VENTURE CAPITAL FINANCING

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Introduction

Venture

A project or activity that involves risk

Venture Capital

The capital invested in a project in which there is a substantial element of risk, typically a new or expanding business.

Capital

The money or fund needed business

WHAT IS VENTURE CAPITAL

Money provided by investors to startup firms and small businesses with perceived long-term growth potential.

Venture capital (VC)

- It is a type of private equity, a form of financing that is provided by firms or funds to small, early-stage, emerging firms that are deemed to have high growth potential, or which have demonstrated high growth (in terms of number of employees, annual revenue, or both).

- Venture capital firms or funds invest in these early-stage companies in exchange for equity, or an ownership stake, in the companies they invest in.

- Venture capitalists take on the risk of financing risky start-ups in the hopes that some of the firms they support will become successful.

- Because startups face high uncertainty, VC investments do have high rates of failure.

- The start-ups are usually based on an innovative technology or business model and they are usually from the high technology industries

Venture Capitalist

- A **venture capitalist** (VC) is a person who makes such investments, these include wealthy investors, investment banks, other financial institutions other partnerships.

- Venture Capitalists generally:
  - Finance new and rapidly growing companies
  - Purchase equity securities
  - Assist in the development of new products or services
  - Add value to the company through active participation.

Features of Venture Capital

- **High-risk investment:** It is highly risky and the chances of failure are much higher as it provides long-term startup capital to high risk-high reward ventures.
- **High Tech projects**: Generally, venture capital investments are made in high tech projects or areas using new technologies as they have higher returns.
- **Participation in Management**: Venture Capitalists act complementary to the entrepreneurs, for better or worse, in making decisions for the direction of the company.
- **Length of Investment**: The investors eventually seek to exit in three to seven years. The process takes several years for having significant returns and also need the talent of venture capitalist and entrepreneurs to reach completion.
- **Illiquid Investment**: It is an investment that is not subject to repayment on demand or a repayment schedule.

Importance of Venture Capital

- Venture Capital institutions lets entrepreneurs convert their knowledge into viable projects with the assistance of such Venture Capital institutions.
- It helps new products with modern technology become commercially feasible.
- It promotes export oriented units to earn more foreign exchange.
- It not only provide the financial institution but also assist in management, technical and others.
- It strengthens the capital market which not only improves the borrowing concern but also creates a situation whereby they can raise their own capital through capital market.
- It promotes modern technology through the process where financial institutions encourage business ventures with new technology.
- Many sick companies get a turn around after getting proper nursing from such Venture Capital institutions.

Objectives of Venture Capital in India

- It allows for the working together of capitalists and startups/businesses closely and for the promoting of entrepreneurs to focus on making more and more ideas.
- It creates an environment suitable for knowledge and technology-based enterprises.
- It helps to boost scientific, technology and knowledge-based ideas into a powerful engine of economic growth and wealth creation in a suitable manner.
- It aims to play a catalytic role to India on the world map as a success story.

Process Of Venture Capital Financing

- The Venture Capital Funding process gets completed in six different stages:

Stages of Venture Capital

Financial Stage	Meaning	Period (Funds locked in years)	Risk Perception	Activity to be financed
Seed Money	Low level financing needed to prove a new idea.	7-10	Extreme	For supporting a concept or idea or R&D for product development
Start Up	Early stage firms that need funding for expenses associated with marketing and product development.	5-9	Very High	Initializing operations or developing prototypes
First Stage	Early sales and manufacturing funds.	3-7	High	Start commercials production and marketing

Financial Stage	Meaning	Period (Funds locked in years)	Risk Perception	Activity to be financed
Second Stage	Working capital for early stage companies that are selling product, but not yet turning a profit .	3-5	Sufficiently high	Expand market and growing working capital need
Third Stage	Also called Mezzanine financing, this is expansion money for a newly profitable company .	1-3	Medium	Market expansion, acquisition & product development for profit making company
Fourth Stage	Also called bridge financing, it is intended to finance the "going public" process .	1-3	Low	Facilitating public issue

VC INVESTMENT PROCESS

Step 1: Idea generation and submission of the Business Plan

- The initial step in approaching a Venture Capital is to submit a business plan. The plan should include the below points:
- There should be an executive summary of the business proposal
- Description of the opportunity and the market potential and size
- Review on the existing and expected competitive scenario
- Detailed financial projections
- Details of the management of the company
- There is detailed analysis done of the submitted plan, by the Venture Capital to decide whether to take up the project or no.

Step 2: Introductory Meeting

- Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project in detail.
- After the meeting the VC finally decides whether or not to move forward to the due diligence stage of the process.

Step 3: Due Diligence

- The due diligence phase varies depending upon the nature of the business proposal.
- This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews, and other such exchanges of information during this time period.

Step 4: Term Sheets and Funding

- If the due diligence phase is satisfactory, the VC offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement.
- The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.

Step 5: Exit route

There are various exit options for Venture Capital to cash out their investment:

- IPO
- Promoter buyback
- Mergers and Acquisitions
- Sale to other strategic investor

Methods of venture capital

Equity

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Conditional loan

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Income note

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Other financing method

Methods of Venture Financing

- A pre-requisite for the development of an active venture capital industry is the availability of a variety of financial instruments which cater to the different risk-return needs of investors. They should be acceptable to entrepreneurs as well.

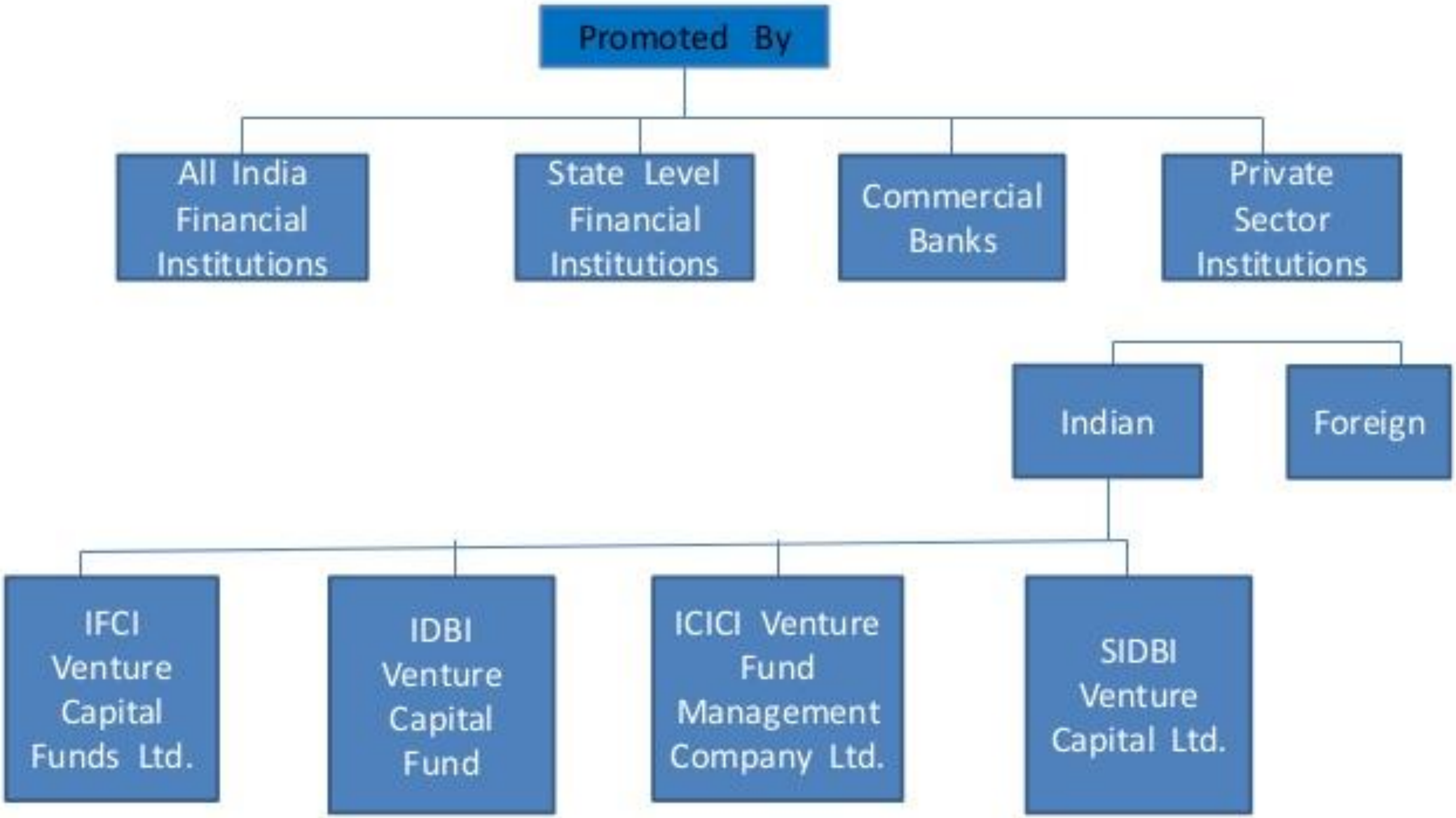
- Venture capital financing took in forms of
  - Equity and quasi equity
  - Conditional Loan
  - Income notes
  - Convertible Debentures
  - Cumulative Convertible Preference Share

- **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.
- **Quasi Equity:** A form of finance that combines some of the benefits of equity and debt
- **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.

VENTURE CAPITAL FUNDING IN INDIA

Venture Capital in India
Evolution of Venture Capital

- In 1983, the first analysis was reported on risk capital in India.
- It indicated that new companies often face barriers while entering into the capital market and also for raising equity finance which weakens their future expansion and growth.
- It also indicated that on the whole, there is a need to assess the equity cult by ensuring competitive return on equity investment.
- This all came out as institutional inadequacies and resulted in the evolution of Venture Capital.
- In India, IFCO was the first institution to initiate the idea of Venture Capital when it established the Risk Capital Foundation in 1975.
- It provided the seed capital to all small and risky projects. However, the concept of Venture Capital got its recognition for the first time in the budget for the year 1986-87.


Promoted By
All India Financial Institutions
State Level Financial Institutions
Commercial Banks
Private Sector Institutions
Indian
Foreign
IFCI Venture Capital Funds Ltd.
IDBI Venture Capital Fund
ICICI Venture Fund Management Company Ltd.
SIDBI Venture Capital Ltd.

Venture capital funds in India

VCFs in India can be categorized into following five groups:

1) Those promoted by the Central Government controlled development finance institutions. For example:
   - ICICI Venture Funds Ltd.
   - IFCI Venture Capital Funds Ltd (IVCF)
   - SIDBI Venture Capital Ltd (SVCL)

2) Those promoted by State Government controlled development finance institutions.

For example:

- Punjab Infotech Venture Fund
- Gujarat Venture Finance Ltd (GVFL)
- Kerala Venture Capital Fund Pvt Ltd.

3) Those promoted by public banks.

For example:

- Canbank Venture Capital Fund
- SBI Capital Market Ltd

4)Those promoted by private sector companies.

For example:

- IL&FS Trust Company Ltd
- Infinity Venture India Fund

5)Those established as an overseas venture capital fund.

For example:

- Walden International Investment Group
- HSBC Private Equity management Mauritius Ltd

REASONS FOR GROWTH OF VENTURE CAPITAL

- High Technology
- Human Resource Capital
- Scientific & Technical Research
- Government Initiative
- SEBI Initiative

How does the Venture Capital work?

- Venture capital firms typically source the majority of their funding from large investment institutions.
- Investment institutions expect very high ROI
- VC's invest in companies with high potential where they are able to exit through either an IPO or a merger/acquisition.
- Their primary ROI comes from capital gains although they also receive some return through dividend.

Advantages of Venture Capital

- **Expansion of Company**: Venture capital provides large funding that a company needs to expand its business.
- It has the ability for company expansion that would not be possible through bank loans or other methods.

- **Expertise joining the company**: Venture capitalists provide valuable expertise, advice and industry connections.
- These experts have deep knowledge of specific market standards and they can help avoid business from many downsides that are usually associated with startups.

- **Better Management**: It's not always that being an entrepreneur one is also a good business manager. However, since Venture Capitalists hold a percentage of equity in the business. They will have the power to say in the management of the business. So if one is not good at managing the business, this is a significant benefit.
- **No Obligation to repay**: In addition, there is an obligation to repay to investors as it would be in case of banks loans. Rather, investors take the investment risk on their own shoulders because they believe in the company's future success.
- **Value Added Services**: Venture Capitalists provide HR Consultants, who are specialist in hiring the best staff for your business. This helps in avoiding to hire the wrong person. It also offers a number of other such services such as mentoring, alliances and also facilitates the exit.

Disadvantages of Venture Capital

- **Complex Process:** It is a lengthy and complex process which needs a detailed business plan and financial projections. Until and unless the Venture Capitalists are properly satisfied with the business plan, whether or not it will succeed in the future, they won't invest. So securing a deal with a Venture Capitalist can be a long and complex process.
- **Loss of control:** Venture Capital firms add one of their team members to the management team, while this is usually done for ensuring the success of the business, it can also create internal problems.
- **Loss over decisions:** Another big problem faced in Venture Capital funding is that one will have to give up many key decisions on how the company will process or operate.
- This is because Venture Capitalist are required to be informed about all the key decision relating to business plans, and they usually ***can override such decision*** if they are unsatisfied with the decision.

- **No Confidentiality:** Generally Venture Capitalist treat information confidentially. But they refuse to sign non-disclosure agreement due to the legal ramification of doing so. This puts the ideas at risk, especially when they are new. Further, investors will expect regular information and consultation to check how things are progressing.
- For example, accounts and minutes of board meetings.
- **Quick Liquidity:** Most Venture Capitalists seek to realize their investment in the company in three to five years.
- If the business plan expects a longer timetable before providing liquidity, then Venture Capital funding may not be a suitable option.

DisInvestment/Exit Mechanism

- An important aspect of venture capital investing is the exit strategies. Venture capital funds primarily invest with an exit in mind after a few years.
- After successfully funding at seed, pre-production, production and expansion stages, a venture capitalist will start assessing exit strategies.
- The exit in the form of disinvestment or liquidation is the last and final stage of the venture capital funding.
- The key types of liquidation/disinvestment are trade sales, sale of quoted equity post initial public offering (IPO), and write-offs. Let's look at each of these in detail:

- **Trade Sales**: In this type of strategy the private company is sold or merged with an acquirer for stocks, cash, or a combination of both.

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- **IPO**: If the company has done well, the venture capital investors will take the IPO route, by issuing shares registered for public offering.
- An example is the upcoming Facebook IPO, which is expecting to raise about $15 billion through IPO and is valued at approx. 100 billion.
- The venture capital investors and other private investors will get their portion of shares who can put them in the open marketplace for trading after an initial lock-in period

- **Write-offs**: These are voluntary liquidations that may or may not result in any proceeds.
- Apart from the above three types of disinvestment, there are a few other options:

- **Bankruptcy:** The company may just go bankrupt.

- **Buy-back:** In this method the entrepreneur buys-back the investment share from the venture capitalists and takes it back to being a privately held company.
- Investors who invest in a venture capital fund get distributions of public stock or cash from realized venture capital investments. Sometimes the fund may require further investments from limited partners.
- At other times, they may make cash or share distributions at random times during the lifetime of the fund.
- Investors can sell their interests to another buyer if they find one.

VC at a Glance

FEATURES

PROMOTER'S BUYBACK

1. Generally Equity participant
2. May be also convertible debenture or long term Loan
3. Available for commercializati on of new Idea.

Investment in high risk and high growth projects

Disinvestment Mechanism

1. Promoter's buyback
2. Public Issue
3. Sale to other VCs
4. Sale in OTC Market
5. Management buyouts

Act as Co-Promoters Continuous Involvement Once the venture reaches full potential divest his investment Investment in small medium scale enterprises. Also provide inputs in design, strategy

CHARACTERISTICS

- New Ventures. Use new technology to produce new products with high return
- Continuous involvement- providing loans and managerial skills
- Mode- equity financing for new companies- loan and convertible debentures
- High risk return ventures
- Hands on- value added service, and not interfere in management
- Objective- capital gain on equity when exit, regular return on debt
- Nature of business- Small and medium enterprise.
- Liquidity depends on the success of the ventures

G/

intel Capital

QUALCOMM VENTURES

salesforce ventures

NVF

Johnson & Johnson DEVELOPMENT CORPORATION

SAMSUNG VENTURES

SR·one

Cisco Investments

COMCAST VENTURES

Roche

Microsoft Ventures

novo holdings

ALEXANDRIA

TimeWarner

T · · CAPITAL PARTNERS

Pfizer VENTURE INVESTMENTS

GE VENTURES

MITSUI GLOBAL INVESTMENT

BAI Bertelsmann Asia Investments