Chapter 1

VENTURE CAPITAL THEORETICAL FRAMEWORK
1.0 INTRODUCTION

Between taking-up a job for salary and starting their own risky business venture, many educated youth prefer the former which, they think, will give them comfortable existence. Besides, people have become risk-averse, conditioned by their direct and indirect experiences. What is needed at present is change in the mindset at a faster rate never before seen in history. Every human behaviour is positive, that is, goal-directed, backed by true-will. There is a passion and commitment to start their own venture and be on their own, provided there is high reward associated with high-risk new business projects. The internet and telecom revolutions are affecting life styles, personal interactions, societies and businesses in profoundly many ways. The changes in turn are being fueled by globalization, technology, knowledge and intellectual property.¹
Globalization

The growing integration of the economies of the world has become a global village. As a nation's economy grows, it will have to be increasingly a part of the global economy. Whether it is in the area of media, technology, manufacturing or retail there's no choice but to be a player with global linkages, perspectives and practices.

Knowledge and Intellectual Property

Of all the factors of production, knowledge and intellectual property are the most critical in this increasingly complex, inter-linked, fast growing world. Every physical good and every service being delivered today, at the global level has a knowledge component to it that was not present a few years ago. Productivity of knowledge workers has become engine of economic growth today.

Technology

The deployment of technology to solve critical problems is only now being recognized by the economies of the world. Technology is a fundamental enabler of the creation and dissemination of knowledge and intellectual property-based goods and services which in turn are the natural outcomes of an increasingly globally competitive world.

However, for a substantial number of technocrats who seek to capitalize on their strengths and business opportunities, starting-up a new venture is a distant dream. There are a number of critical factors that contribute to its success or failure of new business. Experience, integrity, prudence and a clear understanding of the market are among
the most sought after qualities of a promoter. Besides these, are other external factors which lie beyond the control of the entrepreneur. Prominent among them are the timely infusion of funds, technical skills, cost competitive manpower, etc. This is where the ‘venture capitalist’ comes in with money, business sense and a lot more.

Therefore, a predominant success factor in entrepreneurial business is ‘Venture Capital’ which can be propelled into a powerful engine of economic growth and wealth. The study conducted by Organization for Economic Co-operation and Development (OECD) in 1985 also shows that there is possibly no substitute for venture capital as a source of funds and management skills for new technology firms and it is not possible for Small and Medium-sized Enterprises (SMEs) to develop without the country having a venture capital market.

1.1 CONCEPTUAL FRAME WORK

The companies or industries engaged in traditional line of business can easily procure necessary financial capital from several traditional institutions which invest in industry or company for gains. But, the companies or industries likely to engage in risky lines of business having no time-tested foundation in the commercial world—electronics, computer application industries, biotechnological application industries and medical instruments— are not favored by the traditional and orthodox investors as an attractive avenue of investment.

Now a question arises – how shall these types of firms then be financed? Under this circumstances, the concept of ‘Venture Capital
'Fund' was born with a fundamental objective to provide initial capital and support in building capital-base to the entrepreneurs having a sound background of professional education and expertise who take initiative to launch the business based on fast-changing technology. Common investors like institutions and banks show apathy to invest in the firms which are projected to deal in new technology, strategic and innovative market. Venture Capital Funds, thus, come forward to finance those firms in the form of long-term equity finance with an objective to earn their returns in the form of capital gain.

The concept of venture capital is not new and had its nurturing under the dictum "no innovative concept shall meet death in its womb for genuine need for finance for venturism". The term "venture capital financing" comprises of three words viz., venture, capital and financing. The word Venture has several meanings, depending on the context of its usage. It means business or commercial deal involving a risk, which refers to variability in the expected rate of return. The word capital is the resources to start an enterprise. From the functional point of view, capital to a company is what is blood to human body. Here capital refers to financial capital and not exactly 'produced means of production' in the version of economists. Financing is the process of organizing the flow of funds so that a business firm can carry out its objectives efficiently by and meet its payment obligations as they fall due.

The term venture capital may be defined as investment in the form of equity, quasi-equity or conditional loan made in new, unlisted,
high-risk or high-technology firms started by technically or professionally qualified entrepreneurs, where venture capitalists.  

- expect the enterprise to have a very high growth rate;
- expect medium to long-term capital gains;
- provide management and business skills to the enterprise; and
- does not expect any collateral to cover the capital provided.

Entrepreneur is a professionally or technically qualified person with inadequate resources or backing to finance the project.

Venture capitalists may be defined as organizational units or persons- who can take-up substantial activity in the management of equity or quasi-equity financing for the start-up and/or development of small, and medium-sized unquoted enterprises having significant growth potential in terms of products, technology, business concepts and services, and can provide active management support to investees.  

He can be described as a ‘probability lender’, lending on ideas, the drive of the entrepreneur and his own assessment of the final product and market.  

Hence, from the perspective of the venture capitalist, venture capital is seen as “you have got the idea, we have the money”.  

Empirically, there are three types of venture capitalists:

- purposeful risk managers who will consider venture fulfilling all essential requirements;
- determined electives who will consider most deals fulfilling minimum criteria; and
parachutists who will consider any venture, provided it has high liquidity 'parachute' through which they could escape in case of difficulty.

The key factors for the success of any project under the consideration of a venture capitalist are:

- clear and objective thinking;
- operational experience, especially in a start-up;
- people management skills;
- ability to spot technology and market trends;
- wide network of contacts;
- knowledge of all facets of business finance, marketing and human resources;
- judgment to evaluate them on the basis of integrity and ability;
- patience to pursue the final goal;
- drive to guide budding entrepreneurs; and
- empathy with entrepreneurs.

From the above description, it can be concluded that 'Venture capital financing' means providing a proper mix of medium and long-term investments in high-risk industrial projects with high reward possibilities. It 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. Medium-term refers to a period ranging between 3-5 years and 'long-term' covers a period of 5-15 years.
1.2 FEATURES OF VENTURE CAPITAL

From the above description of venture capital, some of its characteristic features that distinguish it from other capital investments standout.

1.2.1 Equity Participation

Venture capital is basically equity finance in relatively new companies when it is too early to go to the capital market to raise funds. The equity funds help the company to leverage further bank finance and provide a low-cost source of funds in the early stages of business, because dividends can be delayed unless the company starts making profits. Further, the equity investment implies that investor bears the risks of the venture and would earn a return commensurate with success in the form of medium-term capital gains. The objective may be to keep the management under influence and force it to perform in the best interest of the project so financed.

1.2.2 Long Term Horizon

Venture financing - a long-term illiquid investment, not repayable on demand requires long-term investment attitude requiring the venture capital firms (VCFs) to wait for a long periods, say 5-10 years to make profits.

1.2.3 Participation in Management

According to Wilson, "Success in venture capital most often comes from a creative partnership in which the investor's lengthy and painful experience in the company formation process is combined with the entrepreneur's management skill and detailed knowledge of market
or technology. Venture capitalists do not just invest, but they also contribute to the development of the company by providing the entrepreneur with active management advice, thus reducing the element of high risk.

They bring to the venture more than capital, although that is obviously the most tangible contribution. Besides being an investor he is disciplinarian, a sounding board and a point man with a valuable network of contracts. The venture capitalists usually have wide contacts with experts in technology and management areas, who can be called on to provide strategic inputs to the management team. This active involvement in assisted venture may be attributed to the fact that since the risks are high, venture capitalist in order to reduce uncertainties and to protect and enhance the value of his investment, becomes actively involved, which is commonly known as hands-on/aftercare management.

1.2.4 Value-Added Services

A distinctive feature of venture capital is the value-added services provided by the venture capitalists to the investee companies. Venture capitalists deal with numerous entrepreneurs of various ventures across industries. They have wide experience of handling diverse situations and are thus in a highly advantageous position to provide appropriate assistance and competent advice to the investee companies in their management and development. The most important services are:
Acting as a sounding board for the investee company's planning and decision-making;

Helping in building networks of contacts for the investee company;

Providing advice and assistance in a highly professional and competent way in managerial and technical fields; and

Helping in raising subsequent finances from banks or by organizing Initial Public Offerings (IPOs).

1.2.5 Managerial Support and Monitoring

The distinctive feature of venture financing is that VCFs not only provide finance but also managerial assistance to the entrepreneurs. The hands-on style is a form of supportive and direct involvement, which is generally practiced through the VCFs representation on the assisted firm's board. It also entails close and regular discussion between the venture capital fund manager and the entrepreneur on problems of technology, marketing and general management. The venture capitalist helps a great deal in shaping the strategies, policies and practices and business plan of the entrepreneur's firm. He also assists in affecting prudent financial discipline. Some venture capitalists may choose to act passively, such as hands-off style. Under this they do not participate in management of the firm. A venture capitalist bases his assessment of the management on the evaluation of financial reports which the entrepreneur sends to them periodically. He may choose to follow a middle approach between the hands-on and hands-off styles of management. He may identify key decision areas such as capital investment, appointment of key personnel etc., on
which he may like the entrepreneur to consult him. He can also specify the kind of information which the entrepreneur has to furnish regularly to him.

Whether or not a venture capitalist is directly involved in the management of the assisted firm, he has to develop a sound monitoring system needed not only to safeguard the capital of the venture capitalist but also to help in improving the worth of investment through timely actions. New entrepreneurs require continuous monitoring and support because of their managerial inexperience. Monitoring becomes easy and more effective if the venture capitalist also takes active participation in the management of the enterprise.

1.2.6 High-Risk Proposition

Venture capital financing involves high risk-return spectrum. Matthias Plum believes that "in the venture realm the business risks are usually higher, the assessment of progress is more tenuous, and the evaluation judgments are more difficult." A venture capitalist, while investing, assumes four types of risk, viz., management risk, when team may not be able to work together due to infrequent payrolls; product risk, when product does not become commercially viable; market risk, when product is not accepted by buyers in the market; and the operations risk arising from increased product cost and decreased gross margins. If these risks are successfully combated then the potential exits for very substantial reward.

1.2.7 Investment in Hi-Tech Areas
Venture capital is not technology finance, though technology finance may form a sub-set of venture capital financing. In reality, venture capitalists are attracted by the prospect of high rewards to compensate themselves for the high risks they undertake and the predominance of Hi-Tech investments made may be explained by the fact that in general terms hi-tech projects offer a high prospective return than projects in more traditional areas. The opportunities in low-tech areas are found to be scattered and miscellaneous. However, a venture capitalist looks not only for high technology but the innovativeness through which the project can succeed.

1.3 VISION OF VENTURE CAPITAL

The vision of venture capital is focused on new projects, seed capital, technology and innovation. It aims at:

- Fueling ambitions and dreams;
- Breathing life into promising business ventures;
- Charting the course of incisive business ideas;
- Providing foresight with a free sense of direction;
- Helping in building enterprise vision; and
- Guiding smoothly over rough passages;
- Partnering enterprises on to script thrilling success;
- Complementing acumen and enterprise with a steady flow of resources;
- Inspiring enterprises to script thrilling success; and
- Plotting venture capital finances are plotted on a firm life-cycle curve.
1.4 STAGES OF VENTURE FINANCING

The selection of investment by a venture capital company is closely related to the stage and type of investment. Venture capital companies (VCCs) all over the world follow more or less similar practices of financing. Enterprises in different stages of their growth with equity funds as per their requirements. In other words, venture capital financing is dependent upon the growth stages of corporate enterprises. Table 1.1 gives various stages of venture financing.

Table 1.1
STAGES OF VENTURE FINANCING

<table>
<thead>
<tr>
<th>Stages in Venture Capital Financing</th>
<th>Name of the Stages</th>
<th>Description of Status of the Project</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stage – I</td>
<td>Seed</td>
<td>Conceptualization/planning</td>
</tr>
<tr>
<td>Stage – II</td>
<td>Start-up</td>
<td>Operational/production</td>
</tr>
<tr>
<td>Stage – III</td>
<td>Expansion</td>
<td>Expansion in production/marketing</td>
</tr>
<tr>
<td>Stage – IV</td>
<td>Mezzanine</td>
<td>Last stage before IPO</td>
</tr>
<tr>
<td>Stage – V</td>
<td>Buy-out</td>
<td>Acquisition of a product line/business</td>
</tr>
<tr>
<td>Stage – VI</td>
<td>Turnaround</td>
<td>Re-establishment of business</td>
</tr>
</tbody>
</table>


Based on the experiences of Venture Capital Companies (VCCs), the above mentioned stages can broadly be divided into two broad categories viz., (i) Early stage venture financing; and (ii) Later stage venture financing. Under each of these two broad stages venture financing is provided in sub-divisions, the time span of each of which depends on the degree of risk involved. This is illustrated in table 1.2
Table 1.2
STAGES OF GROWTH OF VENTURE CAPITAL FINANCING

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Stage Description</th>
<th>Lock-in Period (in years)</th>
<th>Degree of Risk</th>
<th>Expected Return (indicative percentage)</th>
<th>Finance for the Activity Involved</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Early Stage Investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i</td>
<td>Seed</td>
<td>7-10</td>
<td>Extremely high</td>
<td>60</td>
<td>Manufacturing and research based business</td>
</tr>
<tr>
<td>ii</td>
<td>Start-up</td>
<td>5-10</td>
<td>Very high</td>
<td>40 - 60</td>
<td>Business commitment</td>
</tr>
<tr>
<td>iii</td>
<td>Second round</td>
<td>3-7</td>
<td>High</td>
<td>30 - 40</td>
<td>Marginal progress</td>
</tr>
<tr>
<td>2.</td>
<td>Later Stage Investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i</td>
<td>Development finance</td>
<td>1-3</td>
<td>Medium</td>
<td>25-35</td>
<td>Expansion of business</td>
</tr>
<tr>
<td>ii</td>
<td>Replacement finance</td>
<td>1-3</td>
<td>Low</td>
<td>20-30</td>
<td>Planned exit</td>
</tr>
<tr>
<td>iii</td>
<td>Buy-outs</td>
<td>1-3</td>
<td>Low</td>
<td>20-30</td>
<td>New management</td>
</tr>
<tr>
<td>iv</td>
<td>Turnaround</td>
<td>3-5</td>
<td>Medium to high</td>
<td>30-40</td>
<td>Rescue finance</td>
</tr>
</tbody>
</table>

Source: Adapted from S. Ramesh and Arun Gupta, Oxford University Press, Delhi, 1995, p. 66.

1.4.1 Early-Stage Financing

Based on the stages of development of a business, the early stage financing may be sub-classified as seed capital, start-up finance and second round finance. During the first stage of starting a business, i.e., formulation of an idea stage, the risk associated is very high. Here an idea needs to be translated into a business proposition. So the finance required in this stage is the seed finance from the venture capital fund. In the next stage, being the implementation phase, start-up finance from venture capital is required for the purpose of implementing the appropriate production processes. In second round
finance, commercial production is to be started and beginners finance is required to develop marketing and other infrastructures.

**Seed Stage**

This stage is a pre-start up stage needing funds for testing the prototype and giving it a commercial shape. This is the preliminary stage associated with research and development (R&D). Briefly the following situations are typical of the pre-starting stage:

- Research and development prior to commercial application;
- Initial period of technology transfer, licensing stage for technology transfer;
- Testing of proto-type prior to commercialization;
- Generating commercial awareness of the invention prior to marketing;
- Industrial joint ventures; and
- Establishment of business by entrepreneur in university- or research institution- linked science parks.

**Start-up Stage**

An entrepreneur may feel the need for finance when the business activity is just starting which involves the launching of a new business. Start-up of a new business activity may have the following features:

- New business activity could be based on the experiences of the industry experts, spin-offs from R & D institutions, R & D of a big
corporation, transfer of technology from overseas-based business, or a joint venture between an entrepreneur and a technology expert, etc;

- New product/service from the above activity yet to be tried;
- Entrepreneur lacks financial resources required for the enterprises;
- Indication of potential but untried market for the product/service;
- The enterprise, which has a formal organizational structure as a limited company, is no longer an individual owner-managed set-up but needs the support of experts.

**Second Round Finance**

The circumstances under which second-round finance is needed by an enterprise after start-up may be positive or negative. The reasons are:

- Over-runs in the project before completion, necessitating a second round of equity funding to avoid liquidations;
- A period of loss after start-up, necessitating equity-type funding for maintaining acceptable debt-equity ratio; and
- Inability to get further equity finance from other sources, necessitating backing by venture capitalists who have earlier provided funding.

On a positive note, if a start-up is successful and the business is growing space, additional funding is required for expansion.
1.4.2 Later-Stage Financing

It refers to post-early stage financing when a project has established itself and business is spreading its wings and is looking for higher growth. Funds are utilized for further plant expansion, marketing, working capital or development of an improved product. The fund seeks a minimum level of achieved profitability in a potential investee. In United States such type of financing is popularly called 'mezzanine finance', combing equity with debt or subordinate debt packages which after significant spreads.

Most VCCs in India as well as developed countries prefer investing in the later stage of a project for the following reasons.28

- For immediate income in addition to expected high capital gains; and
- To gain high controlling interest in the enterprise by increasing the quantity of funds.

The various sub-divisions of later-stage financing are:

- Expansion or developmental finance,
- Replacement capital,
- Buy-outs, and
- Turnarounds

Expansion or Developmental Finance

Expansion of an undertaking or enterprise may be through an organic growth or by way of acquisition or takeover. For the venture capitalist there is no difference between the two growth forms from the point of investment.
In the case of organic development the entrepreneur retains maximum equity holding. In case of acquisition equity holdings of the purchaser and the investor could be in the ratio of 50:50 depending upon the net-worth of the required business, its purchase price and the amount raised from the investors by the acquiring company.  

**Replacement Capital/Money-out Deal**

Replacement capital, which essentially means substituting one shareholder for another rather than raising new capital, aims at enhancing the equity base in an enterprise, resulting in a change of ownership/ownership pattern of the enterprise. Venture capitalists make finance available by purchasing existing shares from entrepreneurs or their associates to reduce their holdings in the unlisted company. This sale of shares may be by persons other than entrepreneurs or their associates. This is known as ‘money out deal’. The venture capitalist may buy ordinary shares from vendors and may convert them into preference shares bearing fixed dividend coupons. Such shares may be reconverted into ordinary shares if the company is listed or sold. This mode of later-stage financing was much in vogue when unlisted security markets or over-the-counter-sales were not developed, but is not very common now.  

**Buy-outs**

Buy-outs, which refer to transfer of management control, fall into two categories viz., management buy-outs (MBOs) and management buy-ins (MBIs). In MBOs funds are provided by the VCCs to enable the current operating management to acquire an existing
product line/business. In MBIs funds are provided to enable an outside group of managers to buy an on-going company. They usually bring three elements together i.e. a management team, a target company and an investor. They are less popular than MBOs. An MBIs is inherently more risky because the management comes from outside who finds it difficult to assess the actual potential of the target company. Generally, MBIs are able to target only the weaker under-performing companies.

The leveraged buyouts (LBOs), by contrast, is a less risky mechanism that enables a venture capitalist to invest in solid, on-going businesses, for example, by buying subsidiaries from top heavy conglomerates. It has low-businesses risk because the company has existed for sometime and often has a positive cash flow to service the debt needed for an LBO.

**Turnaround/Recovery Finance**

Turnaround deal, which implies the recovery of an enterprise, resembles early-stage financing where the business is not yet profitable. Turnaround situations arise when established company runs into trouble, even bankruptcy, and needs money to prepare for a major restructuring to revitalize profit growth. The company may also face mounting debt burden, and slowing down of cash inflows, and need more funds to reach a recovery point. The enterprise may seek a moratorium from creditors for unpaid liabilities. The original entrepreneur may be compelled to relinquish the enterprise to a new management. The venture capitalist plays an active role in such a
situation by providing more equity investments and deploying managerial experts.

1.5. INSTRUMENTS OF FINANCE

The Indian venture capital industry has attempted to maintain the risk-reward sharing nature of the financial relationship through a variety of innovative instruments for structuring the investment. These instruments have been in response to:

- The constraints on pricing imposed by the securities pricing regulations;
- The Indian entrepreneurial ethos which lay considerable emphasis on ownership and control of the company; and
- The company law regulations.

The availability of a wide variety of financial instruments provides considerable flexibility in structuring a venture capital deal.

Table 1.3

<table>
<thead>
<tr>
<th>S.No</th>
<th>Equity Instruments</th>
<th>Debt Instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Equity shares (ES)</td>
<td>Conditional loans</td>
</tr>
<tr>
<td>2</td>
<td>Preference shares (PS)</td>
<td>Conventional loans</td>
</tr>
<tr>
<td>3</td>
<td>Redeemable and non-redeemable preference shares</td>
<td>Non-convertible loans</td>
</tr>
<tr>
<td>4</td>
<td>Cumulative and non-cumulative preference shares</td>
<td>Partially convertible loans</td>
</tr>
<tr>
<td>5</td>
<td>Convertible and non-convertible preference shares</td>
<td>Income notes</td>
</tr>
<tr>
<td>6</td>
<td>Participating and non-participating preference shares</td>
<td>Secured premium notes</td>
</tr>
<tr>
<td>7</td>
<td>Equity warrants</td>
<td>Zero interest bonds</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Deep discount bonds</td>
</tr>
</tbody>
</table>


However, venture finance is made available in the form of equity as well as debt. The equity and debt instruments for a mixed
investment to reduce risk and structure a profitable deal, are listed in table 1.3

1.5.1 EQUITY INSTRUMENTS

Equity and equity-like instruments are of primary importance for the venture capital firms. The several kinds of instruments available, including a few not yet permitted in India, are briefly discussed below.

Equity Shares

Equity shares represent an ownership position. The venture capitalist provides venture capital equity form for the project and acts as 'co-owner' with the entrepreneur, sharing profit/loss in the venture. The equity is generally less than the promoter's contribution, not exceeding 49 per cent of the total capital so that the promoter can retain effective control and majority ownership of the enterprise. The equity shareholders have the right over earnings, and at the same time run the risk of receiving nothing if earnings are insufficient to cover all obligations. The return is from two sources viz., dividends and capital gains through disinvesting shares by selling them.

Preference Shares (PS)

Preference shares are those shares which carry preferential rights over equity shares. The preference extends to assets as well as dividends. These shares carry a coupon rate of dividend which requires to be paid before the declaration of dividend to common equity shareholders. It is sometimes referred to as 'hybrid' instrument as it has some features of both equity and debt.
- **Redeemable Preference Shares**
  Preference shares are redeemable generally after 12 years and for this purpose, the company is required to provide for transfer out of profits a sum to the reserves called capital redemption reserve.

- **Non-redeemable Preference Shares**
  If there is no provision to redeem PS, they are non-redeemable preference shares. As these non-redeemable shares were not popular, they were abolished by the Companies (Amendment) Act of 1988.

- **Cumulative Preference Shares (CPS)**
  PS which have a right to receive dividends in a cumulative fashion are called cumulative preference shares. These enjoy the right to receive dividends in all the years in which the dividends are skipped, as profits were inadequate in those years. The fixed dividend on PS should be paid later in a cumulative way when profits are adequate before any dividends are declared for equity holders.

- **Non-cumulative Preference Shares**
  PS which have no right to receive dividends in a cumulative fashion are called non-cumulative preference shares.

- **Convertible and Non-convertible Preference Shares**
  PS are convertible, if there is a provision for their conversion into equity after a specified period in a particular ratio to the existing equity shares. PS may not be convertible if no such provision is made and is called non-convertible preference shares.
Participating and Non-participating Preference Shares

PS are participating, if they can share in profits in excess of a guaranteed fixed return, if such a provision is made in the Articles of Association of the company and specify the level of profitability such as an equity dividend of 20 per cent. If these are not so participative, they are called non-participating preference shares.

Equity Warrants

Warrants are recent introduction in the family of financial instruments available in India. Warrants induce investors to invest in debentures or bonds offering less favourable terms than they would otherwise look for. The less favourable terms are generally with regard to the interest rate or period of redemption. However, in return for accepting these less favourable terms, investors get warrants which provide them with the option of acquiring common stock at a later date and benefiting from a possible future appreciation of the stock.

1.5.2 DEBT INSTRUMENTS

To ensure that the entrepreneur retains managerial control and VCCs receive a running yield during the early years when the equity portion is unlikely to yield any return, debt instruments are also used by VCCs. They include conditional, conventional, non-convertible, partly convertible, income notes, secured premium notes, zero-interest bonds and deep discount bonds.
Conditional Loans

It is a form of loan finance without any pre-determined repayment schedule or interest rates. The suppliers of such loans recover a specified percentage of sales towards the recovery of the principle as well as revenue in a pre-determined ratio usually 50:50. The charges on sales is known as royalty. The investor stands to gain/lose, depending on whether the actual sales are higher/lower than the projected sales. Conditional loan, in a sense, is quasi-equity instrument.

Conventional Loans

These loans are modified to the requirements of venture capital financing, carry lower interests initially which increase after commercial production commences. A small royalty is additionally charged to cover the interest foregone during the initial years. Although the repayment of the principle is based on a pre-stipulated schedule, the VCCs usually do not insist upon mortgage/other security.

Non-Convertible Debentures (NCDs)

This instrument carries a fixed rate of interest and is redeemable after a specified period in one lump sum or in installments. Sometimes NCDs carry a premium payable at the time of redemption. They are secured instruments and can be either cumulative or non-cumulative. NCDs may also carry a variable rate of interest instead of a fixed coupon rate. In such a case, the interest usually varies in accordance with some pre-determined formula.
Partly Convertible Debentures

It is a combination of convertible and non-convertible portion. The convertible portion is converted into equity shares at par/premium. The non-convertible portion earns interest till redemption generally at par, such instruments are best suited to second round venture capital financing.

Income Notes

It is a hybrid security combining the features of both conventional loan and conditional loan. In this security, a floor rate of interest (say 8%) and a royalty on sales of the company are charged. But the floor interest rate is much lower than for the conventional loan and the rate of royalty is also less. The principle is re-paid according to a stipulated schedule.

Secured Premium Notes (SPNs)

These are secured redeemable at premium in lumpsum/installments, have zero interest and carry a warrant against which equity shares can be acquired. This instrument is also useful for later stage financing. TISCO was the first company to raise funds from the capital market through the issue of SPNs in July, 1992.

Zero Interest/Coupon Bonds

Mahindra & Mahindra Ltd., was the first company to issue this instrument. These debentures can be either convertible or non-convertible with zero interest rate. The non-convertible bonds are sold at a discount from their maturity value while the convertibles are converted into equity shares at a stipulated price and time. They offer considerable flexibility and are appropriate instrument for later stage venture capital financing.
Deep Discount Bonds

These are issued at a large discount to their maturity level. As a long-term instrument, it is not suited to venture capital investment. The main advantage of this instrument is that the difference between the acquisition price and the maturity value can be treated as capital gain.

1.6 INDUSTRY CLASSIFICATION

The Indian Venture Capital Association (IVCA) has classified the industries under the following broad heads [see table 1.4] for the analysis of industry-wise investments.

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Name of the Industry</th>
<th>Description of activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Biotechnology</td>
<td>Human Medical Biotechnology, Agricultural Animal Biotechnology, Industrial Biotechnology related Research &amp; Production Equipment, Biotechnology related Research &amp; Other Service</td>
</tr>
<tr>
<td>2</td>
<td>Computer Hardware and systems</td>
<td>Computers, CAD/CAM, CAE system, graphic systems and peripherals, Tumkey Systems Scanning related Peripherals, Other computers related systems</td>
</tr>
<tr>
<td>3</td>
<td>Computer Software and services</td>
<td>Computer Services, System software integration, Applications software, Graphics software, Artificial intelligence related software services, peripherals, other computer related services</td>
</tr>
<tr>
<td>4</td>
<td>Telecommunications</td>
<td>Data Telephone related, facsimile transmission, Data communication, Satellite, Microwave, other communication related services</td>
</tr>
<tr>
<td>5</td>
<td>Other Electronics</td>
<td>Electronic components, battery and power supplies, electronics related equipment, laser related, fibre optics, analytical &amp; scientific instrumentation</td>
</tr>
<tr>
<td>6</td>
<td>Energy Related</td>
<td>Oil and Gas exploration, drilling and production and alternative energy, enhanced oil recovery, coal related, energy conservation related, others</td>
</tr>
<tr>
<td>7</td>
<td>Medical</td>
<td>diagnostic product and services, therapeutic products and services, specialized hospital equipment, drugs and pharmaceuticals</td>
</tr>
<tr>
<td>8</td>
<td>Industrial Products &amp; Machinery</td>
<td>Energy management, measurement &amp; sensing equipment, process control, robotics, numeric control, biomedical instrumentation, pollution and recycling related others</td>
</tr>
<tr>
<td>9</td>
<td>Food &amp; Food Processing</td>
<td>Packaging, preservation, processing, other post harvest operations</td>
</tr>
<tr>
<td>10</td>
<td>Consumer related</td>
<td>Leisure and recreational products and services, reading, food and beverages, consume products, consumer services, others</td>
</tr>
<tr>
<td>11</td>
<td>Others</td>
<td>Transportation, agriculture, mining, service (not elsewhere classified) manufacturing (not elsewhere classified) construction &amp; building products, utilities, others</td>
</tr>
</tbody>
</table>

1.7 VENTURE CAPITAL ACTIVITY

Venture capital has three major participants; it is basically a relationship among the sources, venture capitalists and the entrepreneurs. The investors contribute to the pool of funds which are invested in opportunities by a venture capitalist. The entrepreneurial teams that supply these opportunities to the venture capitalists form a major part of the venture capital process.

Venture capitalists and entrepreneurs are engaged in a process aimed at long-term creation of wealth for them and for their companies. But, beyond the task of equity financing, they put in their efforts in monitoring and aiding the business in all the aspects. They are not passive providers of capital; rather they are active coaches and cheer leaders for the entrepreneurs with whom they work. In a broader sense the venture capital activity involves:

1. Generating deal flow;
2. Screening and due diligence;
3. Deal structuring and monitoring; and
4. Exit or harvesting

1.7.1 Generating Deal Flow

Venture capitalists, being destination sources of capital, must learn to compete for the best deals. But the old adage always holds good: "money walks; entrepreneur runs". The venture capitalist should not run behind deals; deals should come to him/her
Deals may originate in various ways. Referral system is an important source of deals. Deals may be referred to VCFs by their parent organizations, trade partners, industry associations, friends, etc. Yet another important source of deal flows is the active search through networks, trade fairs, conferences, seminars, dinner clubs, etc. A third source used by venture capitalists are the intermediaries who match VCFs and the potential entrepreneurs.

1.7.2 Screening and Due Diligence

Venture capital is a service industry and VCFs generally operate with a small staff. In order to save on time and to select the best ventures before going for an in-depth analysis, VCFs carry out initial screening of all projects on the basis of some broad criteria, for example, the screening process may limit projects to areas in which the venture capitalist is familiar in terms of technology, product or market scope. The size of investment, geographical location and stage of financing could also be used as the broad screening criteria.

Once the proposal has passed through initial screening, it is subjected to a detailed evaluation or due diligence process. Due diligence is a rigorous analysis and investigation of the deals received by the venture capitalists. The analysis examines the company, the entrepreneurial team, the product or service and its chances of success in the market.

The process takes several weeks and may also run into months sometimes. It involves verifications, references and background checks on management, thorough analysis of the product or service.
and marketability of the product through systematic studies of suppliers, competitors, employees and customers. Due diligence process consists of the following five audits:

- the audit of P
- the audit of S
- the audit of E
- the audit of Financial Statements, and
- the legal audit

These audits are conducted to see as to how a deal can be eliminated faster. The deal has to withstand these rigorous tests to get funding. While a business plan is being framed, the entrepreneur has to define the project properly, since the venture capitalists are looking for big 'P' or big problem, entrepreneurial ideas.

The values of 'S' (solution to a problem) are more difficult to calibrate because they are composed of two factors, 'B' and 'T', where 'B' stands for business plan or the solution delivery mechanism and 'T' stands for the existence of low-priced technology. The valuation for 'S' is arrived at by the formula, \( S = B \times T \).

Experienced venture capitalists look for elegant 'S' which means that if the solution is a product, it should be proprietary and if it is a service, it should be non-duplicable. The technology (T) component of 'S' factor is important in arriving at an elegant 'S'. New technologies can be protected via basic patents and process patents, but as the axiom goes: "Anything worth doing is worth duplicating". In order to maintain a competitive edge, the company should continuously adopt
new methods. In the case of a services company, the service delivery system should be unique, non-duplicable. Any services can be non-duplicable if it is too expensive for others to copy.

The sub-factor ‘B’ or business plan component of the ‘S’ is quite another matter. It is important for an entrepreneur to spare time and make efforts to develop a thorough and competently presented business plan. The venture capitalist ultimately takes his business decision based on the credibility of the operating statements' projections.

1.7.3 Deal Structuring and Monitoring

Once the venture has been evaluated as viable, the venture capitalist and the investee company negotiate the terms of the deal viz., the amount, form and price of the investment. This process is termed as deal structuring. The agreement also includes the protective covenants and earn-out arrangements. Covenants include the venture capitalist’s right to control the investee company and to change its management if needed, buy-back arrangements, acquisition, making IPOs. Earn-out arrangements specify the objectives to be achieved.

Venture capitalists generally negotiate deals to ensure protection of their interest. They would like a deal provider for:

- A return commensurate with the risk.
- Influence over the firm through broad membership.
- Minimizing taxes.
- Assuring investment liquidity and
- The right to replace management in case of consistent poor managerial performance.

There are three most important issues that are considered while a deal is structured:

- **Risks involved in the business**: They can be ascertained by the process of due diligence.

- **Valuation of the business**: pricing the business, based on the financial projections of business; and

- **Management control**: putting in place structures and systems that control the process and evaluate its performance.

The goal of any company seeking equity capital is to maximize the value of the company. Pricing refers to the valuation of the company before and after the financing. Traditionally, the more optimistic entrepreneur wants the highest price possible for the company. The venture capitalist, usually more skeptical, recognizes that plans never proceed according to the schedule and wants a lower valuation. If the venture capitalists are defensive and would like a lower pricing, on the other hand, clever entrepreneurs will try to trudge out a better price.

There are several methods of valuation such as asset-based valuation, the discounted cash flow method, or the market multiplier approach. The popular methods of market multiplier are:

- Traditional pricing method.

- Fundamental pricing method.
In all the above methods some multiple is assigned to one of the performance measures, i.e., projected income, net income, etc. The multiple generally chosen would be P/E ratio of a comparable company or industry.

Once it has been structured and agreement finalized, the venture capitalist generally assumes the role of a partner and collaborator. He also gets involved in shaping of the direction of the venture and constant on-going involvement during the entire life of the investment in investee companies. The enduring relationship between the venture capital company and portfolio enterprises and the active role by the former in the management of the latter is termed as investment nurturing after care.

The style of nurturing refers to the extent of participation by the venture capital company in the affairs of the portfolio enterprises. The style depends upon a variety of factors such as the specialization of the venture capital company, stage of investment, financing plan, the stage of development of the venture capital industry itself and so on. It broadly falls into three categories:

- Hands-on nurturing.
- Hands-off nurturing
- Hands-holding nurturing
Hands-on Nurturing

It means continuous and constant involvement in the operational aspects of the venture. The venture capital firm invariably takes a seat on the board of directors of the investee company and also tries to provide advice and guidance on macro issues. The venture capital firms, following this style of management, feel that in view of their wider exposure and experience in the area, they can provide useful guidance on the aspects of long-term business planning, technology development, financial planning, marketing strategy and so on.

Hands-off Nurturing

Venture capital firms play a relatively passive role in hands-off style of nurturing. Although they usually reserve the right, they rarely have nominee directors on the board of investee companies. They, moreover, do not normally actively participate in formulating strategies/policies inspite of the right to do so. This style of nurturing is appropriate in case of syndicated/joint/consortium venture financing in which some financiers may follow hands-on approach while others may follow hand-off approach. The hands-off style may also be appropriate after the initial plan of the venture is over and the business is running smoothly.

Hands-holding Nurturing

This is an intermediate style between hands-on and hands-off styles. Like the hands-on style, the venture capital firm has the right to have a nominee on the board of directors of the investee company, but actively participates in the decision making process only on being
approached by the latter. If the investee company experiences any difficulty, the venture capital firms provide either in-house assistance or assistance from outside experts.

The purpose of close monitoring of investee companies is to avoid losses by foreseeing impending dangers, and to preserve capital. If a venture capitalist does not avail himself/herself of the privileges of close monitoring, then he/she is taking unusual risks with the capital entrusted to him/her. As a part of their monitoring effort, they routinely undertake the following services which would aid the investment success.41

➢ They act as sounding board for top management.

➢ They offer their broad contacts for diversification, networking between other portfolio companies, foreign marketing expertise, banking contacts, and consultants with special skills.

➢ They are continuously involved in strategic planning such as acquisitions, compensation plans and top management screening. Besides, they provide help in all functional fields of management.

➢ If the company requires additional funds, they may arrange for some more private equity.

➢ Their contacts with the investment community enable orderly planning and execution of public issues.

➢ The expertise of the venture capitalist is used in identifying and selecting an excellent top management team.
The involvement by the venture capitalists in some of the aspects listed above is important because through their involvement they ensure that the venture does not deviate from the original plan. They also ensure that all statutory obligations are fulfilled and the company performs on a sustained basis. In case of non-compliance and default, the venture capitalist would replace the management.

1.7.4 Exit or Harvesting

The last stage in venture capital financing is the exit to realize the investment so as to make a profit or minimize losses. The precise timing of exit depends on several factors such as nature of the investment, the extent and type of financial stage, the state of actual and potential competition market condition, and the style of functioning as well as perception of the investee companies and so on.

Venture capitalist typically aims at making medium to long-term capital gains. They generally want to cash-out their gains in 3-7 years after the initial investment. They play a positive role in directing the company towards particular exit routes. A venture capitalist can exit in four ways:42

- Initial Public Offerings (IPOs),
- Acquisition by another company,
- Re-purchase of the venture capitalist's share by the investee company, and
- Purchase of the venture capitalist's share by a third party.
1.8 CONCLUSION

In the wake of globalization and its resultant, high competition as marks all national economies of the World, India being no exception. The banking and financial industry has been evolving to meet the changing requirements of the business – from commercial banking to industrial finance, to venture capital financing. VC is based on the dictum that no innovative business idea shall meet its death for lack of venture capital finance. Among many features of VC, the note-worthy features are equity participation, long-term horizon, high-risk investment in high-tech areas. Broadly instruments of VC are equity and debt instruments. These two instruments are tailor-made to fit into the requirements of portfolio enterprises in two stages namely, early stage and later stage. In early stage are included three sub-stages viz., seed capital, start-up and second round finance. Later stage includes four sub-stages such as bridge capital, replacement capital, buyouts and turnarounds. VC activity is a four stage activity: generating deal flow, screening and due diligence, deal structuring and monitoring, and exit.
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