

# Venture Capital

## Meaning

Venture Capital is money invested in businesses that are small; or exist only as an initiative, but have huge potential to grow. The people who invest this money are called venture capitalists (VCs). The venture capital investment is made when a venture capitalist buys shares of such a company and becomes a financial partner in the business.

Venture Capital investment is also referred to risk capital or patient risk capital, as it includes the risk of losing the money if the venture doesn't succeed and takes medium to long term period for the investments to fructify.

Venture Capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms.

It is the money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there's a significant risk associated with the company's future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan.

Venture capital is a form of private equity and a type of financing that investors provide to startup 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. Though it can be risky for investors who put up funds, the potential for above-average returns is an attractive payoff. For new companies or ventures that have a limited operating history (under two years), venture capital funding is increasingly becoming a popular – even essential – source for raising capital, especially if they lack access to capital markets, bank loans or other debt instruments. The main downside is that the investors usually get equity in the company, and, thus, a say in company decisions.

## **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.
2. The main objective underlying investment in equities is to earn capital gains there on subsequently when the enterprise becomes profitable.
3. 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.
4. Venture capital does not confine to supply of equity capital but also supply of skills for fostering the growth and development of enterprises.
5. 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.
6. 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.

## **The Funding Process: Approaching a Venture Capital for funding as a Company**

The venture capital funding process typically involves four phases in the company's development:

- Idea generation
- Start-up
- Ramp up
- Exit

### **Step 1: Idea generation and submission of the Business Plan**

The initial step in approaching a Venture Capital is to submit a business plan. The plan should include the below points:

- There should be an executive summary of the business proposal
- Description of the opportunity and the market potential and size
- Review on the existing and expected competitive scenario
- Detailed financial projections
- Details of the management of the company

There is detailed analysis done of the submitted plan, by the Venture Capital to decide whether to take up the project or no.

### **Step 2: Introductory Meeting**

Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project in detail. After the meeting the VC finally decides whether or not to move forward to the due diligence stage of the process.

### **Step 3: Due Diligence**

The due diligence phase varies depending upon the nature of the business proposal. This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews, and other such exchanges of information during this time period.

### **Step 4: Term Sheets and Funding**

If the due diligence phase is satisfactory, the VC offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.

## Types of Venture Capital funding

The various types of venture capital are classified as per their applications at various stages of a business. The three principal types of venture capital are early stage financing, expansion financing and acquisition/buyout financing.

The venture capital funding procedure gets complete in six stages of financing corresponding to the periods of a company's development

- **Seed money:** Low level financing for proving and fructifying a new idea
- **Start-up:** New firms needing funds for expenses related with marketing and product development
- **First-Round:** Manufacturing and early sales funding
- **Second-Round:** Operational capital given for early stage companies which are selling products, but not returning a profit
- **Third-Round:** Also known as Mezzanine financing, this is the money for expanding a newly beneficial company
- **Fourth-Round:** Also called bridge financing, 4th round is proposed for financing the "going public" process

## Credit Rating

Credit Rating is an assessment of the borrower (be it an individual, group or company) that determines whether the borrower will be able to pay the loan back on time, as per the loan agreement. Needless to say, a good credit rating depicts a good history of paying loans on time in the past. This credit rating influences the bank's decision of approving your loan application at a considerate rate of interest.

It is usually expressed in alphabetical symbols. Although, it is a new concept in Indian financial market but slowly its popularity has increased. It helps investors to recognize the risk involved in lending the money and gives a fair assessment of the borrower's creditability.

## Importance of Credit Rating

Here are the benefits of credit rating:

### For The Money Lenders

1. **Better Investment Decision:** No bank or money lender companies would like to give money to a risky customer. With credit rating, they get an idea about the credit worthiness of an individual or company (who is borrowing the money) and the risk factor attached with them. By evaluating this, they can make a better investment decision.
2. **Safety Assured:** High credit rating means an assurance about the safety of the money and that it will be paid back with interest on time.

### For Borrowers

1. **Easy Loan Approval:** With high credit rating, you will be seen as low/no risk customer. Therefore, banks will approve your loan application easily.
2. **Considerate Rate of Interest:** You must be aware of the fact every bank offers loan at a particular range of interest rates. One of the major factors that determine the rate of interest on the loan you take is your credit history. Higher the credit rating, lower will the rate of interest.

### Short-Term vs. Long-Term Credit Ratings

A short-term credit rating reflects the likelihood of the borrower defaulting within the year. This type of credit rating has become the norm in recent years, whereas, in the past, long-term credit ratings were more heavily considered. Long-term credit ratings predict the borrower's likelihood of defaulting at any given time in the extended future.

### So, what's the Difference between Credit Rating and Credit Score?

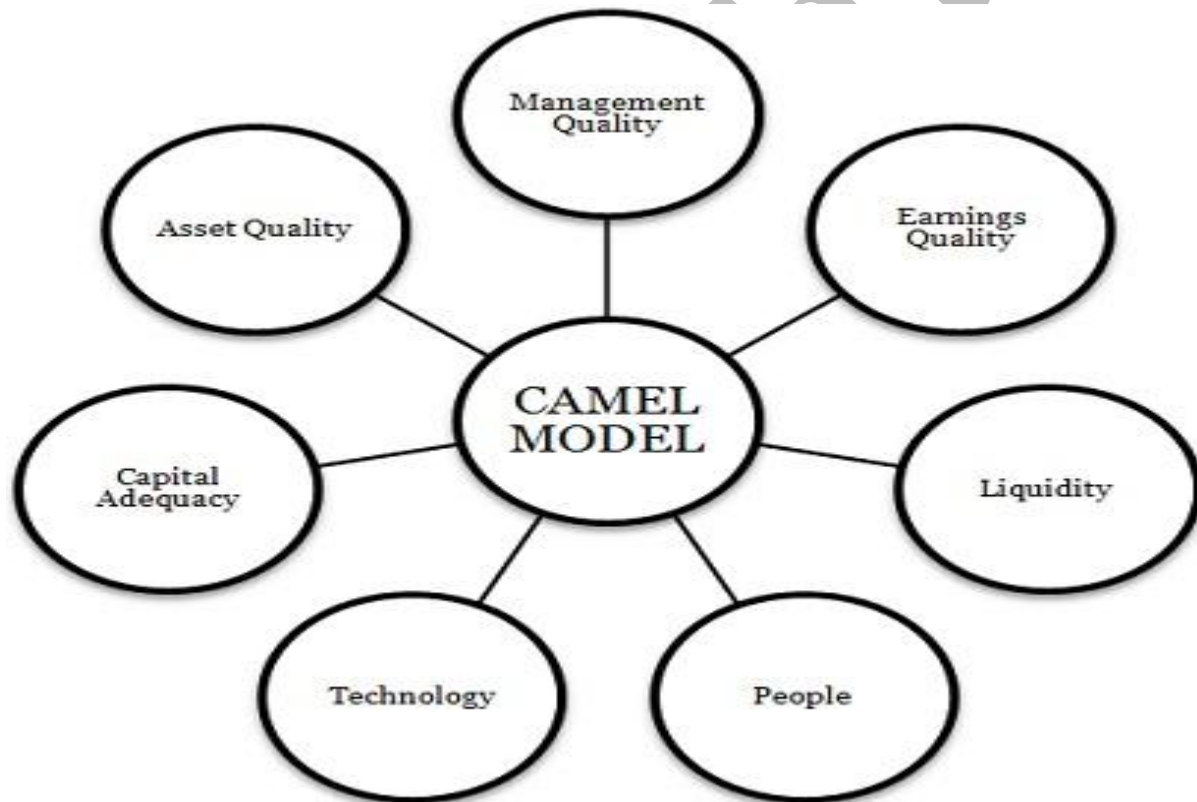
Often, these two terms are interchanged but they are not exactly same. Here are the differences between the two:

Credit Rating is basically a credit worthiness of a business or a company. However, it is not really used to individuals like us. It gives an understanding the ability of the company. These ratings are based on corporate financial instruments and usually denoted in alphabetical symbols. Higher the rating, lower is the probability of default pays.

Whereas credit score is a number, calculated by credit bureau and given to individuals based on the credit information report. This number can be in between 300 and 900. Credit report plays an important role in loan and credit card approval process.

### CAMEL Model

CAMEL rating expands to:



- **Capital:** Capital structure i.e. retained earnings and external funds raised, fixed dividend for preferred stockholders and fluctuating dividend for common stockholders and adequacy of long-term debts adjusted to gearing level.

- **Assets:** Revenue earning capacity of the assets which are in use or to be used, fair values, obsolescence, consistency, methods of depreciation etc.
- **Management:** The degree to which management personnel is involved, authority, teamwork, timeliness, appropriateness of decision-making and so on.
- **Earnings:** Stability, trends, absolute levels, adaptability to cyclical fluctuations, the firm's capability to discharge debts.
- **Liquidity:** Corporate policies for stock and creditors, the effectiveness of working capital management, etc.

The parameters discussed above are the key basis for determining the creditworthiness of an issuer, which results in the rating of a debt instrument.