CHAPTER 1

What is Venture Capital?

"Be you in what line of life you may, it will be amongst your misfortunes if you have not time properly to attend to pecuniary [monetary] matters. Want of attention to these matters has impeded the progress of science and of genius itself."
William Cobbett

What is a Venture?

In common parlance, the term venture refers to a business undertaking. The dictionary definition is more specific. The word "venture" is *defined* as follows*:

> ***"venture*** (vĕn'chər)
> n.
> 1. An undertaking that is dangerous, daring, or of uncertain outcome.
> 2. A business enterprise involving some risk in expectation of gain.
> 3. Something, such as money or cargo, at hazard in a risky enterprise."

As you may note, there is a lot of emphasis on the words "risk" and

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* *The American Heritage® Dictionary of the English Language*, Fourth Edition. Houghton Mifflin Company, 2004. 31 August, 2008. <Dictionary.com http://dictionary.reference.com / browse / venture>"

"uncertain" in the definition of a venture. It is also interesting to note the evolution of this word:

> ***"venture (v.)***
> c.1436, "to risk the loss" (of something), shortened form of *adventure,* itself a form of adventure. General sense of "to dare, to presume" is recorded from 1559. Noun sense of "risky undertaking" first recorded 1566; meaning "enterprise of a business nature" is recorded from 1584. Venture capital is attested from 1943" *

Clearly, the term venture is the shortened form of "aventure", which itself is the abridged version of "adventure". In short, the origin of the word is associated with adventure, risk and uncertainty of outcome. In terms of its usage to refer to a risky undertaking, the word is almost 400 years old.

But the term "venture capital" is much more recent and came into general usage only about 1950.

It is evident from the definition and history of the term venture that the term venture capital is associated with the undertaking of risk and uncertainty in expectation of gain from a business enterprise.

What Then is Venture Capital?

Venture capital is money invested in businesses that are small; or exist only on paper as a concept, but have the potential to grow and become immense. The people who invest this money are called venture capitalists or, simply, VCs. The businesses VCs choose to invest in are; typically, privately owned, their shares are not listed on the stock exchange and also carry restrictions regarding their transfers. The venture capital investment is made when a VC buys shares of such a company and becomes a financial partner in the business.

As the VC investment is made in a company's equity, it is also referred to as risk capital, denoting that, unlike loans that are secured by lenders through charges made against the assets of the company, this

* Online Etymology Dictionary. Douglas Harper, Historian. 31 August 2008. <Dictionary.com http://dictionary.reference.Com / browse / venture>

investment is at risk of being completely wiped out if the business goes into bankruptcy. VC money is also sometimes referred to as "patient risk capital" as the investment is usually made for a medium to long-term period ranging from anywhere between 2 to 3 years to about 5 to 7 years, and in some rare cases as long as 10 years. Clearly, the objective of the VC is not to earn a regular income from his investment but to make a substantial gain, for example, 3 to 5 times the amount invested, by selling his shares either at the time of the listing of the company's shares on the stock exchange, or through the sale of the company to a strategic investor.

VCs who provide their own money to entrepreneurs for "seed capital" to research an idea, draw up a business plan and other initial business activities are referred to as "angels" and the money they invest is called "angel capital", which is one of the ways "informal venture capital" works. "formal venture capital", in contrast, refers to money collected by money managers and "pooled" in a company or trust which then is called a "VC Fund". This money collected from rich individuals (HNIs — high-net worth individuals), pension funds and other institutions is invested in businesses that meet the pre-defined criteria

"Private equity" is another term that you will come across in your search of venture capital. The meaning of this term is commonsensical. Private is something that is not public. So, private equity simply means shares of a company that are not listed on the stock exchange and hence are not available for the general public to invest in. Private equity investment means buying into the share capital of a privately owned company whose shares are not listed on a stock exchange.

For all practical purposes, private equity is the same as venture capital and the two terms are often used interchangeably, especially in India and Europe. But you must be alert to the fact that in USA, the birth place of the VC industry as it is known today, the term venture capital is used in a narrower and limited sense of investment only in nascent, rapidly growing, innovative and, often, technology-based firms. The term excludes buyout capital provided for mergers, acquisitions and re-organization among large existing companies, the data for which is collected and tracked separately by analysts. As this narrower the US definition of venture capital keeps the origins of this form of capital alive in memory, it is also often called classic venture capital.

The difference between private equity (PE) and venture capital (VC) is basically the stage of the lifecycle of the business at which each form of capital is directed. VC is regarded as a sub-set of PE, with both forms of capital being invested in privately owned business by buying shares of the company. PE investments are made in businesses in their expansion stage, when the businesses have established products, markets, etc., and have a history of steady cash flows. VC investments are, in contrast, made in the earlier stages of the lifecycle of a business when the credibility of its business model is still in the process of being established. As the VC investment comes in at an early stage of business, it remains invested in the business for a longer period, and is also a riskier form of investment than is PE. PE money usually seeks a 3-year investment horizon. As such, VC money seeks a higher return than PE money to account for the higher risk that it takes.

Some PE money also goes into companies which are already listed on the bourses. These are called PIPE investments. PIPE is an acronym for "Private Investments in Public Equity" which explains the nature of such investments. PIPE investments are less risky as they invest in companies which are already listed and hence have already to comply with all the disclosure and investor protection laws. This makes a lot of information available in the public domain, making PIPE investments decisions informed ones and hence less risky than other PE and VC investments.

You will also come across the term "Corporate Venture Capital" (CVC) in your quest for raising funds for your business. CVC refers to venture capital investments made by large corporations to further their strategic interest. CVC investments may be done through a dedicated pool of money organized as a formal VC fund, or as corporate direct investment in the investee companies. Big companies such as Intel, Dell, Microsoft, etc. make CVC investments which are mostly strategic in nature, that is, these investments are made with a view to enhancing their own financial or market position. However, these companies also make investments purely for superior financial returns. A more detailed explanation of CVC is attached in Appendix 3.

What Venture Capital is Not

Venture capital is *not* money available at a rate of interest payable at regular intervals although VCs usually do take some regular payment as fees to provide support to the companies in which they invest. This form of investment should also not be confused with other financial services which are performed for a fee, such as management consulting, merchant and investment banking, or business intermediary services.

To put the definition of venture capital in sharper focus, let us review the contrast between debt capital, or simply, loans from banks, and venture capital.

Loans are available from banks at a fixed rate of interest. The bank assesses the ability of your business to pay regular interest, which means that your business has to be able to generate enough cash to meet the regular cash outflows on account of interest. The bank also likes to secure the principal amount, that is the amount it gives you as loan, by:

- Taking mortgage or pledge against the assets of the business;
- Taking mortgage or pledge against your personal assets as collateral security; and
- Taking personal guarantees from you for re-payment of the principal.

Banks are concerned with limiting their liability in case you default on the loan and hence are conservative in their dealing, seeking as much security as possible to cover for their loan to you. Now here comes the catch — if you and your business had enough assets, and the business generated enough cash to pay interest, then why would you need a loan? On the other hand, if your business has no assets but you have great ideas and the wherewithal to translate them into a viable business, where do you find the money to realize your dreams, as you would certainly not qualify for bank loans?

This is the gap that venture capital fills.

The VC, in contrast to a bank, evaluates the potential of a business to grow and become a very big business. Unlike a bank, a VC does not want regular payments, so the money that he invests in exchange for the shares of your company stays as capital in the business for a long time. He does not ask for any security and he puts in substantially more money that you as the entrepreneur have invested. To "de-risk", i.e. protect, himself, he likes to keep himself informed of the happenings in your business and, through the investment agreements, takes rights to have a say in major decisions of the business.

Do VCs Provide Only Money?

VCs provide what is known in the industry as "smart money". This phrase means that VCs' contribution is not limited to money. They function as guides and mentors and help the entrepreneur in making the business succeed.

VCs are backers of ideas and potential. Apart from capital, they provide expertise to enable a start-up business to succeed and grow. They are experienced professionals who have had successful careers as entrepreneurs. They have "been there and done that". They are knowledgeable about the dynamics and the business landscape of fast growth ventures, the markets they cater to, and the key factors that are required for such ventures to succeed. They use this knowledge to evaluate the growth potential of businesses in which they invest.

VCs require a sharp nose to smell investment opportunities. They also have to be able to make judgements about the people running the businesses which they are evaluating as investment candidates. Besides, they also keep themselves updated with the different markets, business technology trends, etc. to arrive at the odds of a business's success. In other words, a VC is not only good with numbers but is also very adept at networking and judging people, opportunities and business dynamics.

The VCs can, and often do, make valuable contribution in areas such as long- and short-range business planning, recruitment of key personnel, development of key customer relationships and developing strategic alliances in their investee businesses.

Mostly, a VC's involvement in a business he has invested in tends to be need-based, and is most likely in businesses where he thinks he can "fill in the blanks", that is, provide skills in areas where they are lacking. In all the businesses in which VCs invest, they try to identify any gaps in the critical skills that are crucial for the venture's success. They then work to provide that expertise. For them, providing help and a leg-up to the management team is a risk control measure. It is one way of ensuring that their investment in the business is protected. Their support to the venture reduces the likelihood of the business failing due to any skills gap in the business.

Take, for example, the case of a company being run by a young "techie" with limited business experience. The VC in such a situation is more likely to provide his input on a regular basis. In the case, however, of a business run by an experienced business manager with a full management team in place, VCs are likely to limit their involvement to monthly reviews of the business and, perhaps, to introductions with the potential future constituents of the business, such as senior employees, strategic customers and vendors, joint venture partners, partners in overseas markets, etc.

Of course, you as the entrepreneur may view the VC's active involvement as interference in the running of the business. Such an approach is misplaced. VCs do not actually want to run a business which someone else has created. They are only interested in adding value to the businesses they invest in so that they can multiply their investment manifold. And they cannot do so without being aware of all aspects of the business.

If you are used to operating a "life-style" business on your own, or as part of a small founder group, then don't send an invitation to a VC to join the party. If you do invite him, then be ready and willing to rearrange the chairs at the table, if required.

How Does This Help Me, the Entrepreneur?

The understanding of various terms helps you to focus your search for venture capital. Having come this far, you are unlikely to ask the VC, "How much interest will you charge on the money that you will invest in my business?" You will also be able to now distinguish between whether the money that you plan to raise for your business is PE or PIPE or VC or CVC money. While accessing various websites of investors you will be able to differentiate between their investment focus and dig deeper only those which complement your requirements. Lastly, as each of these types of capital is tracked and reported upon separately, you will be able to understand the industry reports with much greater clarity.