

Limitations of Venture Capitalan Enterpreneural Approach

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ABSTRACT

The venture capital sector is the most vibrant industry in the financial market today. Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for startup companies. Venture capital can be visualized as 'your ideas, our money' concept of developing business. Venture capitalists not only provide financial resources but also help the entrepreneur in formalizing his ideas into a viable business venture. Even though, venture capital has its own limitations.

Introduction

Venture capital is a form of 'risk capital' that is invested in a project where there is a substantial element of risk relating to the future creation of profits and cash flows. The capital is invested as shares (equity) rather than as a loan and the investor requires higher rate of return to compensate him for his risk. When companies enter into negotiations with venture capital firms, there are several issues which need to be defined and agreed upon.

*Valuation:

Valuation is the most prominent negotiating issues. Valuation is the price of the company in which the venture capitalist invests. Valuation determines what percent of the company the investor is buying for their capital.

*Timing of the Investment:

Many investors will commit a large amount of capital, but will contribute that capital to the companies in installments. Often, these installments are only made when pre-designated milestones are met.

*Modifying the Management Team:

Some investors insist that additional or substitute management employees are hired subsequent to their investment. This gives investors additional security that the company will execute on its business model.

Employment Agreements with Key Founders:

Venture capitalists typically do not want companies to have employment agreements that limit the circumstances under which employees can be fired and/or set compensation and benefits levels that are too high.

*Exit Strategy:

Investors are very focused on how they will "cash out" of their investment. In this regard, they will negotiate regarding registration rights (both demand and piggyback); rights to participate in any sale of

stock by the founders (co-sale rights); and possibly a right to force the company to redeem their stock under certain conditions.

*Lock-Up Rights:

Venture capitalists may require a lock-up period at the term sheet stage. The "lock-up period" is typically a 30-60 day period where the investors have the exclusive right, but not the obligation, to make the investment.

Each of these issues is critical when raising venture capital, since the outcome can significantly impact the success of the venture and the wealth potential of the company founders and management team. Venture capitalists' participation is far more extensive and individual than that of a traditional banker. Venture capital represents one solution to finance the high risk, potentially high reward projects. Venture capital funds fill the gap between an entrepreneur's personal resources and funds that may eventually be raised from traditional credit institutions or public stock offerings. Entrepreneurs give up percentage of the ownership of their company, often not more than fifty percent, in exchange for acquiring capital. As a result, entrepreneurs avoid interest payments and can more quickly achieve profitability.

* In venture capital, an entrepreneur approaches to the financier to finance his business. In return the financier (venture capitalist) expects certain percentage of share in profits. Thus, as far as entrepreneurs are concerned the venture capital has some limitations. In venture capital, in exchange of capital the venture capitalist expects certain percentage of stake may be @ 10% or more in business. Moreover he also expects a large Return on Investment for his exit. In such case an owner of the business may lose his own stake.

* The venture capital funding will also bring enamors pressure on the entrepreneur to make the profit quickly. This may lead to wrong decision making on the part of

an entrepreneur. This may affect the entire planning and strategy of the company.

* e.g. Launching of a product in the wrong market.

* Intrusion- the venture capitalists are more likely to want to influence the strategic action of the company the investors may become part owners of the business, where the founder may lose autonomy or control.

* The decision to chase venture capital is often a tempting distraction from the much more 'complex and important entrepreneurial tasks.

Conclusion

The structuring of each venture investment is of course, the subject of negotiation between the venture capitalist and the entrepreneur or 'founder' of the business. Such negotiations are often complicated. After all, an experienced venture capitalist typically will participate in more financing negotiations in a single year than in over the course of a life time. This paper is intended to introduce entrepreneurs some of the important issues that come up in most venture capital negotiations.

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