Venture Capital Financing

- A fund based financial service

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Introduction

VCIs, emerged to fill gaps of conventional financial system by focusing on entrepreneurs & commercialization of new technologies

Defining Venture Capital

- Venture capital can be described as separate asset class, <u>often called as private equity.</u>

- Private equity investment sits at the <u>furthest end of risk-reward spectrum</u>

Features

- Venture capital investor provides finance and business skills to exploit market opportunities and to obtain capital gain.
- Venture capital is basically equity finance in relatively new companies.
- It's basically long-term investment. It's <u>new & long-term capital</u> that is injected to enable the business to grow rapidly.

- Substantial degree of active involvement of VCI with VCU
- "Hands-on" approach/management
- Venture capital financing involves high risk-return spectrum
- Venture Capital is much more than financing new and high-technology oriented companies.

Venture Capital Institution/Fund

- VCI is financial intermediary between investor and entrepreneurs

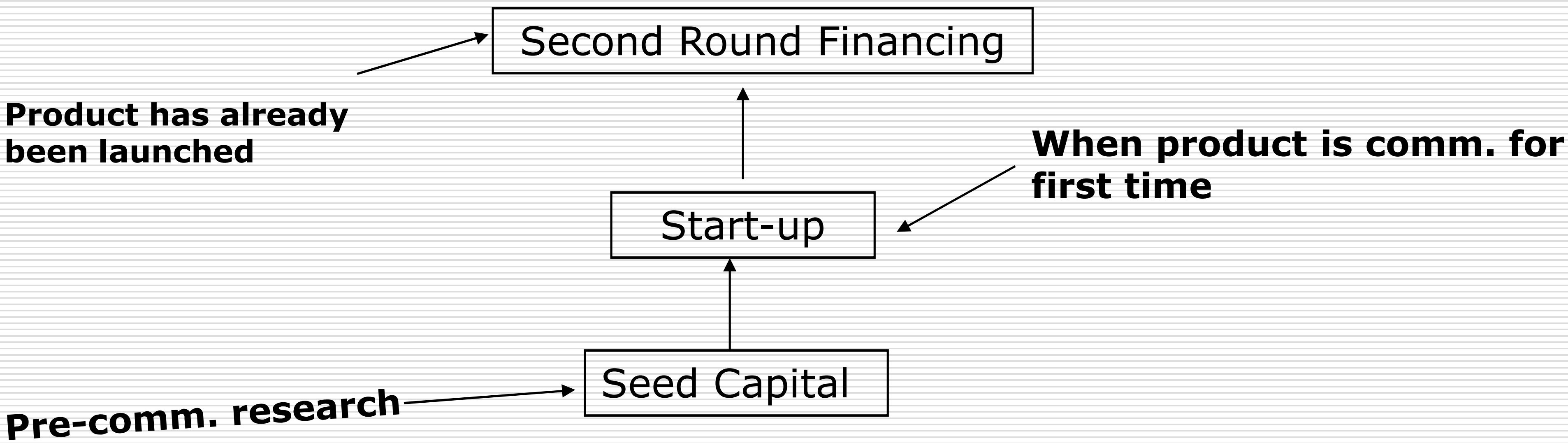
Selection of Investment

- Criteria

- Stages of Financing :
  1. Early Stage
  2. Later Stage

Stages of Financing :

1. Early Stage Financing:



2. Later Stage of Financing:

- This stage includes –
  - Mezzanine Capital
  - Bridge/Expansion (Last round of financing)
  - Buyouts (implies transfer of mgt. control)
    - Mgt. Buyouts (MBO): Funds to existing mgt.
    - Mgt. Buyins (MBIs): Funds provided to an outside group to buy an ongoing company)
    - Turnarounds : buying control of sick comp.

Conclusion

- In the early stage investment, the technology is often untried at commercial level of operation

- In later stage investment, the technology has already been tried out commercially and product has been introduced in the market.

Financial Analysis

- Conventional Valuation Method
- The First Chicago Method
- Revenue Multiplier Method

1. Conventional Valuation Method

- A method of valuation in which Venture Capital Undertaking is being evaluated by <u>Starting time of investment</u> and <u>Exit time.</u>

- Steps in valuation of VCU:

1. Compute annual revenue at the time of liquidation
2. Compute expected earning level
3. Compute future market valuation
4. Obtain the present value of ICs/VCU using a suitable discount factor

- The minimum % of ownership required is 2/5th or 40%

- Weakness :

  - Ignores the **stream of earnings.**
  - Over-emphasis on **the exit date**

2. The First Chicago Method:

This method considers nature of the path between the starting point and the exit point and considers entire earning stream

- Steps involved :
  - “Success”, “Sideways survival” and “Failure” – Probability rating
  - Using discount rate, the P.V. of undertaking is computed.
  - Discounted present value is multiplied by respective probabilities

- The <u>minimum ownership</u> required by VCI is 50 %

3. Revenue Multiplier Method

A factor which will be used to estimate the value of VCU.

$$M = \frac{V \text{ (Present value of VCU)}}{R \text{ (Annual revenue level)}}$$

- Where it can used ?
  - Useful in early stage where earning is considered based on after-stage profits

- Weakness:
  - This method requires a wealth of data which is generally not available in a country like India.

Investment Nurturing/Aftercare

Meaning & Introduction :

- Conventional financial system and active role of VCI
- Investment nurturing differs from the investment monitoring by conventional financial system.
- So, investment nurturing is one in which VCIs plays an enduring relationship with VCU.

- The main elements of Aftercare is –
  - After stage investment decision
  - Building a joint relationship to tackle the problem.
  - Protection of interest/investment of VCI

Styles of Investment Nurturing

1. Hands-on Nurturing:

- A continuous and constant involvement in VCU which is institutionalized in the form of representation on board of directors.
- Useful guidance for long-term business planning, marketing strategies etc.
- Essentially, helpful at the early stage of financing.

2. Hands-off Nurturing:

- Plays a passive role while formulating policy.
- VCIs don't have any person in the board of directors.
- This type of financing is appropriate in syndicated venture capital financing.
- Hands-off approach is also suitable after the initial phase/plan is over.

3. Hands-holding nurturing:

- A mid way between Hands-on and Hands-off nurturing.
- Participate only after being approach by VCU.

Objectives of After Care

- Ensure proper utilization of assistance provided.
- Ensure implementation of the project with the time and cost
- Time and cost overruns the project
- To ensure VCU doesn’t default in any statutory obligations
- To evaluate the performance of the project

Techniques of Aftercare

- Personal Discussions
- Plant visits
- Feedback through nominee directors
- Periodic Reports
- Commissioned Studies

What are the important channels for EXIT of investments in VCF ?

- Disinvestments of Equity
  - Going Public
  - Sale of shares to entrepreneurs/Earn out
  - Trade Sales
  - Takeout/Sales to a new investor
  - Liquidation
- Exit of Debt Instruments