

The Seed Capital



Commerce

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Fayza Z.

Research Scholar, Dept. of Commerce, University of Jammu

ABSTRACT

The paper aims to give a conceptual idea of Seed money. Sometimes known as seed funding, is a form of securities offering in which an investor purchases part of a business. The term seed suggests that this is an early investment, meant to support the business until it can generate cash of its own, or until it is ready for further investments. Seed money options include friends and family funding, angel funding, financial institutions.

Introduction: Seed capital is needed to get most businesses off the ground. It is considered a high-risk investment, but one that can reap major rewards if the company becomes a growth enterprise. This type of funding is often obtained in exchange for an equity stake in the enterprise, although with less formal contractual overhead than standard equity financing. Banks and venture capital investors view seed capital as an "at risk" investment by the promoters of a new venture, which represents a meaningful and tangible commitment on their part to making the business a success. Frequently, capital providers will want to wait until a business is a little more mature before making the larger investments that typify the early stage financing of venture capital funding. Since the early 1980s, Venture capital activity has grown rapidly in all major economies and currently billions of dollars of risk capital are allocated annually to high potential enterprises (Denis, 2004). The initial capital used to start a business. Seed capital often comes from the company founders' personal assets or from friends and family. The amount of money is usually relatively small because the business is still in the idea or conceptual stage. Such a venture is generally at a pre-revenue stage and seed capital is needed for research & development, to cover initial operating expenses until a product or service can start generating revenue, and to attract the attention of venture capitalists.

Review of Literature: Previous research has focused on informal venture capital and different types of informal investors (Mason and Harrison, 2002; Kolvereid and Landstrom, 1997; Landstrom, 1992, 1993, 1998; Reitan and Sørheim, 2000; Stevenson and Coveney, 1994; Freear et al., 1994; Sørheim and Landstrom, 2001; Erikson et al., 2003; Erikson and Sørheim, 2005). Most of the studies of informal investors have recognized that the populations of informal investors are heterogeneous; and a number of studies have categorized these informal investors. For instance, Gaston (1989) divides informal investors into what he perceived was the ten most important categories. He provides a market profile for each category and compares the different categories with the profile of the American composite angel. These are: business devils; godfathers; peers, corporate achievers; stockholders; high-tech angels; Daddy Warbuck; Kildare; Cousin Randy, and "very hungry" angels. Freear et al. (1994) made a survey of a few 100 high net worth individuals and identified active informal investors and potential informal investors. Others have also made some useful categorizations. For instance, Stevenson and Coveney (1994) made a taxonomy based on the level of investment activity and entrepreneurial background. They found six useful categories of investors. In short, those are: virgin; latent; wealth maximizing, income seeker, entrepreneurial, and corporate investors. Landstrom (1992) identifies four different informal investors: individuals in the business environment, individuals making few large investments, individuals making few small investments, and professional informal investors. Landstrom (1998) also identifies the informal investor as the lead entrepreneur. Moreover, Sørheim and Landstrom (2001) categorize investors' accordance to their investment activity and competencies. They found four useful typologies, namely: business angels, traders, lotto investors as well as analytical investors. Their empirical findings suggests that there are considerable differences among the four categories of investors, for example when it comes to the use of information sources, involvement in the company, co-investing,

time horizon and geographic preferences. Erikson et al. (2003) and Erikson and Sørheim (2005) investigate technology angels and family angels. Erikson and Sørheim also make a distinction between Schumpeterian angels and Austrian angels. In other words, investors that push technology as opposed to those who identify market opportunities, and reallocates resources to meet market demands. Most of these typologies have been based on empirical data. However, the two latter typologies (Schumpeterian and Austrian angels) are both rooted in theory. Indeed, time is mature to contrast other resource providers than informal seed investors; preferably from a theoretical point of view. Seed capital is, per definition, risk capital, and can be employed in the earlier, intermediate or later stages in new firms' growth cycle. However, we do not expect venture capital firms to operate much in the very early phases of firm development, as they typically contribute in the subsequent stages. Nevertheless, smaller venture capital firms do invest in the earlier stages. In order to assess for differences in their conduct, this study aims to benchmark the actual nature of seed capital firms with comparable venture capital firms. Are they operating in the same market segment, or are the smaller seed capital firms also focusing on the later segments of early stage new venture creation? For this we need a research framework, and we need data. These are elaborated on in the following sections.

The Benefits & Limitation of Seed capital:

The Benefits of Seed Capital:

There are some benefits to venture capital funding. In many cases, the company able to secure venture capital funds can receive services that may include:

- **Business Consultations** - Many seed capital firms have consultants on their staffs that are well versed in specific markets. This can help a start up firm avoid many of the pitfalls that are often associated with start-up business ventures.
- **Management Consultations** - Unfortunately, not all entrepreneurs are good business managers. Since seed capital firms almost always require a percentage of equity in the start-up firm, they likely will have a say in how the firm is managed. For the non-management expert, this can be a significant benefit.
- **Human Resources** - In terms of finding the best talent for start up firms, seed capital firms often provide consultants who are specialists in hiring. This can help a start up firm avoid the pitfalls of hiring the wrong people for their company.
- **Additional Resources** - Starting a new business is fraught with concerns about legal matters, payroll matters, and tax issues. It is not unusual for a seed capital firm to take an interest in providing these resources since they have a vested interest in the success of the company.

In general, business resources that are provided by seed capital firms who have taken an equity position in a start up company can be invaluable to the success of the company. Many start up firms securing venture capital are able to thrive and become giants in their industries.

The Limitations of Seed Capital: Securing venture/seed capital typically means that you have to give up something in

exchange for the funding. Most venture capital firms are not interested in merely receiving the capital that they have invested along with a standard interest rate. In fact, there are some things that venture capital firms may ask for that may surprise you. These include:

- **Management Position** - In many cases, a venture capital firm will want to add a member of their team to the start up company's management team. This is generally to ensure that the company can be successful, though this can also create internal problems.
- **Equity Position** - Most venture/seed capital firms require that the company give up an equity position to them in return for their funding. This amount is not small, in many cases it can be as much as 60 percent of the equity in the company. In effect, this means that the entrepreneur is not controlling their business; it is being controlled by the venture capital firm.
- **Decision Making** - One of the biggest problems that many entrepreneurs face when they agree to accept venture capital is they often are giving up many key decisions in how their company will operate. Venture capital firms that have taken an equity position want a "seat at the table" when any major decision is made and they often have the power to override decisions.
- **Business Plans** - When a business plan is written and submitted for financing considerations, most finance companies will agree to sign a non-disclosure agreement. This is not the case in most venture capital firms. Venture capital firms will nearly always refuse to sign a non-disclosure agreement due to the legal ramifications of doing so. This can put ideas from an entrepreneur at risk.
- **Funding Plan** - If an entrepreneur writes their business plan and determines they need \$500,000 to get the business launched, they may be lulled into thinking that these funds will

come up front. This is simply not the case. Venture/seed capital firms almost always set goals and milestones for releasing funds. Funding from venture capital firms is typically done in stages with an eye on the expansion of the business.

These are only a few of the possible problems an entrepreneur could face when they secure venture/seed capital funding. It is important that they carefully review all agreements and have them reviewed by an attorney as well.

Market risk parameters:

Market risk, or systematic risk, has been described as the degree of uncertainty associated with gaining a competitive advantage due to environmental factors (Barney et al., 1989; Fiet, 1991, 1995; Porter, 1980). Although it cannot be directly observed, we can "make inferences about it based upon how it affects indicator variables that are observable" (Fiet, 1995, p. 553). For quoted firms, the beta is predominantly employed. However, emerging ventures are normally not quoted, and measures of such risk are therefore practically non-existent. Fiet (1995, p. 553) identified the following indicators as a proxy for market risk:

- technical obsolescence;
- many competitors;
- many potential, new competitors;
- many substitute products;
- weak customer demand; and
- market attractiveness.

Conclusion

If considering seed capital, the advantages and disadvantages are many. This type of funding is not right for everyone. Those companies who have high growth potential such as electronics manufacturers, green technologies, and other high tech ventures are usually the ones who fare best with seed capital funding. Thus one should be clear with the pros and cons and the market risk parameters attached with the project.

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