Venture Capital : Concept, Characteristics and Functions:

Concept of Venture Capital:

Narrowly speaking, venture capital refers to the risk capital supplied to growing companies and it takes the form of share capital in the business firms. Both money provided as start-up capital and as development capital for small but growing firms are included in this definition.

In developing countries like India, venture capital concept has been understood in this sense. In our country venture capital comprises only seed capital, finance for high technology and funds to turn research and development into commercial production.

In broader sense, venture capital refers to the commitment of capital and knowledge for the formation and setting up of companies particularly to those specialising in new ideas or new technologies. Thus, it is not merely an injection of funds into a new firm but also a simultaneous input of skills needed to set the firm up, design its marketing strategy, organise and manage it.

In western countries like the USA and UK, venture capital perspective scans a much wider horizon along the above sense. In these countries, venture capital not only consists of supply of funds for financing technology but also supply of capital and skills for fostering the growth and development of enterprises.

Much of this capital is put behind established technology or is used to help the evolution of new management teams. It is this broad role which has enabled venture capital industry in the West to become a vibrant force in the industrial development. It will, therefore, be more meaningful to accept broader sense of venture capital.

Characteristics of Venture Capital:

Venture capital as a source of financing is distinct from other sources of financing because of its unique characteristics, as set out below:

1. Venture capital is essentially financing of new ventures through equity participation. However, such investment may also take the form of long-term loan, purchase of options or convertible securities. The main objective underlying investment in equities is to earn capital gains there on subsequently when the enterprise becomes profitable.

2. Venture capital makes long-term investment in highly potential ventures of technical savvy entrepreneurs whose returns may be available after a long period, say 5-10 years.

3. Venture capital does not confine to supply of equity capital but also supply of skills for fostering the growth and development of enterprises. Venture capitalists ensure active participation in the management which is the entrepreneur's business and provide their marketing, technology, planning and management expertise to the firm.

4. Venture capital financing involves high risk return spectrum. Some of the ventures may yield very high returns to more than Compensates for heavy losses on others which may also have earning prospects.

In nut shell, a venture capital institution is a financial intermediary between investors looking for high potential returns and entrepreneurs who need institutional capital as they are yet not ready/able to go to the public.

Dimensions of Venture Capital:

Venture capital is associated with successive stages of the firm's development with distinctive types of financing, appropriate to each stage of development. Thus, there are four stages of firm’s development, viz., development of an idea, start up, fledgling and establishment.

The first stage of development of a firm is development of an idea for delineating precise specification for the new product or service and to establish a business-plan. The entrepreneur needs seedling finance for this purpose. Venture capitalist finds this stage as the most hazardous and difficult in view of the fact that majority of the business projects are abandoned at the end of the seedling phase.

Start-up stage is the second stage of the firm’s development. At this stage, entrepreneur sets up the enterprise to carry into effect the business plan to manufacture a product or to render a service. In this process of development, venture capitalist supplies start-up finance.

In the third phase, the firm has made some headway, entered the stage of manufacturing a product or service, but is facing enormous teething problems. It may not be able to generate adequate internal funds. It may also find its access to external sources of finance very difficult. To get over the problem, the entrepreneur will need a large amount of fledgling finance from the venture capitalist.

In the last stage of the firm’s development when it stabilizes itself and may need, in some cases, establishment finance to explicit opportunities of scale. This is the final injection of funds from venture capitalists. It has been estimated that in the U.S.A., the entire cycle takes a period of 5 to 10 years.

Functions of Venture Capital:

Venture capital is growingly becoming popular in different parts of the world because of the crucial role it plays in fostering industrial development by exploiting vast and untapped potentialities and overcoming threats.

Venture capital plays this role with the help of the following major functions:
Venture capital provides finance as well as skills to new enterprises and new ventures of existing ones based on high technology innovations. It provides seed capital to finance innovations even in the pre-start stage.

In the development stage that follows the conceptual stage, venture capitalist develops a business plan (in partnership with the entrepreneur) which will detail the market opportunity, the product, the development and financial needs.

In this crucial stage, the venture capitalist has to assess the intrinsic merits of the technological innovation, ensure that the innovation is directed at a clearly defined market opportunity and satisfies himself that the management team at the helm of affairs is competent enough to achieve the targets of the business plan.

Therefore, venture capitalist helps the firm to move to the exploitation stage, i.e., launching of the innovation. While launching the innovation the venture capitalist will seek to establish a time frame for achieving the predetermined development marketing, sales and profit targets.

In each investment, as the venture capitalist assumes absolute risk, his role is not restricted to that of a mere supplier of funds but that of an active partner with total investment in the assisted project. Thus, the venture capitalist is expected to perform not only the role of a financier but also a skilled faceted intermediary supplying a broad spectrum of specialist services- technical, commercial, managerial, financial and entrepreneurial.

Venture capitalist fills the gap in the owner’s funds in relation to the quantum of equity required to support the successful launching of a new business or the optimum scale of operations of an existing business. It acts as a trigger in launching new business and as a catalyst in stimulating existing firms to achieve optimum performance.

Venture capitalists role extends even as far as to see that the firm has proper and adequate commercial banking and receivable financing. Venture capitalist assists the entrepreneurs in locating, interviewing and employing outstanding corporate achievers to professionalize the firm.

SEBI Guidelines for Venture Capital Funds:

Regularizing various conditions into uniform measures:
At present, we have various conditions imposed on **venture capital investments**. Instead of such measures, we can make venture capital as a single window clearance. The Income Tax Act under Section 10 (23FA) must provide automatic tax exemptions to venture capital fund.

Structure of Venture Capital Fund:
Limited partnership firms and limited liability companies can also be created by amending the existing Partnership Act and Companies Act.

Foreign **venture capital investor**, registered with SEBI should not have any ceiling for investment in India and there is no need for approval from Foreign Investment Promotion Board and Reserve Bank of India.

Resource Mobilization:
Mutual funds, Banks and Insurance companies should be allowed to invest in venture capital funds.

Investments by Venture capital institutions:
There should not be any restrictions with regard to investment by venture capital institutionsInvestments can be allowed even in real estates and other finance companies. At present, there is a ceiling of 40% in the paid up capital of the borrowing company. This should be removed.

The Venture capital institutions must be allowed freely to invest in equity or equity related investments and also subscribe in Initial Public Offer (IPO).

Domestic Venture Capital institutions must be allowed to invest in securities of companies registered outside India. There may be a ceiling for such investments.

Exits:
Under the Companies Act, buy back of securities needs amendment to the Act. There is a prohibition of fresh issue of capital for a period of 2 years which can be reduced to 6 months for unregistered companies. The venture capital institutions should also be exempted from SEBI takeover code.

SEBI Regulations:
The present SEBI guidelines on Initial Public Offer (IPO), applicable to companies earning profits for 3 years should be reduced.

Transfer of securities: The practice of obtaining no objection certificate should be dispensed with.
The definition of SEBI with regard to venture capital institutions should undergo a change. It should include funds set-up and other legal entities. **Venture capital institutions** must be permitted to invest in equity related instruments or in IPO. Investment in listed securities of sick companies may be given up. Financial assistance to companies obtaining Venture Capital Funds needs relaxation.
Company Law:
Suitable amendments should be made for buy back facility.

Other issues:
Other related issues consist of employees stock option plans, investment in foreign companies and tax issues.

The above recommendations of Chandrasekaran Committee have been accepted by the Government.