ORIGINAL RESEARCH PAPER

Management

A CONCEPT OF VENTURE CAPITAL

KEY WORDS:

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ABSTRACT

Capital is one of the most important factors of production. No entity can start functioning without required capital as this helps the entrepreneurs in acquiring machinery, equipment and other productive facilities. The companies engaged in traditional line of business can easily procure necessary financial capital from the conventional capital market. But the entrepreneurs face great difficulty while venturing out to procure financial capital for newly floated enterprises as at the initial stages of business the risk is very high and the return, quite uncertain. Common

Investors hesitate to invest their savings in such companies even though they leas to high industrial growth and economic development, because it is difficult to trade-off between risk and returns. Lack of finance deters the new entrepreneurs and technocrats from starting new ventures even though they may very well have innovative ideas and requisite technological knowledge. Hence the question arises that how these types of firms shall then be financed? Under the circumstance, the concept of venture capital fund was born with fundamental objective to provide initial capital and support in building capital base to the entrepreneurs, having a sound background of professional education, expertise and initiative to launch the business based on fast changing technology.

Concepts

Venture Economics had defined Venture Capital as 'providing seed, start-up and first stage financing' and also funding 'the expansion of companies that have already demonstrated their business potential but do not yet have already demonstrated their business potential but do not yet have access to the public securities market or to credit oriented institutional funding sources, venture capital also provides management in leveraged buyout financing.

The European Venture Capital Association has described it as risk finance for entrepreneurial growth oriented companies, and investment for medium or long-term to maximize returns. It is a partnership with the entrepreneur in which the investor can add value to the company because of his knowledge and experience.

Characteristics of the Venture capital

The main characteristics of the venture capital are long time horizon, lack of liquidity, high risk, equity participation and participation in management.

- Long Time Horizon: Venture financing is a long-term illiquid investment; it is not repayable on demand. It requires a long-term investment attitude that necessitates the venture capital firms to wait for a long-period, say 5 to 10 years, to make substantial profits.
- Lack of Liquidity: Because venture capital investment are made in private companies, the investments are illiquid until the company goes public or is sold and the proceeds are distributed to the limited partners. This illiquidity is inherent in the nature of the securities that venture capitalists' purchase and in the stages of development that a typical partnership must go through.
- High Returns: Venture capital has historically achieved high rates of return. But venture capital performance has also varied greatly. This wide variation in returns over time emphasizes the importance of diversifying across time as well as industry and stage of investment.

METHODS OF VENTURE CAPITAL

For all entrepreneurs except a chosen few, "Raising money" is the hardest part of starting a business – and the most rewarding when one is successful at it. There are various methods of financing entrepreneurial ventures. They are seed money financing, development financing, later stage financing, turn around.

1. Seed money financing: The venture capital institution provides seed capital at the early stage of the borrowing concern. In seed capital, the funds are provided for testing the product and examining the commercial viability of the product. It enables the venture capital institution to find out the technical skill of the borrowing concern and its market potentiality. So, we can say seed capital is more of a product development and all the finance required at this stage is provided by the venture capital institution. Once the product is tested in the market and after being satisfied with its acceptability by the market, financing will be provided for further development of the product and marketing of the product.

The startup may be classified into four categories.

1. A new high technology, introduced by the entrepreneur.

*.A new business started by an entrepreneur who has a thorough working knowledge and experience-normally started by persons who were working in an established firm and having gained sufficient experience.

* New projects started by existing companies

* A new company promoted by existing company. Here, the venture Capital institution is keen to have a first-rated management which may have a second rated product. But not vice versa i.e., venture capital will not be provided for a concern having a second-rated management but a first-quality product

2. Development financing: The borrowing concern has successfully launched the product in the market which is evident from its acceptability. However, the business has not become commercially successful for want of some more finance. It is at this stage, the venture capital institution provides more funds than at the initial stage. It is also known as expansion financing and financing can be for working capital or for expansion.

3. Later stage financing: The business concern which has borrowed venture capitals has now become a well established business. But still, it is not able to go in for public issue of shares. At this stage, the venture capital institution will provide finance.

- ***Mezzanine capital*:** This is a stage where the borrowing company is not only well established but has overcome the risks and has started earning profits. But they have to go for some more years before reaching the stage of self sustenance. This finance is used by the borrowing company for purchase of plant and machinery, repayment of past debts, and entering new areas.
- ***Bridge capital*:** This is a medium term finance ranging from one to three years and used for growth of the business.

- ***Management buy-outs*:** Here, we deal about the nature of management that is likely to exist in the borrowing concern. In the case of management buy-outs, venture capital is used for removing the external control on the management, by acquiring all the shares and the voting rights.

- ***Management Buy-in*:** In the case of buy-in, funds are provided for an outside group to buy an ongoing company. But this is not popular as it requires a ready management, an investor and a company to take over the existing one.

4. Turn around: A sick company may be taken over by providing two important inputs of capital and management.

- ***Financial turnaround*:** When the company is able to improve its conditions financially, it is called financial turnaround, which is due to the financial assistance by venture capital institution.

- ***Management turn around*:** Similarly, when the management of the company makes a turn around by becoming self dependent and is able face the challenges of business, it is called

Management turns around.

MODES OF VENTURE FINANCING

The financing pattern of the deal is the most important element. Venture capitalists carry out substantial financial engineering to provide enough flexibility to meet the requirements of the company. The venture capitalist typically makes an investment in equity and quasi-equity.

- **Equity:** The venture capital company invests in the equity of the company either at par or premium. Investment in the form of equity is the most desirable form of venture financing, as it does not put any pressure on the cash flow of the company in the initial period. Ideally the venture capital assistance should be provided entirely through equity, reflecting an approach of sharing risks and rewards. However in order to retain the day-to-day management and control with the promoter, the normal limit of assistance by way of equity is to be at a level slightly lower than of the promoter's equity.

- **Quasi-equity:** The quasi-equity instruments are converted into equity at a later date. The convertible instruments are used by the venture capitalist due to necessity of leverage, and need to provide incentive to the promoters. These instruments are normally converted into equity at the book value or at a premium in a later date. The premium automatically rewards the promoter for their initiative and hard work. Since it is performance related, it motivates the promoter to work harder so as to minimize dilution of their control on the company. The convertible instruments include convertible debentures and convertible preference shares.

VENTURE CAPITAL INVESTMENT PROCESS

The venture capital investment activity is a sequential process involving following steps.

- **Deal origination:** A continuous flow of deals is essential for the venture capital business. Deals may originate in various ways. Referred system is an important source of deals. Deals may be referred to VCFs by their parent organizations, trade partners, industry associations, friends, etc. Yet another important source of deal flows is the active search through networks, trade fairs, conferences, seminars, etc. A third source used by venture capitalists is certain intermediaries who match VCFs and the potential entrepreneurs.

- **Screening:** As venture capital is a service industry and operates on small staff, before going in for the in-depth analysis, the VCFs screen out projects on certain broad criteria. For example, the screening process may limit project to areas on which venture capitalists are familiar in terms of technology, or product or market scope, etc.

- **Evaluation:** During this process, the venture capitalists ask the firm for a business plan, wherein detailed information about the proposed venture is given and then an assessment of the possible risk and return on the venture is done. The venture capitalists evaluate project's risk in isolation and thus effects of risk on total portfolio investment are rarely assessed. As a result a little effort has been made to eliminate the risk factors in order to enhance profit as well to hedge the risk.

- **Deal structuring:** This involves negotiating the terms of the deal, i.e. a return commensurate with the risk, minimizing taxes, and assuring investment liquidity, board membership and right

to replace management in case of consistent poor managerial performance.

- **Post investment activities and exit:** The most crucial stage in any venture capital investment is the exit. The goal of the venture capitalist is to sell the investment in a period at a considerable gain. The different possible routes for exit from venture investments are: Initial public offer, Trade sale, Promoters buy back, Company buy back, and Management buyout.

ADVANTAGES OF VENTURE CAPITAL

Venture capital has made significant contribution to technological innovations and promotion of entrepreneurism. Many of the path breaking technologies computers have emerged from small business set up by people with ideas (but no financial resources) and supported by venture capital. There are abundant benefits to economy, investors and entrepreneurs provided by venture capital.

Economy oriented

- Helps in the industrialization of the country.
- Helps in the technological development of the country.
- Generates employment.
- Helps in developing entrepreneurial skills.

- **Entrepreneur oriented**
- Helps small and medium first generation entrepreneurs to translate their ideas into a reality.
- Promotes entrepreneurship and foster entrepreneurism in the country.

CONCLUSION

When companies want to raise finance but are not in a strong position to borrow money, they can negotiate a sale of the part of the equity stake in a new business. This share capital for new or expanding business is often referred to as 'risk capital,' emphasizing the risk involved in any investment in shares or suggesting the idea that it would lead to growth. Where normal lending seems appropriate instead, venture capital will not be provided and for some business, the offer of venture capital is linked to other loans such as convertible loans in a fixed time limit as part of a complete financing package.

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