



SECTION - 3

VENTURE CAPITAL FINANCING

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3.1. INTRODUCTION

- 3.1.1 **Venture capital** is a type of private equity capital typically provided by professional, outside investors to new, high risk, high return and high-potential projects. Venture capital investments are generally made as cash in exchange for shares in the invested company. A **venture capitalist** (VC) is a person who makes such investments. A **venture capital fund** is a pooled investment vehicle (often an LLC or LP or HNI) that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans. VC Funding is generally for technology projects such as Information Technology, Bio Technology etc. When the technocrat entrepreneur is not able to convert his brilliant ideas into reality for want of initial capital, VCs come into picture. VCs undertake the risk by investing on behalf of original promoters, at a very high premium. They exit when the project can stand alone on its own by divesting their stake in one of the pre-determined ways. Venture capital can also include managerial and technical expertise.
- 3.1.2 Most venture capital comes from a group of wealthy investors, investment banks and other financial institutions that pool such investments or partnerships. This form of raising capital is popular among new companies, or ventures, with limited operating history, who cannot raise funds through a debt issue. The downside for entrepreneurs is that venture capitalists usually get a say in company decisions, by having a position in the Board of the company, in addition to a portion of the equity.



3.2. WHAT IS VENTURE CAPITAL ?

- 3.2.1 According to International Finance Corporation (IFC), venture capital is an equity or equity featured capital seeking investment in new ideas, new companies, new production, new process or new services that offer the potential of high returns on investments.
- 3.2.2 As defined in *Regulation 2(m) of SEBI (Venture Capital Funds) Regulation, 1996* “venture capital fund means a fund established in the form of a company or trust which raises monies through loans, donations issue of securities or units as the case may be and makes or proposes to make investments in accordance with these regulations.
- 3.2.3 Thus venture capital is the capital invested in young, rapidly growing or changing companies that have the potential for high growth. The VC may also invest in a firm that is unable to raise finance through the conventional means.

3.3. THE ORIGIN OF VENTURE CAPITAL

- 3.3.1 In the 1920's & 30's, the wealthy families provided the start up money for companies that would later become famous. Eastern Airlines and Xerox are the more famous ventures they financed. Among the early VC funds set up was the one by the Rockefeller Family which started a special fund called VENROCK in 1950, to finance new technology companies.
- 3.3.2 General Doriot, a professor at Harvard Business School, in 1946 set up the American Research and Development Corporation (ARD), the first firm, as opposed to a private individuals, at MIT to finance the commercial promotion of advanced technology developed in the US Universities. ARD's approach was a classic VC in the sense that it used only equity, invested for long term and was prepared to live with losers. ARD's investment in Digital Equipment Corporation (DEC) in 1957 was a watershed in the history of VC financing.
- 3.3.3 While in its early years VC may have been associated with high technology, over the years the concept has undergone a change and as it stands today it implies pooled investment in unlisted companies.

3.4. HOW VCS DIFFER FROM BANKS

- 3.4.1 Conventional financing generally extends loans to companies, while VC financing invests in equity of the company. Conventional financing looks to current income i.e. dividend and interest, while in VC financing returns are by way of capital appreciation. Assessment in conventional financing is conservative i.e. lower the risk, higher the chances of getting loan. On the other hand VC financing is a risk taking finance where potential returns outweigh risk factors.

- 3.4.2 Venture Capitalists also lend management support and provide entrepreneurs with many other facilities. They even participate in the management process. VC generally invest in unlisted companies and make profit only after the company obtains listing. VC extend need based support in a number of stages of investments unlike single round financing by conventional financiers.
- 3.4.3 VC are in for the long run and rarely exit before three years. To sustain such a commitment VC and private equity groups seek extremely high returns, a return of about 30% per annum. A bank or an FI will fund a project as long as it is sure that enough cash flow will be generated to repay the loans. VC is not a lender but an equity partner. Selectively VCs provide conditional loans also in addition to Equity.
- 3.4.4 Venture capitalists take higher risks by investing in an early-stage company with little or no history and they expect a higher return for their high-risk equity investment. Internationally, VCs look at an internal rate of return (IRR) of 40% plus. In India, the ideal benchmark is in the region of an IRR of 25% for general funds and more than 30% for IT-specific funds. With respect to investing in a business, institutional venture capitalists look for average returns of at least 40 per cent to 50 per cent for start-up funding. Second and later stage funding usually requires at least a 20 per cent to 40 per cent return compounded per annum. Most firms require large portions of equity in exchange for start-up financing.
- 3.4.5 The VC approach is called 'hockey-stick) concept. It means, in the initial years, the project profitability will tend to be lower and would slowly pick up there after year after year. This curve resembles hockey stick. In the initial years, the term lenders will lose patience and would pressurize for payments. Whereas, the VCs would extend enough support during this period.

3.5. TYPES OF VCS

- 3.5.1 Generally there are three types of organised or institutional venture capital funds: venture capital funds set up by angel investors, that is, high net worth individual investors; venture capital subsidiaries of corporations and private venture capital firms/ funds. Venture capital subsidiaries are established by major corporations, commercial bank holding companies and other financial institutions.
- 3.5.2 Venture funds in India can be classified on the basis of the type of promoters:
1. Financial institutions led by ICICI ventures, RCTC, ILFS, etc.
 2. Private venture funds like Indus, etc.
 3. Regional funds: Warburg Pincus, JF Electra (mostly operating out of Hong Kong).
 4. Regional funds dedicated to India: Draper, Walden, etc.
 5. Offshore funds: Barings, TCW, HSBC, etc.
 6. Corporate ventures : Venture capital subsidiaries of corporations
 7. Angels: High Net Worth individual investors
 8. Merchant bankers and NBFCs who specialize in "bought out" deals also fund companies.



INVESTMENT DECISIONS

3.6. INCUBATORS

- 3.6.1 They are generally non-profit entities that provide value added advisory, informational and certain support infrastructure which include productive office environment, finance and complementary resources. Incubators are mostly promoted by government or professional organisations seeking to develop small enterprises in a particular area. Some times venture capital funds also have their own incubators and companies also set up in-house incubators. Incubators support the entrepreneur in the pre-venture capital stage, that is, when he wants to develop the idea to a viable commercial proposition which could be financed and supported by a venture capitalist.

3.7. VC IN INDIA

- 3.7.1 This activity in the past was possibly done by the developmental financial institutions like IDBI, ICICI and State Financial Corporations. These institutions promoted entities in the private sector with debt as an instrument of funding.
- 3.7.2 For a long time funds raised from public were used as a source of VC. This source however depended a lot on the market vagaries. And with the minimum paid up capital requirements being raised for listing at the stock exchanges, it became difficult for smaller firms with viable projects to raise funds from public.
- 3.7.3 In India, the need for VC was recognised in the 7th five year plan and long term fiscal policy of GOI. In 1973 a committee on Development of small and medium enterprises highlighted the need to foster VC as a source of funding new entrepreneurs and technology. VC financing really started in India in 1988 with the formation of Technology Development and Information Company of India Ltd. (TDICI) - promoted by ICICI and UTI.
- 3.7.4 The first private VC fund was sponsored by Credit Capital Finance Corporation (CFC) and promoted by Bank of India, Asian Development Bank and the Commonwealth Development Corporation viz. Credit Capital Venture Fund. At the same time Gujarat Venture Finance Ltd. and APIDC Venture Capital Ltd. were started by state level financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high net-worth individuals. Though an attempt was also made to raise funds from the public and fund new ventures, the venture capitalists had hardly any impact on the economic scenario for the next eight years.

3.8. TAX BENEFITS

- 3.8.1 In terms of section 10(23 F) of IT Act income by exemptions way of dividend and long term capital gains received by approved VC Companies/ Funds from investment made by way of equity shares in a VC undertakings are exempt from tax.
- 3.8.2 IT rules amended on 18th July 1995 introduced a rule 2(D) which allowed tax exemption under the aforementioned section provided, among others,



- (1) An application is made to Director of IT (Exemptions) by the VCC or VCF
- (2) VCF/VCC is registered with SEBI.
- (3) Not less than 80% of the fund corpus/paid up capital is invested by year 3.
- (4) The VCC/VCF does not invest more than 5% of paid up capital/fund corpus in one VC undertaking.
- (5) VCC/VCF does not invest more than 40% in equity capital of one VC undertaking.

3.9. HOW VC'S INVEST IN A VENTURE ?

- 3.9.1 A Venture Capitalist looks at various aspects before investing in any venture. A strong management team - each member of the team must have adequate level of skills, commitment and motivation that creates a balance between members in areas such as marketing, finance and operations, research & development, general management, personnel management and legal and tax issues.
- 3.9.2 A viable idea - establish the market for the product or service, why customers will purchase the product, who the ultimate users are, who the competition is and the projected growth of the industry. Business plan: the plan should concisely describe the nature of the business, the qualifications of the members of the management team, how well the business has performed, and business projections and forecasts.
- 3.9.3 Unique Selling Proposition (USP) must be well defined;
- 3.9.4 Early entrant advantage has to be clearly established;
- 3.9.5 Return on Investment has to be in geometrical progression year after year vis-à-vis arithmetical progression in normal projects;
- 3.9.6 Exit option must be well provided for in the proposal itself
- 3.9.7 So while approaching a venture fund one needs to be fully prepared and keep the above requirements in mind while submitting the business plan.

3.10. THE VC PHILOSOPHY

- 3.10.1 As against Bought out deals (BODs) , VCs carry out very detailed due diligence and make 2-7 year investments. The VCs also hand-hold and nurture the companies they invest in besides helping them reach IPO stage when valuations are favourable. VCFs help entrepreneurs at four stages: idea generation, start-up, ramp-up and finally in the exit, which is done through M&As.
- 3.10.2 According to Indian Venture Capital Association, almost 41% (Rs 5146.40 m) of the total venture capital investment is in start-up projects followed by Rs 4478.60 m in later stage projects and only Rs 82.95 in turnaround projects . Majority have invested in only three stages of investment, indicating that most VCs in India have not started developing niches for investing with regard to the stages of projects.



- 3.10.3 The main difficulty in early stage funding are related to lack of exit opportunities as probability of an IPO or buy out by VC stake is less due to lack of understanding for evaluation of the knowledge based companies compared to the companies in the traditional sectors. Some such VCs are: ICICI ventures, Draper, SIDBI and Angels.

Funding growth or mezzanine funding till pre IPO :

The size of investment is generally less than US\$1mn, US\$1-5mn, US\$5-10mn, and greater than US\$10mn. As most funds are of a private equity kind, size of investments has been increasing. IT companies generally require funds of about \$ 5-10mn in an early stage which fall outside funding limits of most banks/institutions/VC funds and that is why the government is promoting schemes to fund start ups in general and in IT in particular.

Management of investee firms :

The venture funds add value to the company by active involvement in running of enterprises in which they invest. This is called “hands on” or “pro-active” approach. Draper falls in this category. Incubator funds like e-ventures also have a similar approach towards their investment. However there can be “hands off” approach like that of Chase. ICICI Ventures falls in the limited exposure category.

In general, venture funds who fund seed or start ups have a closer interaction with the companies and advice on strategy, etc while the private equity funds treat their exposure like any other listed investment. This is partially justified, as they tend to invest in more mature stories.

3.11. MAIN ALTERNATIVES TO VENTURE CAPITAL

- 3.11.1 As the strict requirements venture capitalists have for potential investments, many entrepreneurs seek initial funding from angel investors, who may be more willing to invest in highly speculative opportunities, or may have a prior relationship with the entrepreneur.
- 3.11.2 Furthermore, many venture capital firms will only seriously evaluate an investment in a start-up otherwise unknown to them if the company can prove at least some of its claims about the technology and/or market potential for its product or services. To achieve this, or even just to avoid the dilutive effects of receiving funding before such claims are proven, many start-ups seek to self-finance until they reach a point where they can credibly approach outside capital providers such as VCs or angels. This practice is called “bootstrapping”.



3.12. A GLOSSARY OF TERMS USED IN VENTURE CAPITAL FUNDING IS APPENDED AT THE END OF THE CHAPTER.

Venture Capital Glossary

Acquisition

The act of one company taking over controlling interest in another company. Investors often look for companies that are likely acquisition candidates, because the acquiring firms are often willing to pay a premium to the market price for the shares.

Angel Investors

Individuals that provide venture capital to seed or early stage companies.. Business angels can usually add value through their contacts and expertise.

Benchmarks

Benchmarks are performance goals against which a company's success is measured. Often, they are used by investors to help determine whether a company will receive additional funding or whether management will receive extra stock. Sometimes management will agree to issue more stock to its investors if the company does not meet its benchmarks, thus compensating the investor for the delay of his return.

Bridge Loans

Bridge Loans are short-term financing agreements that fund a company's operations until it can arrange a more comprehensive longer-term financing. The need for a bridge loan arises when a company runs out of cash before it can obtain more capital investment through long-term debt or equity.

Buyout

Funds provided to enable an enterprise to acquire another enterprise or product line or business.

Capital Gain

When an investor sells a stock, bond or mutual fund at a higher price than he or she paid for it.

Capital Under Management

The amount of capital available to a management team for venture investments.

Closing

The final event to complete the investment, at which time all the legal documents are signed and the funds are transferred.



Corporate Venturing

The practice of a large company taking a minority equity position in a smaller company in a related field.

Debt Financing

Money that business owners must pay back with interest. There are myriad types of debt financing, from simple commercial loans to bridge / swing loans in which a lender makes a short-term loan in anticipation of equity financing at a later stage in the development of a business.

Due Diligence

The investigation and evaluation of a management team's characteristics, investment philosophy, and terms and conditions prior to committing capital to the fund.

Equity Financing

Selling an interest in your business to an outside party to raise money.

Equity Offerings

Raising funds by offering ownership in a corporation through the issuing of shares of a corporation's common or preferred stock.

Executive Summary

Executive Summary refers to a synopsis of the key points of a business plan.

Exit

The sale or exchange of a significant amount of company ownership for cash, debt, or equity of another company.

Exit Route

The method by which an investor will realize an investment.

Follow-On

A subsequent investment made by an investor who has made a previous investment in the company — generally a later stage investment in comparison to the initial investment.

Fund Of Funds

An investment vehicle designed to invest in a diversified group of investment funds.

Going Private

The repurchasing of all of a company's outstanding stock by employees or a private investor. As a result of such an initiative, the company stops being publicly traded. Sometimes, the company might have to take on significant debt to finance the change in ownership structure.



Institutional Investors

It refers mainly to insurance companies, pension funds and investment companies collecting savings and supplying funds to markets, but also to other types of institutional wealth (e.g. endowment funds, foundations etc.).

IPO (Initial Public Offering)

Issue of shares of a company to the public by the company (directly) for the first time.

IRR

Compound Internal Rate of Return.

Lead Investor

The investor who leads a group of investors into an investment. Usually one venture capitalist will be the lead investor when a group of venture capitalists invest in a single business

Leveraged Buy-out (LBO)

An acquisition of a business using mostly debt and a small amount of equity. The debt is secured by the assets of the business.

Limited Partnerships

The legal structure used by most venture and private equity funds. Usually fixed life investment vehicles. The general partner or management firm manages the partnership using policy laid down in a Partnership Agreement. The Agreement also covers, terms, fees, structures and other items agreed between the limited partners and the general partner.

Liquidation

The sale of the assets of a portfolio company to one or more acquirors when venture capital investors receive some of the proceeds of the sale.

Lock-Up Period

The period an investor must wait before selling or trading company shares subsequent to an exit — usually in an initial public offering the lock-up period is determined by the underwriters.

Management Buy-in (MBI)

Purchase of a business by an outside team of managers who have found financial backers and plan to manage the business actively themselves.

Management Buy-out (MBO)

Funds provided to enable operating management to acquire a product line or business, which may be at any stage of development, from either a public or private company.



Mezzanine Financing

Financing for a company expecting to go public usually within 6–12 months; usually so structured to be repaid from proceeds of a public offerings, or to establish floor price for public offer.

Minority Enterprise Small Business Investment Companies (MESBICS)

MESBICs (Minority Enterprise Small Business Investment Companies) are government-chartered venture firms that can invest only in companies that are at least 51 percent owned by members of a minority group or persons recognized by the rules that govern MESBICs to be “economically disadvantaged.”

PIPE

Private Investment in Public Equities. Investments by a private equity fund in a publicly traded company, usually at a discount.

Portfolio company

The company or entity into which a fund invests directly.

Private Equity

Private equities are equity securities of companies that have not “gone public” (in other words, companies that have not listed their stock on a public exchange). Private equities are generally illiquid and thought of as a long-term investment. As they are not listed on an exchange, any investor wishing to sell securities in private companies must find a buyer in the absence of a marketplace. In addition, there are many transfer restrictions on private securities. Investors in private securities generally receive their return through one of three ways: an initial public offering, a sale or merger, or a recapitalization.

Raising Capital

It refers to obtaining capital from investors or venture capital sources.

Recapitalization

The reorganization of a company’s capital structure. A company may seek to save on taxes by replacing preferred stock with bonds in order to gain interest deductibility.

Return On Investment (ROI)

The internal rate of return on an investment.

Secondary Public Offering

This refers to a public offering subsequent to an initial public offering. A secondary public offering can be either an issuer offering or an offering by a group that has purchased the issuer’s securities in the public markets.



Secondary Purchase

Purchase of stock in a company from a shareholder, rather than purchasing stock directly from the company.

Seed Capital

Money used to purchase equity-based interest in a new or existing company. A venture capitalist's return usually comes from preferred stock, a share of profits, royalties or capital appreciation of common stock. Most venture capitalists look for companies with high growth potential.

Series A Preferred Stock

The first round of stock offered during the seed or early stage round by a portfolio company to the venture investor or fund. This stock is convertible into common stock in certain cases such as an IPO or the sale of the company. Later rounds of preferred stock in a private company are called Series B, Series C and so on.

Small Business Investment Companies (SBIC)

SBICs (Small Business Investment Companies) are lending and investment firms that are licensed by the federal government. The licensing enables them to borrow from the federal government to supplement the private funds of their investors. Some of these funds engage only in making loans to small businesses or invest only in specific industries. The majority, however, are organized to make venture capital investments in a wide variety of businesses.

Syndication

The process whereby a group of venture capitalists will each put in a portion of the amount of money needed to finance a small business.

Term Sheet

A non-binding agreement setting forth the basic terms and conditions under which an investment will be made. The Term Sheet is a template that is used to develop more detailed legal documents.

Turnaround

This word is used to describe businesses that are in trouble and whose management will cause the business to become profitable so they are no longer in trouble.

Venture Capital

Money used to purchase equity-based interest in a new or existing company. A venture capitalist's return usually comes from preferred stock, a share of profits, royalties or capital appreciation of common stock. Most venture capitalists look for companies with high growth potential.