VENTURE CAPITAL

LECTURE - 3

Topics to be covered

- Structure of venture capital firms and funds
- Dimensions of venture capital
- Stages of financing offered in venture capital

STRUCTURE OF VENTURE CAPITAL FIRMS & FUNDS

Venture capital firms are typically structured as partnerships, the general partners of which serve as the managers of the firm and will serve as investment advisors to the venture capital funds raised. Venture capital firms in the United States may also be structured as limited liability companies, in which case the firm's managers are known as managing members. Investors in venture capital funds are known as limited partners. This constituency comprises both high net worth individuals and institutions with large amounts of available capital, such as state and private pension funds, university financial endowments, foundations, insurance companies and pooled investment vehicles, called fund of funds or mutual funds.

DIMENSIONS OF VENTURE CAPITAL

Venture capital in India is available in four forms:

1) Equity Participation: The venture capital finances up to 49% of the equity capital and the ownership remains with the entrepreneur.

2) Conventional Loan: Under this, a lower fixed rate of interest is charged to the unit till its commercial operation. After normal rate of interest is paid, loan is to be repaid as per the agreement.

3) Conditional Loan: A conditional loan is repayable in the form of royalty ranging between 2 and 15% after the venture is able to generate sales and no interest is paid on such loans.

4) Income Notes: The income note combines the features of conventional and conditional loans in a way that the entrepreneur has to pay both interest and royalty on sales at low rates.

STAGES OF FINANCING OFFERED IN VENTURE CAPITAL

There are typically six stags of financing offered in Venture Capital, that roughly correspond to these stages of a company's development:

1) Seed Money: Low – level financing needed to prove a new idea (often provided by "angle investors").

2) Start-up: Early stage firms that need funding for expenses associated with marketing and product development.

3)First- Round: Early sales and manufacturing funds.

4) Second – Round: Working capital for early stage companies that are selling product, but not yet turning a profit.

5) Third- Round: Also called Mezzanine financing, this is expansion money for a newly profitable company.

6) Fourth- Round: Also called bridge financing, 4th round is intended to finance the "going public" process.

TYPES OF FINANCING

1) **Seed Financing:** During the developments stage of a venture's lifecycle, the primary source of funds is in the form of seed financing to determine whether the idea can be converted into a viable business opportunity. The primary source of funds at the development stage is the entrepreneur's own assets. As a supplement to this limited source, most new ventures will also resort to financial bootstrapping, i.e., creative methods, including barter, to minimize the cash needed to fund the venture. Money from personal bank accounts and proceeds from selling other investments are likely sources of seed financing. It is quite common for founders to sell personal assets (e.g., an automobile or a home) or secure a loan by pledging these assets as collateral.

   Although it can be risky, entrepreneurs often use personal credit cards to help finance their business, Family members and friends also provide an important secondary source of seed financing; they may make loans to the entrepreneur or purchase an equity position in the business. (It is often said that family and friends invest in the entrepreneur rather than in a product or service) Such financing is usually relatively inexpensive, at least compared with more formal venture investing. While there are a few professional and business angel investors that engage in seed-stage investing, they are not a typical source of financing at this stage.

TYPES OF FINANCING

2) **Start-Up Financing:** Start- up financing coincides with the start-up stage of the venture's lifecycle; this is financing that takes the venture from having established a viable business opportunity to the point of initial production and sales. Start-up financing is usually targeted at firms that have assembled a solid management team, developed a business model and plan and are beginning to generate revenues. Depending on the demands placed on the entrepreneur's personal capital during the seed stag, the entrepreneur's remaining assets, if any, may serve as a source of start-up financing, family and friends may continue to provide financing during start-up.

   However, the start-up venture should begin to think about the advantages of approaching other, more formal, venture investors.

TYPES OF FINANCING

- ***Venture Capital:*** *Although sales or revenues begin during the start-up stage, the use of financial capital is generally much larger than the inflow of cash. Thus, most start-up stag ventures need external equity financing. This source of equity capital is referred to as venture capital, which is early stage financial capital often involving substantial risk total loss. The flip side of this risk of total loss is the potential for extraordinarily high returns when an entrepreneurial venture is extremely successful. Venture capital investors will require the venture, if it has not yet done so, to organize formally in order to limit the risk assumed by venture investors to the amount invested.*

  Two primary sources of formal external venture capital for start-up stage ventures are:

- *i) Business Angels: Business angles are wealthy individuals, operating as informal or private investors, who provide venture financing for small businesses. They may invest individually or in joint efforts with others. While business angels may be considered informal investors, they are not uniformed investors. Many business angels are self-made entrepreneur multi- millionaires, generally well educated, who have substantial business and financial experience. Business angels typically invest in technologies, products and services in which they have a personal interest and previous experience.*

- *ii) Venture capitalists (VCs): They are individuals who join in formal, organized venture capital firms to raise and distribute venture capital firms typically invest the capital they raise in several different ventures, in an effort to reduce the risk of total loss of their invested capital.*

TYPES OF FINANCING

3) **First Round Financing:** The survival stage in a venture's lifecycle is critical to whether the venture will succeed and create value or be closed and liquidated. First round financing is external equity financing typically provided by venture investors during the venture's survival stage to cover the cash shortfalls when expenses and investments exceed revenues. While some revenues begin during the start-up stage, the race for market share generally results in a cash deficit, Financing is needed to cover the marketing expenditures and organizational investments required to bring the firm to full operation in the venture's commercial market. Depending on the nature of the business, the need for first-round financing may actually occur near the end of the start-up stage.

TYPES OF FINANCING

Survival – stage *ventures seek financing from a variety or external sources, For example, both suppliers and customers become important potential sources of financing.*

i) Trade Credit: Financing provided by suppliers in the form of delayed payments due on purchases made by the venture.

ii) Small Business Administration (SBA): It was established by the federal government to provide financial assistance to small businesses.

iii) Government Assistance Programs: Financial support, such as low- interest rate loans and tax incentives provided by State and Local Governments to help small businesses.

iv) Commercial Banks: Financial intermediaries that take deposits and make business and personal loans.

TYPES OF FINANCING

4) **Second Round Financing:** The major sources of financing during the rapid growth stage come from business operations, suppliers and customers, commercial banks and financing intermediated by investment bankers. Most ventures upon reaching the rapid revenue growth stage, find that operating flows, while helpful, remain inadequate to finance the desired rate of growth stage, find that operating flows, while helpful, remain inadequate to finance the desired rate of growth. Rapid growth in revenues typically involves a prerequisite rapid growth in inventories and accounts receivable, which requires significant external funding. Because inventory expenses are usually paid to collecting on the sales related to those inventories, most firms commit sizable resources to investing in "working capital."

THANK YOU

References:

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Machiraju, ‘Indian Financial System’, Vikas Publishing House, 2nd Edition.