VENTURE CAPITAL

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- Jane Koloski Morris, editor of the well known industry publication, venture Economics, defines 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 access to the public securities market or to credit oriented institutional funding sources…."***

VENTURE CAPITAL

- The European Venture Capital Association describes it as risk finance for entrepreneurial growth oriented companies.

- It is investment for the medium – or long-term seeking to maximize medium –or-long –term return for both parties.

VENTURE CAPITAL

- In an attempt to define venture capital as generically as possible for an international study , International finance corporation , Washington D.C. 17C(W) defines …..
- ***VC as an equity or equity featured capital seeking investment in new ideas, new companies, new products, new process or new services, that offer the potential of high returns on investment***.

CHARACTERSTICS OF VENTURE CAPITAL

- Equity or equity-featured instrument of investment.
- Young companies that do not have access to public sources of equity or other forms of capital.
- Industry, products or services that hold potential of better that normal or average revenue growth rates.
- Companies with better than normal or average profitability.

CHARACTERSTICS OF VENTURE CAPITAL

- Products/ services in the early stages of their life cycle.
- Higher than average risk levels that do not lend themselves to systematic quantification through conventional techniques and tools.
- Turnaround companies.
- Long-term (more than three years) and active involvement with investee.

History and Evolution

It started in 1946 in USA through American Research and Development Corporation of General Doriot.

Soon the popularity of VC spread to Canada, European countries and Asia.

In India, it started with the budget speech of the Finance Minister in 1988.

ICICI came forthwith initiatives for addressing technology intensive projects.

Pursuant to the budget speech in 1988, a cess of 5% was levied on all payments for import of technology/knowhow resulting in creation of Venture Fund to be administered by IDBI.

Enabling Environment for VC

- Enterprise Culture
- Professional Entrepreneurship
- Tax Policy
- Developed Capital Market
- Free Market Forces

STAGES IN COMPANY FINANCING

Early –stage financing

Seed financing is a relatively small amount of capital provided to an entrepreneur to prove a concept. It may include product development and market research as well as building of management team and developing a business plan, if the initial steps are successful.

Start-up financing is provided to companies completing product development and initial marketing. Companies may be in the process of organization or they may already be in business for one year or less but may have not sold their product commercially.

First stage financing is provided to companies that have expended their initial capital (often in developing and market testing a prototype) and require funds to initiate full scale manufacturing and sales.

EXPANSION FINANCING

Second Stage Financing is working capital for the initial expansion of a company that is producing and shipping and has growing accounts receivables and inventories.

Third Stage or Mezzanine Financing is provided for major expansion of a company when sales volume is increasing and that is breaking even or profitable. These funds are used for further plant expansion, marketing, working capital or development of an improved product.

Bridge Financing is needed at times when a company plans to go public within six months to a year. Often bridge financing is structured so that, it can be repaid from the proceeds of a public underwriting.

ACQUISTION (BUYOUT) FINANCING

- Acquisition financing provides funds to finance an acquisition of another company.
- Management /Leveraged Buyout fund enable a operating management group to acquire a product line or business (which may be at any stage of development) from either a public or private company; often these companies are closely held or family owned.

THE VENTURE INVESTMENT PROCESS

- The VC investment process has variances/ feature that are context specific to countries/regions.
- However, activities in a VC fund follow a typical sequences with a number of commonalties.
- The typical stages in an investment cycle are as below:

THE VENTURE INVESTMENT PROCESS

Generating a Deal flow

Due Diligence

Investment Valuation

Pricing and Structuring the deal

Value Addition and Monitoring and

Exit

GENERATING A DEALFLOW

- In generating a deal flow, the VC investor creates a pipeline of ‘deals’ or investment opportunities that he would consider for investing in. This is achieved primarily through plugging into a appropriate network.
- The most popular network obviously is the network of VC funds/investor. It is also common for VC funds/investor to develop working relationships with R&D institutions, academia, etc., which could potentially lead to business opportunities.

DUE DILIGENCE

- Due diligence is the industry jargon for all the activities that are associated with evaluating an investment proposal .
- It includes carrying out reference checks on the proposal related aspects such as management team, products, technology and market.
- The important feature to note is that VC due diligence focuses on the qualitative aspects of an investment opportunity.

INVESTMENT VALUATION

The investment valuation process is an exercise aimed at arriving at an acceptable price for the deal.

It will go through the following sequence: Evaluate future revenue and profitability, Forecast likely value of the firm based on expected market capitalization or expected acquisition proceeds depending upon anticipated exit from investment, forecast the desired appreciation on the proposed investment (on a discounted cash flow basis).

STRUCTURING THE DEAL

- VC investment require and permit innovativeness in financial engineering.

- While VC investments follow no set formula, they attempt to address the needs and concerns of the investor and the investee.

STRUCTURING THE DEAL

The investor tries to ensure the following:

1. Reasonable reward for the given level of risks;
2. Sufficient influence on the management of the company through board representation.
3. Minimization of taxes; and
4. Ease in achieving future liquidity on the investment

STRUCTURING THE DEAL

The entrepreneur at the same time seeks to enable:

I. The creation of the business that he has conceptualized(operating and strategic control);
II. Financial rewards for creating the business;
III. Adequate resources needed to achieve their goal and;
IV. Voting control.

STRUCTURING THE DEAL

Common considerations for both sides include:

I. Flexibility of structure that will allow room to enable additional investments later, incentives for future management and retention of stock if management leaves.
II. Balance sheet attractiveness to suppliers and debt financiers.
III. Retention of key employees through adequate equity participation

VALUE ADDITION AND MONITORING

- This process of the VC investor’s involvement in the portfolio company is often referred to broadly as ‘value addition’ .
- The ‘value’ that the VC brings to the portfolio company can vary from one VC professional to another depending upon the individual's background and approach to VC.
- There are VC professionals, especially those who invest in very early stage situations, whose involvement can go up to providing operating management support.

VALUE ADDITION AND MONITORING

- Monitoring portfolio companies is a straightforward, yet delicate task.

- The straightforwardness lies in the well established tools and techniques that are, used for the purpose: periodic reports, Board of Directors meetings, review sessions and so forth.

EXIT

The process of exiting from a VC investment is as important as in any other process in the investment cycle. The two exit options are:

1. Sale of the VC's position either along with or subsequent to a public offering ; and
2. Acquisition of the company

Difference between Venture Capital and Angel Investors

- Risk: High risk for Angel Investors than Venture Capitalists (VCs).
- Return: Expected rate of return (ROI) is higher for Angel Investors.
- Source of Funds: Angel investors use their own funds whereas VCs use the funds of other people.
- Quantum of funds: The quantum of funds is more for VCs than Angel Investors.
- Stage of financing: Angel Investment is for the early stage whereas VC investment is for later stage of entrepreneurial ventures.
- Authority: VCs exert more authority (even sits on board of companies) than Angel Investors.