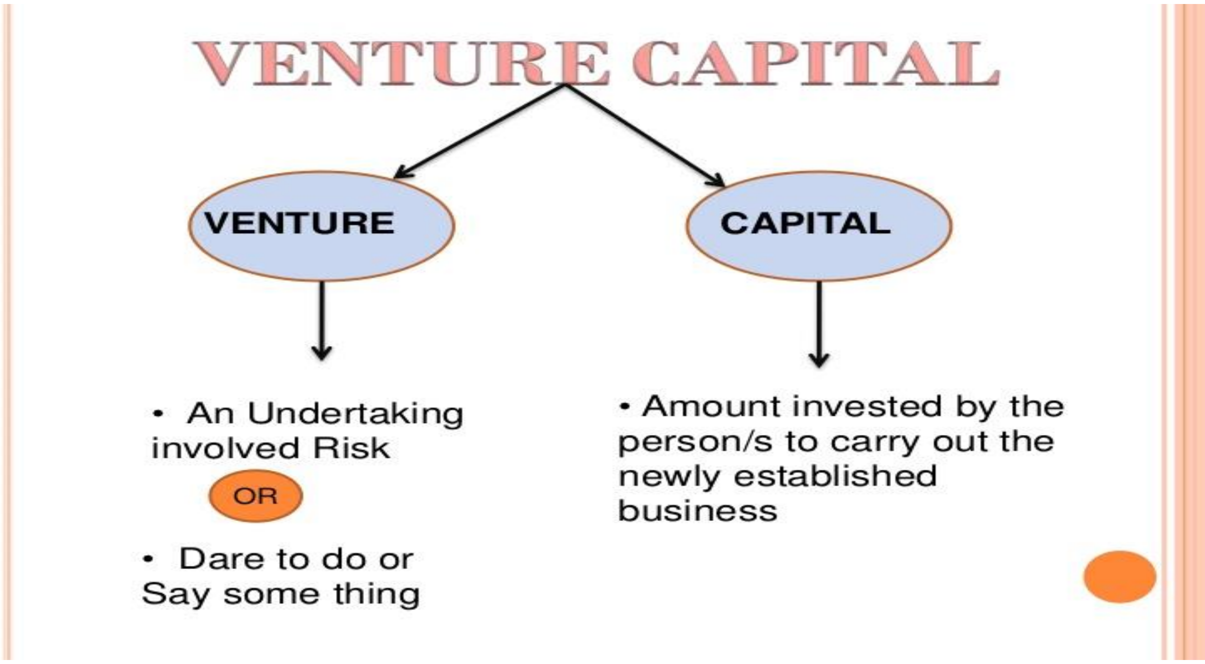

Venture capital is a form of private equity and a type of financing that investors provide to start up companies and small businesses that are believed to have long term growth potential. Venture Capital generally comes from well-off investors, investment banks and any other financial institutions. However, it does not always take a monetary form; it can also be provided in the form of technical or managerial expertise. Venture capital is typically allocated to small companies with exceptional growth potential, or to companies that have grown quickly and appear poised to continue to expand. The definition of venture capital can be understood with the below diagram-

Venture capital is equity support to fund a new concept that involves a higher risk and at the same time, have a high growth and profit.' "Venture capital is broadly implies an investment of long term, equity finance in high risky projects with high rewards possibilities."

In India, the Security and Exchange board of India (SEBI) guidelines govern the operations of venture capital funds. Venture capital funds may be structured as a company or trust to raise finances through loans, donations, issues of securities or units and to make investments in new ventures in accordance with the SEBI regulation.

Features of Venture Capital investments

- High Risk
- Lack of Liquidity
- Long term horizon
- Equity participation and capital gains
- Venture capital investments are made in innovative projects
- Suppliers of venture capital participate in the management of the company

Advantages of Venture Capital

Economy Oriented:

1. Helps in industrialization of the country
2. Helps in technological development of the country
3. Generates employments
4. Helps in developing entrepreneurial Skills

Investors Oriented:

1. Benefit to the investor is that they are invited to invest only after company starts earning profit, so the risk is less and healthy growth of capital market is entrusted.
2. Profit to venture capital companies
3. Helps them to employ their idle funds into productive avenues.

Entrepreneur Oriented:

1. Finance: The venture capitalist injects long- term equity finance, which provides a solid capital base for future growth.
2. Business Partner: The venture capitalist is a business partner, sharing the risks and rewards.
3. Mentoring
4. Alliances: The venture capitalist also has a network of contacts in many areas that can add value to the company.
5. Facilitation of Exit: The venture capitalist is experienced in the process of preparing a company for an IPOs and facilitating in trade sales.

Disadvantages of Venture Capital

- As the investors become part owners, the autonomy and control of the founder is lost
- It is a lengthy and complex process
- It is an uncertain form of financing
- Benefit from such financing can be realized in long run only

Methods of Venture Financing

- Equity
- Conditional Loan
- Income Note
- Other Financing Methods
    1. Participating Debentures
    2. Partially Convertible Debentures
    3. Cumulative Convertible Preference Shares
    4. Deferred Shares
    5. Convertible Loan Stock

6. Special Ordinary Shares

7. Preferred Ordinary Shares

- **Conditional Loan:** A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India, VCFs charged royalty ranging between 2 and 15 percent; actual rate depended on other factors of the venture such as gestation period, cost-flow patterns, risks and other factors of the enterprise.

- **Income Note:** It is a unique way of venture financing in India. It is a hybrid security which combined the features of both conventional loan and conditional loan. The entrepreneur had to pay both interest and royalty on sales, but at substantially low rates.

Venture Capital Investment Process:

1. **Deal Origination:** A continuous flow of deal is essential for the venture capital business. Deals may originate in various ways:

   A. referral system

   B. active search

   C. intermediaries

2. **Screening:** Venture capital is a service industry, and venture capital funds (VCFs) generally operate with a small staff. In order to save on time and to select the best venture, before going for an in- depth analysis, VCFs carry out initial screening of all projects on the basis of some broad criteria.

3. **Due Diligence:** Once a proposal has passed through initial screening, it is subjected to a detailed evaluation or due diligence process. Most ventures are new and the entrepreneurs may lack operating experience. The venture capitalist evaluates the quality of entrepreneur before appraising the characteristics of the product, market or technology.

The evaluation of ventures by VCFs in India includes the following steps;

a. Preliminary evaluation: The applicant is required to provide a brief profile of the proposed venture to establish prima facie eligibility. Promoters are also encouraged to have a face-to-face discussion to clarify issues.
b. b. Detailed Evaluation: Once the project has crossed the qualifying hurdle through initial evaluation, the proposal is evaluated in greater detail. A lot of stress is

placed on techno- economic evaluation. Most of the VCFs involve experts for the technical appraisal, whenever necessary.

In this stage the venture capitalist analyze product, market, technological and entrepreneurial risks of the venture before they decide to finance it.

4. **Post Investment activities:**

Once the deal has been structured and agreement finalized, the venture capitalist generally assumes the role of a partner and collaborator. He also gets involved in shaping the direction of venture. This may be dome via a formal representation on the board of directors, of informal influence in improving the quality of marketing, finance and other managerial functions.

5. Exit Plan: Venture capitalists typically aim at making medium to long term capital gains. They generally want to cash- out their gains in five to ten years after the initial investment. They play a positive role in directing the company towards particular exit routes. A venture may exit in one of the following ways:

a. Initial public offerings (IPOs)

b. Acquisition by another company

c. Purchase of the venture capitalist’s share by the promoter

d. Purchase of the venture capitalist’s share by the outsider

Stages in Venture Financing:-

1. **Early Stage:**

a. Seed financing for supporting a concept of idea

b. R & D financing or product development

c. Start- up capital for initial production and Marketing

d. First stage financing for full- scale production and marketing

2. **Expansion Financing:**

a. Second stage financing for working capital and initial expansion

b. Development financing for facilitating public issue

c. Bridge financing for facilitating public issue

3. **Acquisition/ Buyout financing growth**

a. Acquisition financing for acquiring another firm for further growth

b. Management buyout financing for enabling operating group to acquire firm or part of its business

c. Turnaround financing for turning around a sick unit

Objective of Venture Capital Investment

To generate substantial capital appreciation through investment in early stage companies capable of achieving rapid growth.

Need of Venture Capital:

- To bridge the gap between Capital and Knowledge
- Maximum utilization of available resources

Future Prospects of Venture Financing

- Rehabilitation of sick units.
- Assist small ancillary units to upgrade their technologies.
- Provide financial assistance to people coming out of universities etc.
- VCFs can play a significant role in the service sector including tourism, publishing, health care, etc.

Important Regulations Laid down by SEBI for Venture Capital Funds-
SEBI amended regulations for VCFs are:

(i) VCF is a fund established in the form of a trust/a company including a body corporate and registered with SEBI. It has a dedicated pool of capital, raised in the specified manner and invested in VCUs in accordance with the regulations. VCU is a domestic company whose shares are not listed on a stock exchange and is engaged in specified business.

(ii) The minimum investment in a VCF from any investor would not be less than Rs. 5 lakh and the minimum corpus of the fund before it could start activities should be at least Rs. 5 crore.

(iii) The norms of investment were modified. A VCF seeking to avail benefit under the relevant provisions of the Income Tax Act will be required to divest from the investment within a period of one year from the listing of the VCU.

(iv) The VCF will be eligible to participate in the IPO through book building route as Qualified Institutional Buyer.

(v) The mandatory exit requirement by VCF from the investment within one year of the listing of the shares of VCUs to seek tax pass- through was removed under the SEBI (VCF) Regulation to provide for flexibility in exit to VCFs.

(vi) The VCFs were directed to provide with the information pertaining to their venture capital activity for every quarter starting form the quarter ending December 31, 2000.

(vii) Automatic exemption was granted from applicability of open offer requirements in case of transfer of shares from VCFs in foreign venture capital investors to promoters of a VCU.
