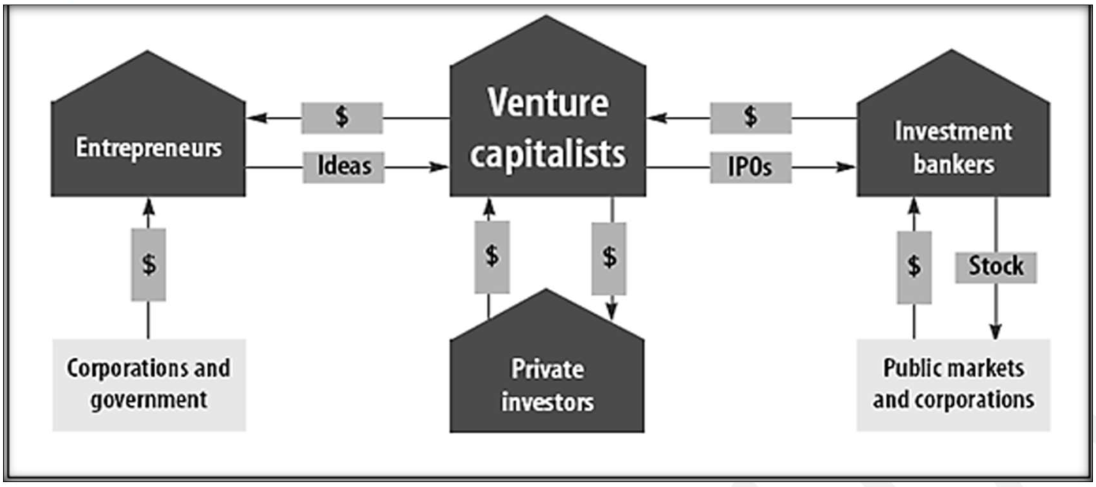
Private Equity and Venture Capital

Venture capital

- **Need for venture capital?**
    - Banks and financial institutions do not easily fund start up's
    - Banks and financial institutions do not give seed capital
    - Banks and financial institutions do not invest in high risk ventures as 9 / 10 fail
- **Definition**
    - Can be visualised as "your ideas and our money" concept of business
    - Typically very large institutions like pension funds, financial firms, insurance companies that put a small percentage of their total funds into high risk investments in exchange of equity
    - They (venture capitalists) invest in high risk, high return ventures that are unable to source funds from regular channels like banks and capital market
- **Venture capitalists**
    - Venture capitalists invest in small firms which have a huge potential to grow
    - Venture capitalists are usually formed as limited partnerships where the partners invest in VC funds
    - They partners are of two types:
        - Limited partners
            - ✓ They are institutional investors which provide money to the fund like university endowments, pension funds, insurance companies, other big corporates and high net worth individuals
        - General partners
            - ✓ They are active members who make the decision of where, when and how much to invest
            - ✓ They are usually industry veterans with business research, and entrepreneurial experience who have a sound knowledge of niche and start up ecosystem
- **Features of venture capital**
    - High risk investment
        - Highly risky as 9 / 10 start ups fail
    - High tech projects
        - Generally investments are made in new technologies as they have higher returns
    - Participation in management
        - Complementary to entrepreneurs in making decisions for the direction of company
    - Length of investment
        - The investors seek to exit in 3 – 7 years
        - The process takes several years to have significant returns
        - Also requires talent of venture capitalist and entrepreneurs to reach completion
    - Illiquid investment
        - It is an investment that is not subject to repayment on demand

- **How venture capital works?**



- **Importance of venture capital**
    - Helps new product with modern technology become commercially feasible
    - Strengthens capital market
    - Promotes export to earn more foreign exchange
    - Many sick companies get a turn around after getting proper nursing from venture capitalists
- **Working of a venture capitalist**
    - Venture capitalist buys stake in entrepreneur's idea
    - Nurtures it for short period of time
    - Exits with the help of investment banker
- Venture money is NOT long term money; the idea is to invest in company until it reaches sufficient size and credibility so that it can be sold to another interested corporation
- The myth is that venture capitalists invest in good ideas and good people, BUT they actually invest in good industries
- **Methods of venture financing in India**
    - Equity participation
    - Conventional loan – lower interest rate initially; after commercial operation of company, the venture capitalist levies high interest rate
    - Conditional loan – interest free loan, but royalty on sales
    - Income notes – combination of conventional and conditional loan
- **Stages of financing**
    - Seed stage – small amount of capital is provided to the entrepreneur to market a better idea having future prospects
    - Start - up stage – if the idea is fit for further investigation, the process moves ahead to second stage (also called as start-up stage)
    - Second stage – idea transforms to product and is being sold; management is monitored by VC in order to know the capability of team; working capital is provided for expansion of business in terms of growing accounts
    - Third stage – also called as "later stage finance"; VC try to multiply market shares by increasing sales of product; tries to have a better marketing promotion
    - IPO stage – also called as "bridge finance stage"; last round of financing before exiting
- VC expect return of 25% – 35% per year overtime lifetime of investment
- **Advantages of venture capital**
    - Expansion of company (provides large funding that the company needs to expand business)
    - Expertise joining the company (VC provide valuable expertise, advice and industry connections)
    - Better management (ensure the team is productive)
    - No obligation to repay (investors take risk on their own shoulders because they believe in company's future success)
    - Value added services (VC provide HR consultants who are specialist in hiring best staff for your business

- **Disadvantages of venture capital**
    - Complex process (needs detailed business plan and financial projections)
    - Loss of control (VC add a member into internal team, which can cause problems)
    - Loss over decisions (will have to give up many key decisions on how the company will process or operate
    - No confidentiality (they refuse to sign NDA due to legal ramification of doing so)
    - Requires quick liquidity (if business plan expects a longer timetable before providing liquidity, then VC might not be a good option
- **Exit routes are as follows:**
    - Promoter's buy back
    - IPO's
    - Sell to another venture capitalist
    - Management buy outs

Private equity

- It will buy a stake in an established company (usually much bigger stake than VC firm would), restructure and revamp the business so that it makes more money and then sell it at a profit (generally through IPO)
- Seen as less risky as private equity buy stakes in an already established firm

Difference between private equity and venture capital

Basis of comparison	Private equity	Venture capital
Meaning	Investments made in those firms which are not publicly listed on any stock exchange	Financing small firms and expect high growth
Stage of investment	Later stage	Initial stage
Investments made in	Few companies	Large number of companies
Companies	Matured companies having good track record	Start – ups
Focus on	Corporate governance	Management capability
Industries	All industries	Industries that require heavy initial investments like energy conservation or high technology
Risk involved	Less risky	High risk
Fund requirement	For growth and expansion of business	For scaling up operations
Ownership of investor	Generally 100%	Does not exceed 49%

Similarity between private equity and venture capital

- Firms with lots of money investing in privately held businesses and hoping to land big returns
- Both raise pools of capitals from investors known as limited partners
- Goals are same:
    - increase the value of business they invest in and sell them
    - increase the value of equity stake and sell it for profit