UDGAM VIGYATI (The Origin of Knowledge)

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Title of the Paper : **CONCEPTUAL FRAMEWORK & SIGNIFICANCE OF VENTURE CAPITAL**

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ABSTRACT

The Dictionary meaning of VENTURE CAPITAL is wealth available for investment in new or speculative enterprises or risk capital. Venture capital can be defined as a type of funding for a new or growing business which usually comes from venture capital firms that specialize in building high risk financial portfolios. With venture capital, the venture capital firm gives funding to the startup company in exchange for equity in the startup. This is most commonly found in high growth technology industries like biotech and software.

A person who deals in venture capital is a venture capitalist, and usually works for a venture capital firm.The firm typically has one or more investment portfolios that are owned by a limited partnership. The venture capitalist is often a general partner in the portfolio, and individual investors or other institutions (particularly university endowments and pension funds) are limited partners in the limited partnership.

The main object of the paper is to throw light on the conceptual framework of Venture Capital. The research paper very compendiously and lucidly elucidate the features , types as well as the process of Venture Capital.

Keywords : **Venture Capital, Equity, Conditional Loan, Income Note, Market**

INTRODUCTION : CONCEPT

The term Venture Capital comprises of two words that is, “Venture” and “Capital”. ***Venture is a course of processing, the outcome of which is uncertain but to which is attended the risk or danger of “loss”. “Capital” means recourses to start an enterprise.*** To connote the risk and adventure of such a fund, the generic name Venture Capital was coined.

Venture Capital has also been described as ‘Unsecured Risk Financing’. The relatively high risk of Venture Capital is compensated by the possibility of high returns usually through substantial capital gains in the medium term. Venture Capital in broader sense is not solely an injection of funds into a new firm, it is also an input of skills needed to set up the firm, design its marketing strategy, organize and manage it. Thus it is a long term association with successive stages of company’s development under highly risky investment conditions, with distinctive type of financing appropriate to each stage of development. Investors join the entrepreneurs as co-partners and support the project with finance and business skills to exploit the market opportunities.

FEATURES OF VENTURE CAPITAL

Following are the essential features of Venture capital:

HIGH RISK

As per the definition, Venture capital financing is highly risky and chances of failure are high as it provides long term startup capital to high risk-high reward ventures. Venture capital assumes four types of risks, these are:

Management Risk : Inability of management teams to work together.

Market Risk : Product may fail in the market.

Product Risk : Product may not be commercially viable.

Operation Risk : Operations may not be cost effective resulting in increased cost decreased gross margins.

HIGH TECH

As opportunities in the low technology area tend to be few of lower order, and hi-tech projects generally offer higher returns than projects in more traditional areas, venture capital investments are made in high tech. areas using new technologies or producing innovative goods by using new technology. Not just high technology, any high risk ventures where the entrepreneur has conviction but little capital gets venture finance. Venture capital is available for expansion of existing business or diversification to a high risk area. Thus technology financing had never been the primary objective but incidental to venture capital.

EQUITY PARTICIPATION & CAPITAL GAINS

Investments are generally in equity and quasi equity participation through direct purchase of shares, options, convertible debentures where the debt holder has the option to convert

the loan instruments into stock of the borrower or a debt with warrants to equity investment. The funds in the form of equity help to raise term loans that are cheaper source of funds. In the early stage of business, because dividends can be delayed, equity investment implies that investors bear the risk of venture and would earn a return commensurate with success in the form of capital gains.

PARTICIPATION IN MANAGEMENT

Venture capital provides value addition by managerial support, monitoring and follow up assistance. It monitors physical and financial progress as well as market development initiative. It helps by identifying key resource person. They want one seat on the company's board of directors and involvement, for better or worse, in the major decision affecting the direction of company. This is a unique philosophy of "hands on management" where Venture capitalist acts as complementary to the entrepreneurs. Based upon the experience other companies, a venture capitalist advise the promoters on project planning, monitoring, financial management, including working capital and public issue. Venture capital investor cannot interfere in day today management of the enterprise but keeps a close contact with the promoters or entrepreneurs to protect his investment.

LENGTH OF INVESTMENT

Venture capitalist help companies grow, but they eventually seek to exit the investment in three to seven years. An early stage investment may take seven to ten years to mature, while most of the later stage investment takes only a few years. The process of having significant returns takes several years and calls on the capacity and talent of venture capitalist and entrepreneurs to reach fruition.

ILLIQUID INVESTMENT

Venture capital investments are illiquid, that is, not subject to repayment on demand or following a repayment schedule. Investors seek return ultimately by means of capital gains when the investment is sold at market place. The investment is realized only on enlistment of security or it is lost if enterprise is liquidated for unsuccessful working. It may take several years before the first investment starts to locked for seven to ten years. Venture capitalist understands this illiquidity and factors this in his investment decisions.

STAGES OF VENTURE CAPITAL FUNDING:

The Venture Capital funding varies across the different stages of growth of a firm.
Following are the various stages:

- **PRE SEED STAGE :-** Here, a relatively small amount of capital is provided to an entrepreneur to conceive and market a potential idea having good future prospects .The funded work also involves product development to some extent.

- **SEED STAGE:-** Financing is provided to complete product development and commence initial marketing formalities.

- **EARLY STAGE / FIRST STAGE:-** Finance is provided to companies to initiate commercial manufacturing and sales.

- **SECOND STAGE:-** In the Second Stage of Financing working capital is provided for the expansion of the company in terms of growing accounts receivable and inventory.

- **THIRD STAGE:-** Funds provided for major expansion of a company having increasing sales volume. This stage is met when the firm crosses the breakeven point.

- **BRIDGE / MEZZANINE FINANCING OR LATER STAGE FINANCING:-** Bridge /Mezzanine Financing or Later Stage Financing is financing a company just before its IPO (Initial Public Offer). Often, bridge finance is structured so that it can be repaid, from the proceeds of a public offering.

METHODS OF VENTURE FINANCING

Venture capital is typically available in three forms in India, they are:

- **EQUITY:-** All VCFs in India provide equity but generally their contribution does not exceed 49 percent of the total equity capital. Thus, the effective control and majority ownership of the firm remains with the entrepreneur. They buy shares of an enterprise with an intention to ultimately sell them off to make capital gains.

- **CONDITIONAL LOAN :-** It is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India, VCFs charge royalty ranging between 2 to 15 percent; actual rate depends on other factors of the venture such as gestation period, cost-flow patterns, riskiness and other factors of the enterprise.

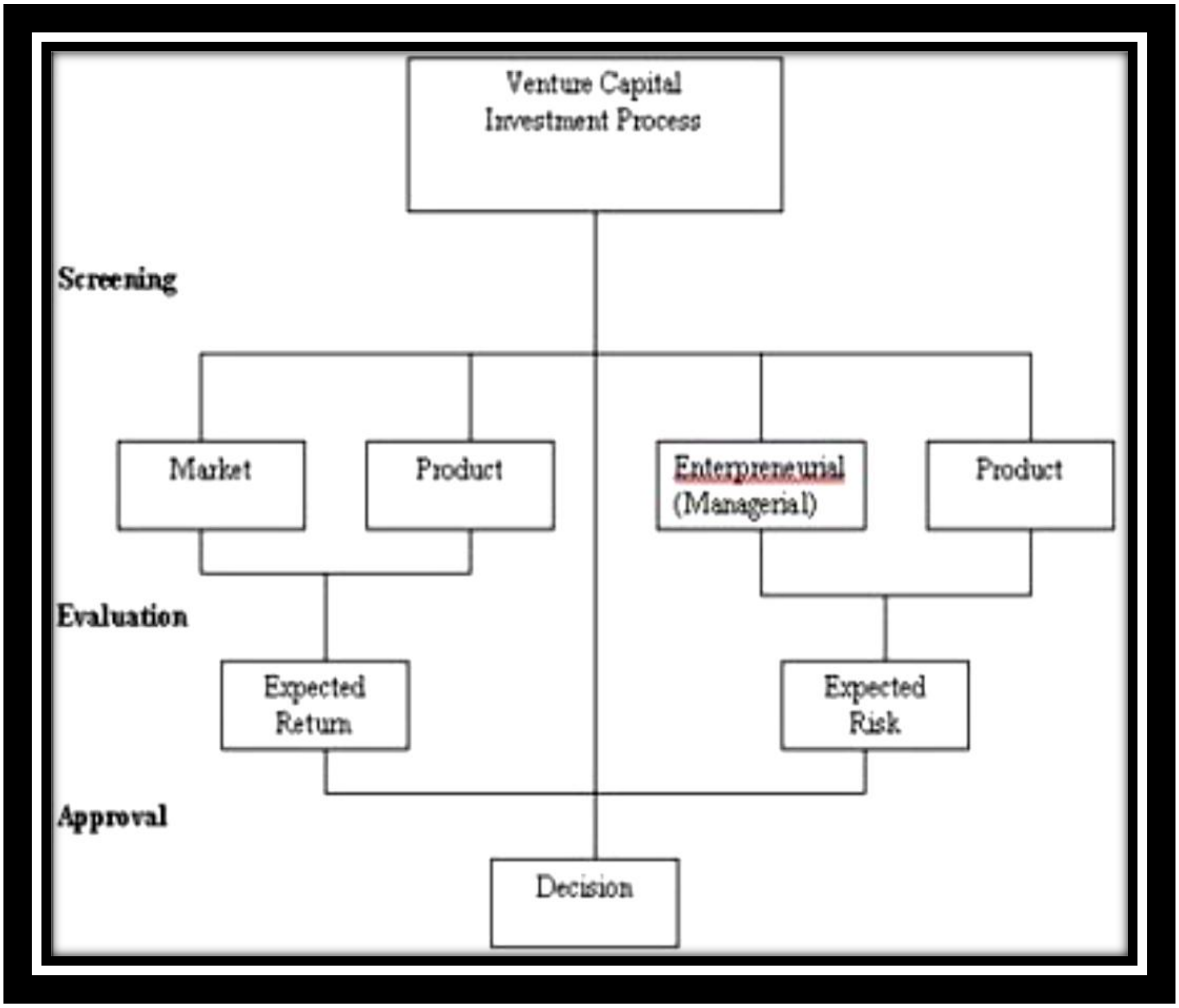
- **INCOME NOTE:-** It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales, but at substantially low rates.

- **OTHER FINANCING METHODS :-** A few venture capitalists, particularly in the private sector, have started introducing innovative financial securities like participating debentures, introduced by TCFC is an example.

THE VENTURE CAPITAL PROCESS

The Venture Capital Investment Process is a meticulous process. The Venture Capital activity is a sequential process involving the following six steps:

- **DEAL ORIGINATION**
- **SCREENING**
- **DUE DILIGENCE EVALUATION**
- **DEAL STRUCTURING**
- **POST-INVESTMENT ACTIVITY**
- **EXIT**



INDIANMBA.COM (FIG 1.1)

DEAL ORIGINATION

- In generating a deal flow, the VC investor creates a pipeline of deals or investment opportunities that he would consider for investing in.
- Deal may originate in various ways. Referral system, Active search system, and intermediaries. Referral system is an important source of deals.

- Deals may be referred to VCFs by their parent organizations, trade partners, industry associations, friends etc. Another deal flow is active search through networks, trade fairs, conferences, seminars, foreign visits etc.

- Intermediaries is used by venture capitalists in developed countries like USA, is certain intermediaries who match VCFs and the potential entrepreneurs.

SCREENING

- VCFs, before going for an in-depth analysis, 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.

DUE DILIGENCE

- Due diligence is the industry jargon for all the activities that are associated with evaluating an investment proposal. The venture capitalists evaluate the quality of entrepreneur before appraising the characteristics of the product, market technology. Most venture capitalists ask for a business plan to make an assessment of the possible risk and return on the venture.

- Business plan contains detailed information about the proposed venture. The evaluation of ventures by VCFs in India includes;

- Preliminary evaluation: The applicant required to provide a brief profile of the proposed venture to establish prima facie eligibility.

- Detailed evaluation: Once the preliminary evaluation is over, the proposal is evaluated in greater detail. VCFs in India expect the entrepreneur to have:-Integrity, long-term vision, urge to grow, managerial skills, commercial orientation.

- VCFs in India also make the risk analysis of the proposed projects which includes:

- Product risk, Market risk, Technological risk and Entrepreneurial risk. The final decision is taken in terms of the expected risk-return trade-off as shown in Figure.

- Deal Structuring: Structuring refers to putting together the financial aspects of the deal and negotiating with the entrepreneurs to accept a venture capital's proposal and finally closing the deal.

- To do a good job in structuring, one needs to be knowledgeable in areas of accounting, cash flow, finance, legal and taxation. Also the structure should take into consideration the various commercial issues (ie what the entrepreneur wants and what the venture capital would require protecting the investment).

- Documentation refers to the legal aspects of the paperwork in putting the deal together. The instruments to be used in structuring deals are many and varied. The objective in selecting the instrument would be to maximize (or optimize) venture capital's returns/protection and yet satisfies the entrepreneur's requirements. The instruments could be as follows:

INSTRUMENT	ISSUES
LOAN	Clean vs Secured
	Interest Bearing vs Non Interest Bearing
	Convertible vs One with features (warrants)

	1st Charge, 2nd Charge,
	Loan vs Loan Stock
	Maturity
Preference shares	**Redeemable (conditions under Company Act)**
	Participating
	Par Value
	Nominal Shares
Warrants	**Exercise Price**
	Expiry Period
Common shares	**New or Vendor Shares**
	Par Value
	Partially-Paid Shares

FIGURE 1.2

- In India, straight equity and convertibles are popular and commonly used. Nowadays, warrants are issued as a tool to bring down pricing.

- A variation that was first used by PACT and TDICI was "royalty on sales". Under this, the company was given a conditional loan. If the project was successful, the company had to pay a % age of sales as royalty and if it failed then the amount was written off.

- In structuring a deal, it is important to listen to what the entrepreneur wants, but the venture capital comes up with his own solution. Even for the proposed investment amount, the venture capital decides whether or not the amount requested is appropriate and consistent with the risk level of the investment.

- The risks should be analyzed, taking into consideration the stage at which the company is in and other factors relating to the project. (eg exit problems, etc)

POST INVESTMENT ACTIVITIES

- Once the deal has been structured and agreement finalized, the venture capitalist generally assumes the role of a partner and collaborator. He also gets involved in shaping of the direction of the venture.

- 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.

EXIT

- Venture Capitalists 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 may exit in one of the following ways:

- Initial public offerings (IPO's)
- Acquisition by another company
- Purchase of the Venture Capitalists shares by the promoter,
- Purchase of the Venture Capitalists share by an outsider.

CONCLUSION

Venture Capital is money invested in businesses that are small; or exist only as an initiative, but have huge potential to grow. The people who invest this money are called venture capitalists (VCs). The venture capital investment is made when a venture capitalist buys shares of such a company and becomes a financial partner in the business. Venture Capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms.

It is the money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there’s a significant risk associated with the company’s future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan.

Venture Capital is the most suitable option for funding a costly capital source for companies and most for businesses having large up-front capital requirements which have no other cheap alternatives. ***Software and other intellectual property*** are generally the most common cases whose value is unproven. That is why; Venture capital funding is most widespread in the fast-growing technology and biotechnology fields.

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