CHAPTER - IV

Venture Capital - A Concept
VENTURE CAPITAL- A CONCEPT

Finance is defined as the provision of money at the time when it is required. Fund is one aspect, which is required by each and every organization. Managing these funds in the best possible way is most important. This involves decisions that result in the procurement and utilization of long-term and short-term funds depending on the nature of the business. The scope of managing funds or financial management extends to a wide range. In modern terms it is not only restricted to raising or procurement of funds but also the allocation of funds. The operating objective of any financial decision is wealth maximization i.e. creating net worth of the firm. This can be done through different modes of financing. Most of the modes are conventional in nature but some innovations in financial services have recently taken place. Venture Capital is one such service.

The dictionary meaning of 'venture' is a course of action, especially in business, of which the result is uncertain and there is a risk of loss or failure as well as a chance of gain or success. This is actually to risk going somewhere or doing something daring (Longman dictionary of contemporary English, 1993). 'Capital' means wealth, especially money which is used to produce more wealth or for starting a business. On combining the two, venture capital means money needed to start a risky or daring business. This is one of the reasons, it is also known as risk capital.

Venture institutes providing venture capital cater to the needs of industrial ventures involving high-risks on account of technological development both in case of Information Technology and biological up gradation as technological advancement is a must in these areas. The research and development activities for new advancements in technology require lots of funds. With the advent of venture capital institutes, the technological field has benefited a lot as it gets finances to progress with the research work. Venture capital funding has surpassed the conventional source of funding. It has become a source when an industry is technology based, entrepreneurs inexperienced and investment carries high risk of loss. Institutes, which provide venture capital emerged world over to fill gaps in the conventional financial mechanism focused on new
entrepreneurs, commercialization of new technology and support to small and medium enterprises in the manufacturing and service sectors (Khan, 1998). Venture capital is the provision of risk-bearing capital, usually in the form of participation in equity, to companies with high-growth potential. This is combined with value addition in the form of management advice and contribution to overall strategy. The relatively high risks for the venture capital investment are compensated by the possibility of high returns usually through substantial capital gains in the medium term (S Rakesh, 1998).

Venture capital financing is different from the conventional mode of financing and the difference lies in terms of uses, securities and requirements. Every mode of financing has its respective advantages and disadvantages. The different financing alternatives are summarized in chart-5.

In the Indian context, Venture capital means investment in the form of equity in unlisted manufacturing company locked in for a period of three years, with the maximum size of investment being up to 5% of the capital of fund and up to 40% of the investee companies equity. Venture funding is altogether a different business in advanced countries and the success ratio is just about 30%.

Most people define ‘Venture Capital’ as the money for start-ups and good ideas. Private investors or ‘angels’ are the principal source of capital for most start-ups and good ideas. Many venture capital companies however define venture capital as money for expansion of an existing business. Clients who rely on the fund managers to make appropriate investment generally fund large venture capital companies (Preparing for venture capital, Jeffrey M. Stoller; http://www.venturecapital.com). It can also be defined as an equity/equity related investment in a growth-oriented small/medium business to enable the investors to accomplish corporate objectives, in return for minority shareholding in the business or the irrevocable right to acquire it. Over the years the concept has shifted from technology oriented manufacturing organizations to being very close to ‘private equity class’ for unlisted new companies in all sectors of the economy irrespective of the nature of their projects (Khan, 1998).
# SUMMARY OF FINANCING ALTERNATIVES

<table>
<thead>
<tr>
<th>ALTERNATIVE</th>
<th>TERMS AND USES</th>
<th>SECURITY</th>
<th>REQUIREMENTS</th>
<th>ADVANTAGES</th>
<th>DISADVANTAGES</th>
<th>SOURCES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank lines of credit or revolving credit</td>
<td>1-3 years; borrowings often float as a percentage of receivables and/or inventory. Seasonal working capital use option.</td>
<td>Unsecured or secured by receivables, inventories, property, plant equipment, fixtures, etc.</td>
<td>Have collateral. Have established sales/earnings record. Have predictable cash flow.</td>
<td>No equity dilution. Support services. Interest deductions. Predictable interest. Flexibility to borrow and repay funds as need dictates.</td>
<td>May need collateral. Leverage can be expensive. Can impede additional financing. Restrictive debt covenants.</td>
<td>Commercial banks. Hybrid lenders. Commercial finance companies.</td>
</tr>
<tr>
<td>ALTERNATIVE</td>
<td>TERMS AND USES</td>
<td>SECURITY</td>
<td>REQUIREMENTS</td>
<td>ADVANTAGES</td>
<td>DISADVANTAGES</td>
<td>SOURCES</td>
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<td>DISADVANTAGES</td>
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<tr>
<td>Leases</td>
<td>Limited to life of asset leased.</td>
<td>1. Asset leased.</td>
<td>Have collateral. Have</td>
<td>No equity dilutions. Support services.</td>
<td>Need collateral. Interest rate may be higher. Payment may be required at end of</td>
<td>Commercial banks.</td>
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<td></td>
<td>Equipment needs. Real estate.</td>
<td></td>
<td>predictable cash flow.</td>
<td>Interest deductions. Interest predictable. May be fixed rate interest.</td>
<td>lease.</td>
<td>Leasing companies.</td>
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<td></td>
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<td></td>
<td></td>
<td>Lower repayment terms over life of asset. May not be capitalized.</td>
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</tr>
<tr>
<td>bonds/debentures</td>
<td>Equipment needs. Acquisitions, expansions.</td>
<td></td>
<td>record.</td>
<td>Interest predictable. Lower repayment terms. May be perceived as additional</td>
<td>Hard to obtain in difficult times. Leverage can be expensive. Can impede</td>
<td>Private and public markets</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Have predictable cash flow.</td>
<td>equity. May be fixed-rate interest.</td>
<td>additional financing. Restrictive debt covenants. Interest rate may be higher.</td>
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<td></td>
<td></td>
<td></td>
<td>Bond rating may be required.</td>
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<td>Generally not available to smaller companies.</td>
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<tr>
<td>ALTERNATIVE</td>
<td>TERMS AND USES</td>
<td>SECURITY</td>
<td>REQUIREMENTS</td>
<td>ADVANTAGES</td>
<td>DISADVANTAGES</td>
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<tr>
<td>Venture Capital (VC)</td>
<td>5-7 years. Exploiting new products, services or market niches. Seeking equity capital in leveraged buyout (LBO). Equipment needs. Acquisitions, expansions.</td>
<td>Equity company.</td>
<td>Need start-up seed capital with potential for rapid growth. Need early stage second- or third-round capital, with potential for rapid growth. Established and growing rapidly.</td>
<td>Management and financial expertise from equity investor. Strength of equity (i.e. greater leverage and cash flow). Enables company to mature enough to make public financing feasible. No cash drain for debt repayments or interest and liquidity needs.</td>
<td>Difficult to obtain. Heavy equity dilution. Process is time-consuming and difficult. No assurance of success. VCs have high expectations. VCs require various reports. Management often gives up economic control to VCs.</td>
<td>Individuals ('Angels'). Private venture capital funds. Investment bankers. Government venture funds. Public venture funds. Institutional venture capital pools.</td>
</tr>
</tbody>
</table>

*Source: Ernst and Young LLP guide to the IPO value journey- Stephen C.B. Blowers; Peter H. Giffith; Thomas L. Milan, 1999*
CONCEPT

The basic concept of venture capital financing in terms of entrepreneurs' means 'my brain funded by venture capitalists' i.e. it is the combination of brain and money. This can be depicted in the following flow-chart

FLOW-CHART-6

CHARACTERISTICS OF VENTURE CAPITAL (Gordan & Natarajan, 1997)

Some of the important characteristics are as follows:

1. Venture capital is usually in the form of equity participation. It may also be in form of convertible debt or long term loan;

2. Investment is made only in highly profitable projects bearing high risks;

3. It is normally available for commercialization of new ideas or new technologies;

4. Venture capitalist joins the entrepreneur as a co-promoter in projects and shares the risks and rewards of the enterprise;

5. The involvement of the investor in the business is continuous;

6. Once the venture has reached the full potential the venture capitalist disinvests his/her holdings either to the promoter or in the market. The basic objective of investment is not profit but capital appreciation at the time of disinvestments;
7. Venture capital is just not injection of money but also an input needed to setup the firm, design its marketing strategy and organize and mange it;

8. Investment is usually made in small and medium scale enterprises.

WORKING OF VENTURE CAPITAL

Venture capitalists are the persons with razor sharp minds and wealth who are ready to take any kind of challenge to enter into unknown, uninterested area. Angels are the private investors who fund start-ups, many being entrepreneurs who have amassed fortunes by taking their own companies public and now invest in other ventures (Taulli, 1999). VCs are mostly past entrepreneurs fairly capable of lending a direction to the company's management. They act as value-adding investors playing non-financial roles of financial advisors, corporate strategists, sounding boards, marketing information providers and management recruiters.

Profile of an ideal entrepreneur (Zider, 1998):

A venture capitalist looks for the following features in an entrepreneur before investing.

- Is qualified in a hot area of interest;
- Delivers sales or technical advances;
- Presentable to outside investors;
- Recognizes the need for speed to an IPO for liquidity;
- Has a good reputation and can provide references that show competence and skill;
- Understands the need for a team with variety of skills;
- Sees why equity has to be allocated to other people;
- Works diligently towards a goal but maintains flexibility;
- Gets along with the investor group;
- Understands the cost of capital and typical deal structures and is not offended by them;
- Is sought after by many VCs;
- Has a realistic expectation about process and outcome.
Just knowing the profile of an entrepreneur, the task of the VCs is not over. The VCs also look for certain factors in the company to be set-up or already established.

**Evaluation of companies by VCs (Mitra, 2000):**

- The key to success is team work;
- Big idea i.e. creating ideas;
- Execution of an idea;
- Planned exit strategy.

Investors in venture capital funds are typically large institutions, which put a small percentage of their total funds into high-risk investments. They expect a return between 25-35% per year over the lifetime of the investment. These institutions invest in the funds looking at the overall track record of the firm. The VCs meet their investors’ expectations at acceptable risk levels by their investment profile and the way they provide funds.

**Structuring a deal:**

It's a myth that the venture capitalists invest in good people and good ideas but the reality is that they invest in good industries. VCs focus on the middle part of the classic industry S-curve. They avoid both the early stages, when technologies are uncertain and market needs are unknown, and the later stages, when competitive shakeouts and consolidations are inevitable and growth rates slow dramatically. The VCs despite of the talent or charisma do not back the entrepreneurs if their businesses are not giving profits. These investment flows therefore reflect, a consistent pattern of capital allocation into industries where most companies are likely to look good in the near future. During the adolescent period of high and accelerating growth, it can be extremely hard to distinguish the winners from the losers because their financial performance and growth rates look strikingly similar. At this stage all companies are struggling to deliver products to a product-starved market. Thus the challenge for the VCs is to identify competent management that can supply the growing demand.
More than 80% of the money invested by VCs goes into the adolescent phase of a company's life cycle. As long as VCs are able to exit the company and industry before it tops out, they can have extraordinary returns at relatively low risk. The deals that are structures may vary but the logic remains the same i.e. to give investors in the venture capital fund both ample downside protection and a favourable position for additional investment if the company proves to be a winner. If the company is the loser, the only alternative left is to go for liquidation of the company.

PROCESS OF VENTURE CAPITAL INVESTMENT

Contrary to popular perception, venture capital plays only a minor role in funding basic innovation. Venture money is not long-term money. The idea is to invest in a company's balance sheet and infrastructure until it reaches a sufficient size and credibility so that it can be sold to a corporation or so that the institutional public-equity markets can step in and provide liquidity. In short the venture capitalist buys a stake in an entrepreneurs idea, nurtures it for a short period and then exits with the help of an investment broker. Venture capital niche exists because of the structure and rules of capital markets (Zider, 1998). Normally the investment is in the risky project with expected higher returns. Basically such kinds of funds are invested in industries, which are unable to get funds through conventional sources. This type of funding may be by way of investment in the equity of the new enterprise or a combination of debt and equity, though equity is the most preferred route. Most of the ventures financed through this route are especially in the industries like InfoTech, electronic, biotech and communications or in short can be said to be ICE industries. Normally the investment process includes the following steps: (Avadhani, 1998)

1. Establishment of contact between the entrepreneurs and the venture capitalists;
2. Preliminary evaluation;
3. Detailed approval;
4. Sensitivity analysis;
5. Financing the new venture portfolio;
6. Monitoring the project and post investment support.
MECHANISM OF VENTURE CAPITAL FINANCING

VCF is no longer about seed financing a small amount of capital extended to an investor to prove a concept or start-up financing funds given for product development and marketing provided the company has been in business for a short while. Instead it's all about extending finance to firms that have already managed to reach a certain level of operations (Dhawan, 1997). The venture capital industry in present times covers the broad spectrum of investment interest from product concept to product development, commercial stage improvement as well as meeting the second stage requirement of funds for expansion. These are the steps during which the risks of enterprise are high due to technological innovations and uncertainty in the market conditions (Mishra, 1996). There is a paradigm shift in venture capital industry. Following flow-chart summarizes this shift.

<table>
<thead>
<tr>
<th>VENTURE CAPITAL- A PARADIGM SHIFT</th>
</tr>
</thead>
<tbody>
<tr>
<td>OLD CONCEPT</td>
</tr>
<tr>
<td>Seed &amp; Start-up Capital</td>
</tr>
<tr>
<td>Conditional loans</td>
</tr>
<tr>
<td>Equity support from</td>
</tr>
<tr>
<td>Financial institution</td>
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<tr>
<td>Social development funds</td>
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<tr>
<td>Informal sources</td>
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<tr>
<td>Expansion Financing</td>
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<tr>
<td>Term loans</td>
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<tr>
<td>Bridge financing</td>
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<tr>
<td></td>
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<tr>
<td>NEW CONCEPT</td>
</tr>
<tr>
<td>Conditional loans</td>
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<tr>
<td>Equity support from</td>
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<tr>
<td>financial institution</td>
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<tr>
<td>Social development funds</td>
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<tr>
<td>Informal sources</td>
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<tr>
<td>Venture leasing</td>
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</table>

CHART-7
Source: Financing Venture Capital, Radhika Dhawan, Business Today, November 22-December 6, 2000
Almost all the venture capital companies all over the world follow more or less same mode of financing. Venture capital financing is dependent upon the growth stages of corporate enterprises. The different stages of VCF are shown in the following flow-chart:

**STAGES OF VENTURE CAPITAL FINANCING**

<table>
<thead>
<tr>
<th>STAGES</th>
<th>NAME</th>
<th>STAGES OF PROJECT</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Seed</td>
<td>Conceptualization/planning</td>
</tr>
<tr>
<td>II</td>
<td>Start-up</td>
<td>Operational/production</td>
</tr>
<tr>
<td>III</td>
<td>I round/Expansion</td>
<td>Expansion in production/marketing</td>
</tr>
<tr>
<td>IV</td>
<td>II round/ Mezzanine</td>
<td>Last stage before public offering</td>
</tr>
<tr>
<td>V</td>
<td>III round/Buy-out</td>
<td>Acquisition of a product line business</td>
</tr>
<tr>
<td>VI</td>
<td>IV round/ Turnaround</td>
<td>Reestablishment of business</td>
</tr>
</tbody>
</table>

**CHART-8**

*Source: Dhawan, 2000, loc.cit.*

The following flow-chart gives a detailed version of the stages depicted in flow-chart-8

**STAGES OF GROWTH AND VENTURE CAPITAL FINANCE**

<table>
<thead>
<tr>
<th>S.NO.</th>
<th>STAGES</th>
<th>PERIOD INVOLVED OF REALIZATION (In years)</th>
<th>DEGREE OF RISK</th>
<th>FINANCE FOR THE ACTIVITY INVOLVED</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. EARLY STAGE INVESTMENT</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>Seed capital</td>
<td>7-10</td>
<td>Extreme</td>
<td>Manufacturing &amp; Research base</td>
</tr>
<tr>
<td>II</td>
<td>Start-up</td>
<td>5-10</td>
<td>Very high</td>
<td>Commencement of business activity</td>
</tr>
<tr>
<td>III</td>
<td>1st stage</td>
<td>4-6</td>
<td>High</td>
<td>To meet demand</td>
</tr>
<tr>
<td>IV</td>
<td>2nd stage/follow-up</td>
<td>3-7</td>
<td>High</td>
<td>Marginal progress</td>
</tr>
<tr>
<td>S.NO.</td>
<td>STAGES</td>
<td>PERIOD INVOLVED OF REALIZATION (In years)</td>
<td>DEGREE OF RISK</td>
<td>FINANCE FOR THE ACTIVITY INVOLVED</td>
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<tr>
<td>2. LATER STAGE/THIRD STAGE INVESTMENT</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>Development/Expansion finance</td>
<td>1-3</td>
<td>Medium</td>
<td>Expansion</td>
</tr>
<tr>
<td>II</td>
<td>Replacement/Money-out deal</td>
<td>2-4</td>
<td>Low</td>
<td>Planned exit</td>
</tr>
<tr>
<td>III</td>
<td>Turn-around/Recovery finance</td>
<td>3-5</td>
<td>Medium to High</td>
<td>Rescue Finance</td>
</tr>
<tr>
<td>IV</td>
<td>Bridge Finance</td>
<td>1-3</td>
<td>Low</td>
<td>Company planning to go public</td>
</tr>
<tr>
<td>V</td>
<td>Management/Leverage buy-out</td>
<td>1-3</td>
<td>High</td>
<td>New management</td>
</tr>
</tbody>
</table>

**CHART-9**

**STAGES OF VENTURE CAPITAL FINANCING**

This section takes a look into the different stages and types of investments while selecting a project for investment. The selection of investment in venture capital financing decision is the very first step. The different stages of investment are recognized which vary regarding the time-scale, risk perception and other related characteristics of the investment decision process. The stages can be broadly classified into the following: (refer exhibit-5)

1. Early stage financing
2. Later/III stage financing

1. **EARLY STAGE FINANCING:**

This stage of financing is basically done for the new projects or new entrepreneurs who wish to commercialize their research talents. This stage includes four sub-stages viz.
(i) Seed capital/Pre start-up stage

(ii) Start-up stage

(iii) First round financing

(iv) Second round financing

**Seed capital/Pre start-up stage:** This stage is also known as the pre start-up stage as the financing is done before the business commences. This stage is essentially an applied research phase where the concepts and ideas of the promoters constitute the basis of a pre-commercialization research project, usually expected to end in a prototype, which may or may not lead to a business. According to the European Venture Capital Association, "seed capital is the financing of the initial product development or the capital provided to an entrepreneur to prove the feasibility of a project and qualify for start-up capital (Mishra, 1996). The following situations are typical of the pre start-up stage: (Verma, 1999):

- Research and Development prior to commercial application;
- Initial period of technology transfer licensing stage for techno transfer;
- Testing of prototype prior to commercialization;
- Generating commercial awareness of the invention prior to marketing;
- Industrial joint venture;
- Establishment of business development in University or research institutions linked science parks.

This stage is considered to be the riskiest of all stages as the rate of failure in the initial stages is quite high. Even the venture capitalists of UK and US feel that risks are very high in comparison to the rewards. The major financial risk involved for venture capitalists at this stage is the marketing risk. In this case the seed capital is warranted when there is enough evidence to show that the entrepreneur has used up his/her own resources in carrying his/her idea to the point of acceptance and initiating resources. Since this stage requires more time to complete the process,
external equity is prepared. The period from 1998-2000 saw a large amount of seed capital financing basically to dot.com companies (refer observations). But with the debacle of dot.com companies, the trend has taken a turn and now the investment in the pre start-up stage has declined.

**Start-up stage:** this is the stage when the commercial manufacturing has to commence. According to European Venture Capital Association (EVCA) “start-up capital is the capital needed to finance the product development, initial marketing and the establishment of product facilities” (ref. loc.cit.). The essence of this stage is that the product/service during commercialization for the first time is in association with the venture capitalists. It includes several types of new products such as: (Khan, 1998)

- Greenfield based on a relatively new or high technology;
- New business in which the entrepreneur has good knowledge and working experiences;
- New projects by established companies;
- A new company promoted by an existing company with limited finance to commercialize new technology.

Though this stage is exposed to high risk, more and more venture capitalists with a hope for high capital gains through equity appreciation are eager to finance such projects. The VCs evaluate the projects carefully and negotiate the terms and conditions with the entrepreneur with regards to sharing the management. The experience of developed nations show that 50% of start-ups fail in first two years, whereas in USA 20% stagger on for two years and then expire, and 20% survive in some form. Out of the remaining 40% only half succeed (Verma, 1999).

To finance a start-up VCs must generally take into account the following considerations:

- Viable business plan, market size, growth and market share;
- Potential market for the product or services;
• Management team of the enterprise to verify skills and fitness to job and situations;
• Availability of share of equity;
• Expectation of higher capital gains through realization exit route available at OTCE or other stock exchanges.

**First Stage Financing:** This is the stage wherein the firm requires finance for initial growth of business and to combat the problems arising in the business. The firm here has the product or service, but it has yet to develop the marketing infrastructure to reach the consumers leading the project to face competition from established suppliers and the fresh capital is needed because the firm’s own profits are normally meager to penetrate in the market. According to British Venture Capital Association, early stage finance is “finance provided to companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales. They will not be yet generating profits.”

Different terms are used to describe the phases of the first stage of development, which are as follows:

- **Breed board**: When the product is with initial stage, but not assembled properly.
- **Alpha-site**: Production has been developed but has not been transferred.
- **Beta-site**: Production is given for use to Friendly Corporation since the production is not finished and needs further engineering.

Most of the VCs go in for first stage financing in comparison to seed or start-up capital. This is due to the fact that early stage investments typically have four to six years to realize and the fundamental risk is from factors external to the firms rather than the internal factors.

**Second Stage financing:** This is the stage at which the product has already been launched in the market, but the business is not profitable enough for public offering to attract new investors. In a way the fund invested in second-stage is additional fund apart from the bank fund and is an accepted
pact of the venture capital investment process. At this stage the original venture capital investment may reduce its holding and bring in others to spread the risk. The VCs nowadays provide more funds at this stage than in other stages of early-stage financing. This is partly in the form of debt to provide some income to them.

2. **LATER STAGE FINANCING:**

This is also known as the post-early stage financing when a project has established itself and is looking for higher gains. This is also known as *Mezzanine finance* combining equity with debt, or subordinate debt package, which offers significant spreads. VCs allover, particularly in UK and USA prefer investing in later stage projects in order to have capital gains, ensure immediate income on investments through dividends and encash the investment for capital gains at a later, more appropriate time with an eye on tax relief or other incentives available. The preference is given to this stage due to the following reasons:

- To have immediate income in addition to high capital gains;
- To gain control in firm by increasing the quantity of funds.

The different sub-stages in later stage financing include:

- Development/Establishment stage
- Replacement/Money-out deal
- Turnaround/Recovery stage
- Bridge finance
- Management/Leverage Buy-outs
- Management Buy-Ins

**Development Stage:** The firm having been established in a particular market needs finance for capacity expansion, and setting up a proper distribution network so as to reach critical operating levels at which economies of scale can be made. In this stage financing of established businesses,
which have overcome the extremely high-risk early stage, have recorded profits for few years but are yet to reach a stage to go public and raise money from capital market/conventional sources is done. This is also known as organic expansion. The firm here should have the ability to generate Rs. 5 to Rs. 10 crores in annual sales and to reach profitability. Its primary purpose, thus, here is to improve market acceptance. The use of such type of VCF includes purchase of new equipment/plant, expansion of marketing and distribution facilities, re-finance of existing debt, penetrate into new regions, induction of new management etc. The development capital stage has a time frame of 1-3 years and falls in the medium risk category. Therefore, generally it is more acceptable than earlier forms of venture financing.

Replacement/Money-out deal: Replacement capital aims at enhancing the equity base in an enterprise, resulting in a change of owner/ownership pattern of the enterprise rather than raising new capital. It is provided in case, where one or more shareholders in need of cash, may be forced to sell their shares, where replacement in parties become essential due to serious differences between existing shareholders and owners selling shares directly to existing management in case of succession problems. Venture capitalists invest by purchasing existing shares from entrepreneurs or their associates to reduce their holdings in the unlisted company. This sale may be by persons other than entrepreneurs or associates. This is known as 'money out deal'. The VCs convert these into preferred instruments, bearing a fixed dividend. Such shares may be reconverted into ordinary shares if the company is listed or sold. Thus, in practice this means, investing by means of cash-generating securities, in a cash-generating company. This alternative was very much popular when the securities were unlisted and before the development of OTCE but is not much popular now.

3. TURNAROUND/RECOVERY FINANCE:

This is one of the rare forms of later-stage finance as this involves high degree of risk. Turnaround situation arises when established company runs into trouble (even bankruptcy) and
needs money to prepare for a major restructuring to revitalize profit growth. Therefore, it is also referred to as recovery of an enterprise /firm. This situation occurs in later-stage but is similar to the early-stage wherein an unquoted company has a greater burden of debt rather than of equity; failure to control cash flow, lack of management skills and inability to exploit the market potential. This form of financing has a time frame of 3-5 years. Though this is one of the rare forms of finance, it is gaining widespread acceptance.

4. **BRIDGE FINANCING:**

   This is normally last round of financing before the planned exit. It is the pre-public offering of the pre-merger/acquisition finance in the company’s life. It helps in financing a company, expecting to go public, within six months to a year. This type of financing is structured in such a way, so that it can be repaid from the return of a public underwriting. Companies going in for bridge financing are normally profitable and the time period of realization ranges from 1-4 years and hence the risk associated is comparatively low. The company may not need this type of financing if the IPO market is very low.

5. **BUY-OUTS:**

   Buy-outs are a recent development in the service areas of merchant bankers and savings institutions, and new form of investment in the European venture capital industry. This refers to transfer of management control and has two categories viz. Management buy-outs (MBO) or Leverage buy-outs (LBO) and Management buy-ins (MBI). Out of the two, the MBO is one of the most preferred alternatives of venture finance in the later-stage, accounting for more than half the value of all venture capital investments in various countries. The BVCA defines MBO as ‘funds provided to enable current operating management and investors to acquire an existing product line of business’ (Mishra, 1996). The MBOs/LBOs have low business risk as the company has existed for some time and often has a positive cash flow to service the debt needed for an LBO. The failure
rate is in order of one in ten and it is this that attracts the institutions, which have their own or their client's money ready to invest in new venture.

The buy-outs can be of different kinds. Some of them are as follows:

**Corporate disposal or hire downs:** In this whole business is sold out.

**Receivership acquisition:** It occurs when there is possibility of purchase by outside new management or good part of unattractive group is available.

**Shareholder repurchases:** This is procurement of funds from outside by management team to buy-out the retiring owner and/or his/her family interest who wish to retire but do not wish to sell to a trade buyer or seek stock market listing. MBOs represent an important part of the activity of VCs.

**Management Buy-Ins:** This is more risky as compared to MBOs because the management comes from outside who finds it difficult to assess the actual potential of the target company. The BVCA defines it as 'funds provided to enable a manager or group of managers from outside the company to buy-in the company with the support of venture capital investors'.

Analyzing the above details, one can say that venture capital firms finance early as well as later-stage investments in order to maintain a trade-off between risk and profitability.

**FINANCIAL ANALYSIS** (Khan, 1998)

The venture capital investments are generally *idea/growth based* as compared to the conventional investments, which are *asset based*. The conventional instruments are normally valued on the basis of the tangible assets or future earnings whereas the venture capital investments are valued in order to decide the required venture capital percentage ownership of the VCs in the venture capital undertaking. Some of the valuation methods, which can be adopted by VCs, are as follows:

(i) Conventional venture capitalist valuation method;
(ii) First Chicago method;
(iii) Revenue multiplier method.
(i) **Conventional Venture Capitalist Valuation Method:**

This method of valuation undertakes into account only two points of time in the life of the venture capital investment viz.

(a) **Starting time of investment**  
Exit time

The sequence of steps in the valuation of venture capital undertakings and the determination of the percentage share ownership of the VCs in them are as follows:

- Computing of the annual revenue at the time of liquidation of the investments, the present annual revenue in the beginning is compounded by an expected annual growth rate for the holding period, say five years;
- Compute the expected earnings level = future earnings level multiplied by after tax margin percentage at the time of liquidation;
- Compute the future market valuation of the VCU = earnings level multiplied by expected P/E ratio on the date of liquidation;
- Obtain the present value of the VCU, using suitable discount factor;
- If the present value of the VCU is Rs 50 L and the entrepreneur wants Rs. 20 L as the venture capital investment from the VCs, the minimum percentage of ownership required is two-fifth (40%).

The biggest weakness of this method is that it ignores the stream of earnings (losses) during the entire life cycle and overemphasizes one exit date.

(ii) **First Chicago Method:**

This method is an extension to the conventional method wherein it takes into account the stream of earnings and gives allowance to the nature of the path between the starting and the exit point. The steps involved in the process are:

- Three alternative scenarios are perceived/considered, namely, success, sideways survival and failure. Each one of these alternatives is assigned a probability rating;
• The discounted present value of the VCU is computed using the discount rate. The discount rate is substantially higher to reflect risk dimension;

• The discounted present values are multiplied by the respective probabilities. The expected present value of the VCU is equal to the total of these in the three alternative scenarios;

• Assuming expected present value of Rs 50 L and the fund requirement from the VCs Rs 50 L, the minimum ownership required is 50% (one-half).

(iii) Revenue Multiplier Method:

A revenue multiplier is a factor, which can be used to estimate the value of VCU. The VCs estimate the annual revenue of the company by multiplying the factor. The formula is:

\[ M_t = \frac{V}{R} = \frac{(1 + r)^n (a) (p)}{(1 + d)^n} \]

Where,

- \( V \) = present value of the VCU
- \( R \) = annual revenue level
- \( r \) = expected annual rate of growth of revenue
- \( n \) = expected number of years from the starting date to the exit date (holding period)
- \( a \) = expected after-tax profit margin percentage at the time of exit
- \( p \) = expected price/earnings (P/E) ratio at the exit time
- \( d \) = appropriate discount rate for a venture investment at this stage, risk and other relevant factors

This method can be used in early stage financing when earnings based on after-tax profits may be low/negative in early years but where there may be revenue/sales income. It is difficult to apply this method in a country like India but the First Chicago method can be applied for the valuation purpose.
STRUCTURE OF VENTURE CAPITAL FINANCING (FINANCIAL INSTRUMENTS)

The financial instrument through which the deal of a venture investment is materialized plays an important role. There are various kinds of financial instruments that are used in a venture capital deal. The following flow-chart shows the most popular instruments in use:

TYPES OF FINANCIAL INSTRUMENTS

FINANCIAL INSTRUMENTS

EQUITY INSTRUMENTS

- ORDINARY EQUITY SHARES
- NON-VOTING EQUITY SHARES
- DEFERRED ORDINARY EQUITY
- PREFERRED ORDINARY SHARES
- EQUITY WARRANTS
- PREFERENCE SHARES
- COMULATIVE CONVERTIBLE PREFERENCE SHARES
- PARTICIPATING PREFERENCE SHARES
- COMULATIVE CONVERTIBLE PARTICIPATING PREFERENCE SHARES
- CONVERTIBLE CUMULATIVE REDEEMABLE PREFERENCE SHARES

DEBT INSTRUMENTS

- CONDITIONAL LOAN
- CONVENTIONAL LOAN
- INCOME NOTES
- NON-CONVERTIBLE DEBENTURES
- PARTLY CONVERTIBLE DEBENTURES
- SECURED PREMIUM NOTES
- DEEP DISCOUNT BONDS

SPECIAL PURPOSE VEHICLES

FLOW-CHART-10
EQUITY INSTRUMENTS:

These can be of different types as shown in the exhibit. They can be ordinary in nature or shares which carry high dividends but without the voting rights. Deferred shares on which the ordinary share rights are deferred for a specified period of time. Preferred shares are those, which carry a fixed dividend in addition to the voting rights. There are equity warrants, which entitle the investor in debentures/bonds to acquire ordinary shares at future date.

Apart from the ordinary equity shares, preference shares are also available, which vary according to their nature. Cumulative convertible shares can be converted into ordinary shares after a specified period of time. Participating preference shares have an extra edge over the preference shares in terms of dividends wherein extra dividend apart from the fixed dividend is payable after the payment of dividend to equity shareholders. The other types of preference shares have the combined properties of two or more kinds of preference shares.

In India equity financing is the most popular mode of structuring a venture capital deal but normally the contribution of VCs does not exceed 49% of the total equity capital (Pandey, 1998). Thus the control and majority ownership of the firm remains with the entrepreneur. VCs buy shares in an enterprise with an intention to ultimately sell them to make capital gains.

DEBT INSTRUMENTS:

Debt instruments are also used in structuring a deal. This is normally done to ensure that the entrepreneur retains managerial control and the VCs receive a regular yield during the years when the equity portion is unlikely to yield any return. The debt instruments are also of different kinds depending on their nature.

CONDITIONAL LOAN: It is a form of loan, which does not have a predetermined repayment schedule or interest rate. Generally the repayment is done in form of royalty after the venture is able to generate sales. The supplier of such loans recovers a specified percentage of sales towards the
recovery of principal as well as revenue in predetermined ratio, usually 50:50. This charge on sale is known as royalty. It is a quasi-equity instrument. In India, VCs charge the royalty ranging between 2-15%. The actual rate depends on the factors like, life cycle of the venture, cash-flow patterns, risk etc. Some funds such as RCTC recover only half of the loan if the enterprise fails.

**CONVENTIONAL LOAN:** This type of loan is modified according to the needs of the venture capital company. Initially it carries a low interest rate, which increases after the commercial production starts. A small royalty is additionally charged to cover the interest foregone initially.

**INCOME NOTES:** It is a unique form of venture financing in India. It is a hybrid security, which combines the features of conditional as well as conventional loans. The entrepreneur has to pay both interest and royalty on sales, but at substantially low rates. The principal is repaid according to a stipulated schedule. IDBI's VCF funding provides equal to 80-87.5% of a project's cost for commercial application of indigenous technology or adapting imported technology to wider domestic applications.

**NON-CONVERTIBLE DEBENTURES (NCDs):** This carries a fixed/variable rate of interest, is redeemable at par/premium, in secured, and can be cumulative/non-cumulative.

**PARTLY CONVERTIBLE DEBENTURES (PCDs):** It is the combination of convertible and non-convertible debenture. The convertible portion is converted into equity share after a specified period of time and the non-convertible portion earns interest till redemption generally at par. Such instruments are best suited for second round of financing.

**ZERO INTEREST/Coupon BONDS:** This can be either convertible or non-convertible with zero/no interest rate. The non-convertible bonds are sold at a discount from their maturity value while the convertible is converted into equity shares after a specified period of time. These are most appropriate for later stage financing.
SECURED PREMIUM NOTES: This type of financial instrument is secured, redeemable at premium in lump sum/installments having interest carrying a warrant against which equity shares can be acquired. This is also useful for later stage financing.

DEEP DISCOUNT BONDS: This is issued at a large discount to their maturity value. As a long-term instrument, it is not suited to venture capital investment.

SPECIAL PURPOSE VEHICLE:

This provides the lenders with an additional degree of security. This holds the shares bought back from the venture capital firm in trust until the firm achieves a certain targeted return. Meanwhile, a certain proportion of the firm’s sale can be funneled directly to the special purpose vehicle to amortize the debt. This is a better form of debt repayment and enables new ventures to raise funds.

VENTURE LEASING:

This is a kind of arrangement in which the lessor provides both the asset and the equity capital to the lessee. This minimizes the initial investments by start-ups and the rentals can be adjusted according to the cash-flow profile. In this case the asset risk is transferred to the lessor.

In a country like India, the partly convertible debentures and cumulative convertible preference shares are the best suited as it has an active secondary market and such type of instruments do require active secondary market. Considering the Indian context both venture capitalists as well as entrepreneurs going in for venture capital favour a financial combination, which has a higher component of debt. The reason may be because of the promoter’s fear of loss of ownership and control to the financier and due to the traditional reluctance and conservatism of the venture capitalist to share the risk inherent in the equity.
In countries like U.S.A and U.K. and other European countries other modes of financing like leasing, hire purchase, deferred shares, preferred shares etc. are also used and the overall financing mode is directed towards equity.

**DISINVESTMENT MECHANISM/ EXIT STRATEGY**

The objective of venture capitalist is to have a substantial gain on his/her investments. The gains come by formulating the appropriate exit strategy. The exit strategy or disinvestments mechanism is said to be the last stage of venture capital financing. If the exit route is not proper all the investments are lost. Therefore it is necessary to note the different exit strategies available to the investors. The exit mechanism helps in making profits or minimizing losses. The proper exit timing is to be planned at the beginning of the investment. In India most of the venture funds aim to operate on the commercial lines along with satisfying their development objectives.

The basic objective of almost all the venture capital firms is to finance high-risk business plan by participating with a hope of capital appreciation. As soon as the business stabilizes and starts giving profits, venture capitalists try to exit by opting different modes. There are various exit routes by which venture capitalists divest their holdings. The required divestment mechanism is often achieved in consultation with the promoter, as the latter unlike the VCs may want to stay with his/her Company beyond this point. Since a venture capital investment is for a shorter duration as compared to other investments, predetermining the timing for realization of the investment is essential and as such even unquoted equity investments are to be realized. The exit may be planned or unplanned but in most of the cases it is planned in nature. The following are the possible exit alternatives:
EXIT OF EQUITY/QUASI-EQUITY INVESTMENT

- INITIAL PUBLIC OFFERING (IPO)/FLOTATION
- BUY-BACK BY PROMOTERS OR COMPANY
- SALE OF THE ENTERPRISE TO ANOTHER COMPANY (TRADE SALES)
- SALE TO NEW INVESTOR (TAKE OUT)
- SELF- LIQUIDATING PROCESS
- LIQUIDATION OF THE INVESTEES COMPANY (RECEIVERSHIP)

FLOW-CHART-11

EXIT OF EQUITY/QUASI-EQUITY INSTRUMENTS:

The exit alternatives can be voluntary as well as involuntary in nature. Out of the six alternatives related to the exit of equity investments, only one is involuntary in nature. A brief description of the exit routes follows.

(i) INITIAL PUBLIC OFFERING (IPO)/FLOTATION:

This is one of the most common ways of disinvestments by a VC. This alternative is ideal when the company has successfully implemented its project and has started generating income. This is normally chosen to get a higher price. If the stock market is quite active and developed, it is
likely that the equity shares of the investee can be sold at a higher price than in the public place. Though this route is quite popular, it has its own disadvantages. In the present scenario, the stock markets overall are quite volatile resulting in high fluctuation in share prices. It's not easy for a company, which is going public for the first time to survive in such market conditions. This requires lot of planning so that the shares of the company withstand the highly volatile market.

Related to the public issue method is the Over The Counter Exchange (OTCE) route. In India the OTCE was developed in the 90s and was named as OTCEI. Worldwide the OTCE was developed to provide a platform to small companies, promoted by new entrepreneurs with viable projects having no access to the capital market due to strict stock exchange regulations. This was created to provide an opportunity for smaller firms to raise initial funds of equity finance, with which they can begin to implement their plans for expansion. In this case the VCs can exit by way of a bought-out deal to a member of the OTCEI who would offer the shares thus acquired, to the public at a future date.

(ii) **BUY-BACK BY PROMOTERS OR COMPANY/SHARE REPURCHASE:**

The other exit route for the company is to buy-back its own shares for cash from its VC or from any other shareholder with the proceeds of its own earnings. Though buy-back of shares is not permitted in India under section 77 of Companies Act 1956, however promoters enter into such agreement with VCs agreeing to buy a definite number or percentage of shares held by VCs on the expiry of a particular time limit or on the completion of the investee’s project. The price at which the deal will be made will either be predetermined with put option or may be negotiated at the time of exercise of put option by the venture capitalist.

(iii) **SALE OF THE ENTERPRISE TO ANOTHER COMPANY (TRADE SALES):**

This is also quite common but is less noticed. It involves sale of a company to a 'competitor wishing to buy the investees' market share or production capacity, a supplier looking to integrate
forward, or a customer looking to integrate backward or tie-up sources of supply' (Mishra, 1996). In this case the entire company is sold to another company/third party. The sale may be in any of the following forms:

(a) Sale of equity may be for cash;

(b) Sale of equity may be against notes instead of cash;

(c) Sale of equity may be for equity in another company;

(d) Sale may involve assets of the investee company instead of equity against cash and may be against notes rather than cash;

(e) Sale of assets may be against equity shares in another company or in any combination of the above arrangement.

Corporate sale offers stability particularly from a financial viewpoint to small or medium size venture capital backed business. The management of such company can at least choose its partner, as compared to initial public offering and volatile nature of the stock markets.

(iv) SALE TO NEW INVESTOR (TAKE OUT):

The equity stake of VC can be sold to a new investor, which may be a corporate body or even another venture capital organization or to passive investors who are cash-rich and interested in buying ownership position of the venture capitalist. This route is used when the enterprise wants to get rid of the venture capitalist or the venture capitalist wants to liquidate his/her own investments.

(v) SELF-LIQUIDATING PROCESS:

This type of exit route is rare in India. A very popular venture capital firm, Suez Apec Management(s) in the west (Verma, 1999) has used this route in many projects. In this case, once the planned programme is completed, the asset is sold and the proceeds are distributed to the shareholders through the liquidation of the investee company.
(vi) LIQUIDATION OF THE INVESTEE COMPANY (RECEIVERSHIP):

It is an involuntary exit i.e. the VC is forced to exit due to the poor performance of the business. Here, the companies' assets like land, buildings, machinery and equipments etc. are sold. This exit route is not desirable. The debacle of many dot.com companies in 2001 saw venture capitalists following this route to recover a substantial portion of the amount invested. Liquidation occurs when the company becomes insolvent.

EXIT OF DEBT INSTRUMENTS

The exit of debt instruments is in contrast with the exit of equity/quasi-equity instruments. Here a predetermined route is followed. In case of conventional loans, the exit is possible only at the end of the stipulated time period of loan. In some case where the agreement permits, the exit can be made before the specified time. In case of conditional loans, exit earlier than projected at the time of initial investment is possible on the basis of lump-sum repayment consistent with expectations of the VCs about the likely return on the loan.

In short it can be said that a proper exit mechanism helps the entrepreneur as well as the venture capitalist for both of them gain through this.

MONITORING THE PROJECT

The venture capital companies after investing in the project closely monitor the performance of the company. This is unlike to the conventional mode of financing where the money is invested but the follow-up of the project for which money is given is not done. In venture capital financing the investor and the entrepreneur both have a close and continuous contact. The process of monitoring is also known as Nurturing or After-care. The objectives of the monitoring of project are as follows:

- To ensure the proper utilization of the funds provided. Any deviation or improvement in the initial plan is to be made with the prior approval of the VC.
- To ensure the implementation of the project within the stipulated time.
- If the project over-runs time and cost, additional assistance can be provided.
- To give strategic inputs in every aspect of management.
- To anticipate the problems likely to arise and providing remedial actions.
- Evaluation of the performance of the project.

There can be different styles of monitoring and the styles differ from investor to investor. The style refers to the extent of participation of the venture capitalists. It depends on factors like stage of investment, financing plan etc. Following are the most popular ones:

1. **Hands-on Monitoring:** This refers to the continuous and constant involvement of the VC in the project in the form of representation of board of directors. This type of care is provided either by the in-house expertise or by core group of external advisors/experts in specific areas if the former is not available in all types of projects. This helps in guiding on different aspects of business for the long-term success.

2. **Hands-off monitoring:** In this type of style the VCs play a relatively passive role. Although they usually reserve the right, they rarely have nominee directors on the board of the firm. There is no active participation of the VCs in the decision making process. This type of nurturing is most appropriate in case of syndicated/joint/consortium venture financing.

3. **Hands-holding Nurturing:** This is the mid-way approach and is of reactive nature. Similar to the hands-on style, the VC has the right to have a nominee on the board of directors of the firm but similar to hands-off style, the active involvement in the decision making process is only when approached.

The venture capital industry has grown in the past few years but it still constitutes only a tiny part of the Indian economy. In principle the growth could be exponential in nature. The public markets will check the industry’s growth.