



VENTURE CAPITAL FINANCING – A BLESSING FOR ENTREPRENEURS

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ABSTRACT

Venture Capital is a significant innovation of 20th century. It was originated and popularised in USA in 60's. Venture Capital refers to the investment of capital in relatively high risk enterprise. The investor in such a case is known as Venture Capital Firm (VCF) or venture capitalist and the business enterprise involving risk where investment is to be made is known as Venture Capital Undertaking (VCU).

The present paper tries to focus on the importance of venture capital financing for those entrepreneurs who have a new, innovative idea but no money to convert that idea into reality. This paper discusses the advantages of venture capital financing and the must-haves or requirements which an entrepreneur must fulfil if he wants to raise funds through venture capital. According to a research, only one or two ideas out of hundred are selected for funding by venture capital firms. There is a huge scope for venture capital financing in India, the need is to understand its value, how to raise it keeping in mind the regulations made by Indian Government and other factors which have been discussed in this paper.

KEYWORDS: Venture Capital, risk, Venture Capital Undertaking (VCU), Venture Capital Firm (VCF) or venture capitalist, capital gain.

Introduction

Financial institutions and bankers primarily cater to projects with minimum investment risk, maximum security of lending and uniform return from an early stage investment. Conventional financing schemes are basically security-oriented and are meant for projects based on proven technology.

There are many entrepreneurs with good innovative ideas, but lack the necessary funds to commercialize them. Venture capital can open new avenues for each entrepreneur. It plays an important role in financing high technology projects and helps to turn research and development into commercial production. Besides financing technology, venture capitalist is also involved in fostering the growth and development of enterprises.

“Venture capital financing, generally implying long-term investment in high risk industrial projects with high reward possibilities, may be at any stage of implementation of the project or its production cycle, viz. to start up an economic activity or an industrial or commercial project or to improve a process or a product in an enterprise associated with both risk and reward.”

“This is a business of ambiguity and adversity- ambiguity in that often the venture capitalist must read between the lines, based on his general knowledge and experience, to derive the real state of affairs for an investment, ambiguity in that the investments are often highly illiquid and must be held through good times and bad-ambiguity in that most entrepreneurs have a love/hate relationship with the venture capitalists. They want the money of venture capitalists, and at times, their counsel, but want to be free of limitations and controls. They, in most investments in this risky business go through the valley of death at least once. Prior to becoming successful, venture capital investments go many places most reasonable men would rather not. Creative business development often depends on unreasonable men.”

ADVANTAGES OF VENTURE CAPITAL

Venture Capital bridges the gap where traditional sources of funds actively cannot participate in funding new ventures. Venture Capital gives smart advice, managerial and other skills that help the entrepreneurial vision to be converted to marketable products. Over the last decade Venture Capital financing has grown phenomenally to the extent that as per a report of Perqin, by August 2015, over 500 deals had been funded in the financial year 2015-16 with an investment of over USD 6bn. It was this phenomenal investment that made the Government of India also announce its own INR 10,000 Cr start up fund in 2016.

There are certain advantages that Venture Capital brings to VCF along with funding. These are:

1. Venture Capital investors always remain active.
2. They allow the entrepreneurs to run their business, but they keep a crucial watch and guide them as and when they feel necessary.
3. They help the businesses grow, be it in the form of acquiring new technology, marketing, diversifying which otherwise would not have been possible for the start up

4. They are ready to invest in high risk prone businesses.
5. They build a base for quality IPOs in the future thus helping the money market to grow.
6. They assist the companies in raising further funds.

Venture Capital is thus no more only a financing agency but also a tool and a mentoring platform for the start ups to grow and seek guidance from. Venture capital's importance rises from the fact that it is patient and risk capital without which nascent ideas would not be nurtured.

THE CURRENT SCENARIO

Across the globe, it is encouraging to see such a significant increase in the amount of capital being invested in young, innovative companies. With the improvement in performance, many investors are looking to put more capital to work in venture capital funds. This is likely to encourage even greater levels of venture capital financing in the years to come, says Christopher Elvin, Preqin Head of Private Equity Products. Year 2014 was a great year for the Venture Capital Industry. It recorded a significant improvement in its performance. The amount of venture capital invested in 2014 was \$87bn, over 58% increase over previous year. The average return on venture capital fund was 26%, higher than any other private equity fund type.

Although, Venture Capital industry has mostly been centred in North America, but more recently, there have been encouraging signs in emerging economies. Five of the top 10 largest venture capital investments last year were in China and India. The aggregate value of deals in both countries jumped three times over previous year. China witnessed around 500 deals valued at \$13bn and India around 400 deals valued at \$5 bn. China and India which together constitute one-third of world population offer good opportunities for start-ups. Though the two countries did not go into recession, both are passing through slowdown phase. As start-ups usually might take five to 10 years to mature, the Venture Capital managers would have to wait longer to exit from their investments and make reasonable return. The VC managers need to frame a long term strategy to increase their activities in Asian countries. The investors would have to make long-term bets that create both higher risks and opportunities.

VENTURE CAPITAL VS. SEED CAPITAL

The seed capital is provided to conventional projects on the consideration of low risk and security and the use of conventional techniques for appraisal. Seed capital is normally in the form of low interest-deferred loan as against equity investment by venture capital. Unlike venture capital, seed capital providers neither provide any value addition nor participate in the management of the project.

VENTURE CAPITAL FUNDS- INVESTMENT CRITERIA

Venture capital companies do not invest in the firms where the credential of the management appears to be doubtful. The most important investment determinant of a venture capital fund is the quality of the management. George Doriot, the most successful venture capital funds expert in the USA says, “We can back a first rate management team with a second rate product and have success, but if we back a first rate product with a second rate management team, we can seldom

achieve our objectives.”

Only one or two business plans in 100, result in successful financing. Of every 10 investments made, only one or two are successful. But this is enough to recover investments made by the venture capital (VC) in all 10 start-ups in addition to an average 40-50% return! Securing an investment from an institutional venture capital fund is extremely difficult. It is estimated that only five business plans in 100 are viable investment opportunities and only three in 100 result in successful financing.

A Venture Capitalist looks at various aspects before investing in any venture. But there are basically four key elements in financing of ventures which are studied in depth by the venture capitalists:

1. Management: The strength, expertise & unity of the key people on the board brings significant credibility to the company. The members are to be mature, experienced possessing working knowledge of business and capable of taking potentially high risks.

2. Potential for Capital Gain: An above average rate of return of about 30 - 40% is required by venture capitalists. The rate of return also depends upon the stage of the business cycle where funds are being deployed. Earlier the stage, higher is the risk and hence the return.

3. Realistic Financial Requirement and Projections: The venture capitalist requires a realistic view about the present health of the organisation as well as future projections regarding scope, nature and performance of the company in terms of scale of operations, operating profit and further costs related to product development through Research & Development.

4. Owner's Financial Stake: The financial resources owned & committed by the entrepreneur/ owner in the business including the funds invested by family, friends and relatives, play a very important role in increasing the viability of the business. It is an important avenue where the venture capitalist keeps an open eye.

PROBLEMS IN VENTURE CAPITAL INDUSTRY

Regularly there is information of yet another international VC setting its sights on India. In spite of all the good things happening, there continue to be some problems faced by the venture-capital industry in India. Some of them are:

- i. Large established firms with strong growth figures look like a very attractive proposition. So, many venture-capital firms prefer to invest in established firms rather than get into riskier early-stage investments.
- ii. When the stock markets are in boom, investments in public-listed firms give returns in excess of 30 per cent, at far lesser perceived risk than in investing in new ventures.
- iii. Indian entrepreneurs are perceived as lacking in marketing and management skills. Most of the high-potential companies are being launched by persons who have proven tech skills but are yet to prove themselves as good managers or entrepreneurs.
- iv. Indian entrepreneurs are more reluctant to give up controls than their western counterparts. They would prefer to go for debt or even for raising money from friends and families.
- v. VCs face an exit challenge as there are limited opportunities for selling off their stake before an IPO.
- vi. The VC industry has always been accused of focusing only on a few sectors and ignoring many others. There continues to be a list of favoured industries such as IT and IT-enabled services, Banking and financial services.
- vii. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. Going forward, they want active participation in the company's management.

Venture capitalists mitigate the risk of venture investing by developing a portfolio of new companies in a single-venture fund. Many times, they co-invest with other professional venture-capital firms. In addition, many venture partnership manage multiple funds simultaneously. Venture capitalists have led to the growth of business resulting in significant job creation, economic growth, and international competitiveness. Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft, and Genentech are famous examples of companies that received venture capital early in their development.

PROSPECTS OF VENTURE CAPITAL FINANCING IN INDIA:

With the advent of liberalisation, India has been showing remarkable growth in the economy in the past 10 - 12 years. The government is promoting growth in capacity utilisation of available and acquired resources and hence entrepreneurship development, by liberalising norms regarding venture capital. While only

eight domestic venture capital funds were registered with SEBI during 1996-1998, 14 funds have already been registered in 1999-2000. Institutional interest is growing and foreign venture investments are also on the rise. Many state governments have also set up venture capital funds for the IT sector in partnership with the local state financial institutions and SIDBI. These include Andhra Pradesh, Karnataka, Delhi, Kerala and Tamil Nadu. The other states are to follow soon.

In the year 2000, the finance ministry announced the liberalisation of tax treatment for venture capital funds to promote them & to increase job creation. This is expected to give a strong boost to the non resident Indians located in the Silicon valley and elsewhere to invest some of their capital, knowledge and enterprise in these ventures. A Bangalore based media company, Graycell Ltd., has recently obtained VC investment totalling about \$ 1.7 million. The company would be creating and marketing branded web based consumer products in the near future.

The following points can be considered as factors which promote VC financing in India :-

- (i) Existence of a globally competitive high technology.
- (ii) Globally competitive human resource capital.
- (iii) Second Largest English speaking, scientific & technical manpower in the world.
- (iv) Vast pool of existing and ongoing scientific and technical research carried by large number of research laboratories.
- (v) Initiatives taken by the Government in formulating policies to encourage investors and entrepreneurs.
- (vi) Initiatives of the SEBI to develop a strong and vibrant capital market giving the adequate liquidity and flexibility for investors for entry and exit.

In a recent survey it has been shown that the VC investments in India's I.T. - Software and services sector (including dot com companies)- have grown from US \$ 150 million in 1998 to over US \$ 1200 million in 2002. The credit can be given to setting up of a National Venture Capital Fund for the Software and I.T. Industry (NFSIT) in association with various financial institutions of Small Industries and Development Bank of India (SIDBI). The facts reveal that VC disbursements as on September 30, 2002 made by NFSIT totalled Rs 254.36 mn.

The Indian government's budget for 2014-15 is clearly an investor-friendly one with a slew of provisions and funds earmarked for start-ups in India. Also, a start-up fund worth Rs 10,000 crore is being mulled by the government. According to Finance Minister Arun Jaitley, it will be "equity, quasi-equity, soft loan and other risk capital for start-ups."

This is encouraging news although angel investors and venture capitalists (VCs) have kept the start-up ecosystem thriving in India till date. Venture capital is an investment in the form of shares or a later stock option in potentially high-risk businesses. The beneficiary companies are usually small or medium-sized firms, requiring seed or early-stage funding for innovation and development of technology or products with high growth potential. High annual returns ranging from 25-75% are expected on such investments.

Conclusion:

It has been rightly said "Beyond fear lies the Victory." "No Risk, No Gain." There are many entrepreneurs with good innovative ideas which have high risk involved in them, but lack the necessary funds to commercialize them. Venture capital can open new avenues for each entrepreneur. It plays an important role in financing high technology projects and helps to turn research and development into commercial production. Besides financing, venture capitalist is also involved in fostering the growth and development of enterprises by contributing their experience and business skills gained from helping other companies with similar growth and challenges.

In this cut throat competition, there is an impending demand for highly cost effective, quality products and hence the need for right access to valuable human expertise to guide and monitor along with the necessary funds for financing the new projects.

The Government of India in an attempt to bring the nation at par and above the developed nations has been promoting venture capital financing to new, innovative concepts & ideas, liberalising taxation norms, providing tax incentives to venture firms. There is a huge scope for venture capital financing in India, the need is to understand its value, how to raise it keeping in mind the regulations made by Indian Government.

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