs), the product/ Service size of the potential market, etc.

4) **Deal Structuring**: Once the venture has been evaluated as viable, the venture capitalist and the investment company negotiate the terms of the deal, i.e., the amount, form and price of the investment. This process is termed as dal structuring. The agreement also includes the protective covenants and earn-out arrangements. Covenants include the venture capitalists’ right to control the invest company and to change its management if needed, buy back arrangements, acquisition, making Initial Public Offerings (IPOs), etc. Earn- out arrangements specify the entrepreneur’s equity share and the objectives to be achieved. Venture capitalists generally negotiate deals to ensure protection of their interests. They would like a deal to provide for a return commensurate with the risk, influence over the firm through board membership, minimizing taxes, assuring investment liquidity and the right to replace management in case of consistent poor managerial performance.

5) **Post-Investment Activities and Exit**: Once the deal has been structured and agreement finalized, the venture capitalist generally assumes the role of a partner and collaborator. He also involves in shaping of the direction of the venture. This may be done via a formal representation on the board of director, or informal influence in improving the quality of marketing, finance and other managerial functions. The degree of the venture capitalists involvement depends on his policy. It may not, however, be desirable for a venture capitalist to get involved in the day-to-day operation of the venture. If a financial or managerial crisis occurs, the venture capitalist may intervene and even install a new management team. Venture capitalists typically aim at making medium- to long- term capital gains. They generally want to cash-out their gains in five to ten years after the initial investment. They play a positive role in directing the company towards particular exit routes. A venture capitalist can exit in four ways.

i) **Initial Public Offerings (IPOs):** When the company is making good profits and the market condition is conductive, the venture capitalists offer their shareholding to the public, the advantage of this exit rout is that the shares can be priced at premium in time with the market trend and will bring them good fortune. However, there are some disadvantages like high cost of issue, lower demand, etc.

**ii) Acquisition by Another Company**: Another strategy is to sell their holdings to another company who are interested to expand their business in this line. The advantage of this strategy is that they can negotiate the deal and results into transfer of controlling interest, the existing promoters may play defensive strategies for fear of loss of control. Sometimes the negative reputation of the acquiring company may bring down the business of the acquired company also.

iii) **Repurchase of the Venture Capitalist’s Share by the Investee Company**: If the promoters have enough cash at their disposal, thy can buy- back the shares from the venture capitalists so that they can retain their control over the company. However, if the company is enjoying good reputation in the market, the venture capitalists may demand a hefty amount as compensation for their exit.

iv**) Purchase of VCs Share by a Third Party**: Venture capitalists can sell their holdings through private placements to one or more third parties. Here also there is a chance of loss of control to the existing promoters, who may play some defensive strategies. However, compared to the public offer, this will be a cheaper route for exit.

**Structure of Venture Capital Firms and Funds**

Venture capital firms are typically structured as partnerships, the general partners of which serve as the managers of the firm and will serve as investment advisors to the venture capital funds raised. Venture capital firms in the United States may also be structured as limited liability companies, in which case the firm’s managers are known as managing members. Investors in venture capital funds are known as limited partners. This constituency comprises both high net worth individuals and institutions with large amounts of available capital, such as state and private pension funds, university financial endowments, foundations, insurance companies and pooled investment vehicles, called fund of funds or mutual funds.

**Dimensions of Venture Capital**

Venture capital in India is available in four forms:

1) **Equity Participation**: The venture capital finances up to 49% of the equity capital and the ownership remains with the entrepreneur.

2) **Conventional Loan**: Under this, a lower fixed rate of interest is charged to the unit till its commercial operation. After normal rate of interest is paid, loan is to be repaid as per the agreement.

3) **Conditional Loan**: A conditional loan is repayable in the form of royalty ranging between 2 and 15% after the venture is able to generate sales and no interest is paid on such loans.

4) **Income Notes**: The income note combines the features of conventional and conditional loans in a way that the entrepreneur has to pay both interest and royalty on sales at low rates.

**Advantages of Venture Capital Funding**

Venture capital is popular in different parts of the country as it plays a significant role in fostering industrial development by exploiting vast and untapped potentialities. The advantages of securing a VC are that:

1) Even in the situation when entrepreneur having a good project idea but no previous entrepreneurial track record to leverage the firm, handles customers and bankers, venture capital can help the entrepreneurs in successful launch of their projects.

2) Rapid growth of technology across the globe has led to the growth of technology in India but indigenous technology has been slack due to unwillingness of the people to take entrepreneurial risks.

3) Venture capital has gained importance as it solves the sickness of a company.

4) As the venture capitalists are ready to lend their expertise and standing to the entrepreneur, the local groups and multinational companies can easily enter into joint ventures.

5) Venture capitalists are also helpful to a large number of smaller units under which they are able to upgrade their technology to meet the demands of the major industrial units.

6) Venture capitalists are also playing a significant role in tapping the potentiality of service sector. Thus, venture capital is booming to exploit the potential of Indian economy.

**Disadvantages of Venture Capital Funding**

The disadvantages of venture capital are as follows:

1) Securing a deal with a VC can be a long and complex process.

2) Person will be required to draw up a detailed business plan, including financial projections for which the entrepreneur may need professional help. Support from his local business link may be available for this.

3) If he gets through the deal negotiation stage, he will have to pay legal and accounting fees whether or not he becomes successful in securing funds.

4) Since the venture capitalist is taking the risk, the management control may get out of the entrepreneur.

5) He will also be forced to partner the benefits, such as the profit he got from the business, with the venture capitalist.

**Guidelines for Venture Capital Companies**

The Government of India has issued the following guidelines for various venture capital operating in the country.

1) The financial institutions, Stat Bank of India, scheduled banks and foreign banks are eligible to establish venture capital companies or funds subject to the approval as may be required from the Reserve Bank of India.

2) The venture capital funds have a minimum size of Rs. 10 crore and a debt equity ratio of 1:1:5. If they desire to raise funds from the public, promoters will be required to contribute minimum of 40% of the capital.

3) The guidelines also provide for NRI investment up to 74% on a non-reportable basis.

4) The venture capital funds should be independent of the parent organization.

5) The venture capital funds will be managed by professionals and can be set-up as joint ventures even with non-institutional promoters.

6) The venture capital funds will not be allowed to undertake activities such as trading, broking and money market operations but they will be allowed to invest in leasing to the extent of 15% of the total funds deployed. The investment on revival of sick units will be treated as a part of venture capital activity.

7) A person holding a position of being a full time chairman, chief executive, or managing director of a company will not be allowed to hold the same position simultaneously in the venture capital fund/ company.

8) The venture capital assistance should be extended to the promoters who are new, and are professionally or technically qualified with inadequate resources.