ALTERNATIVE INVESTMENTS PRIVATE EQUITY & VENTURE CAP

Venture Capital

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What is Venture Capital?

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.

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.

Venture Capital

Basics of Venture Capital

In a venture capital deal, large ownership chunks of a company are created and sold to a few investors through independent limited partnerships that are established by venture capital firms. Sometimes these partnerships consist of a pool of several similar enterprises. One important difference between venture capital and other private equity deals, however, is that venture capital tends to focus on emerging companies seeking substantial funds for the first time, while private equity tends to fund larger, more established companies that are seeking an equity infusion or a chance for company founders to transfer some of their ownership stakes.

KEY TAKEAWAYS

- Venture capital financing is funding provided to companies and entrepreneurs. It can be provided at different stages of their evolution.
- It has evolved from a niche activity at the end of the Second World War into a sophisticated industry with multiple players that play an important role in spurring innovation.

History of Venture Capital

Venture capital is a subset of private equity (PE). While the roots of PE can be traced back to the 19th century, venture capital only developed as an industry after the Second World War. [1] Harvard Business School professor Georges Doriot is generally considered the "Father of Venture Capital". He started the American Research and Development Corporation (ARD) in 1946 and raised a $3.5 million fund to invest in companies that commercialized technologies developed during WWII. [2] [3] ARDC's first investment was in a company that had ambitions to use x-ray technology for cancer treatment. The $200,000 that Doriot invested turned into $1.8 million when the company went public in 1955. [4]

Location of the VC

Although it was mainly funded by banks located in the Northeast, venture capital became concentrated on the West Coast after the growth of the tech ecosystem. Fairchild Semiconductor, which was started by the traitorous eight from William Shockley's lab, is generally considered the first technology company to receive VC funding. [5] It was funded by east coast industrialist Sherman Fairchild of Fairchild Camera & Instrument Corp. [6]

Arthur Rock, an investment banker at Hayden, Stone & Co. in New York City, helped facilitate that deal and subsequently started one of the first VC firms in Silicon Valley. Davis & Rock funded some of the most influential technology companies, including Intel and Apple.[7] By 1992, 48% of all investment dollars were on the West Coast and the Northeast coast accounted for just 20%.[6] According to the latest data from Pitchbook and National Venture Capital Association (NVCA), the situation has not changed much. During the second quarter of 2020, west coast companies accounted for 36.7% of all deals (and a massive 60.2% of deal value) while the Mid-Atlantic region had 20.9% of all deals (or approximately 18.6% of all deal value).[8]

Help From Innovations

A series of regulatory innovations further helped popularize venture capital as a funding avenue. The first one was a change in the Small Business Investment Act (SBIC) in 1958. It boosted the venture capital industry by providing tax breaks to investors.[9] In 1978, the Revenue Act was amended to reduce the capital gains tax from 49.5% to 28%.[10] Then, in 1979, a change in the Employee Retirement Income Security Act (ERISA) allowed pension funds to invest up to 10% of their total funds in the industry.[11]

This update to the "Prudent Man Rule" is hailed as the single most important development in venture capital because it led to a flood of capital from rich pension funds. Then the capital gains tax was further reduced to 20% in 1981.[12] Those three developments catalyzed growth in venture capital and the 1980s turned into a boom period for venture capital, with funding levels reaching $4.9 billion in 1987.[13] The dot com boom also brought the industry into sharp focus as venture capitalists chased quick returns from highly-valued Internet companies. According to some estimates, funding levels during that period peaked at $119 billion.[14] But the promised returns did not materialize as several publicly-listed Internet companies with high valuations crashed and burned their way to bankruptcy.[15]

Angel Investors

For small businesses, or for up-and-coming businesses in emerging industries, venture capital is generally provided by high net worth individuals (HNWIs) – also often known as 'angel investors' – and venture capital firms. The National Venture Capital Association (NVCA) is an organization composed of hundreds of venture capital firms that offer to fund innovative enterprises.

Angel investors are typically a diverse group of individuals who have amassed their wealth through a variety of sources. However, they tend to be entrepreneurs themselves, or executives recently retired from the business empires they've built.

Self-made investors providing venture capital typically share several key characteristics. The majority look to invest in companies that are well-managed, have a fully-developed business plan and are poised for substantial growth. These investors are also likely to offer to fund ventures that are involved in the same or similar industries or business sectors with which they are familiar. If they haven't actually worked in that field, they might have had academic training in it.

Another common occurrence among angel investors is co-investing, where one angel investor funds a venture alongside a trusted friend or associate, often another angel investor.

The Venture Capital Process

The first step for any business looking for venture capital is to submit a business plan, either to a venture capital firm or to an angel investor. If interested in the proposal, the firm or the investor must then perform due diligence, which includes a thorough investigation of the company's business model, products, management, and operating history, among other things.

Since venture capital tends to invest larger dollar amounts in fewer companies, this background research is very important. Many venture capital professionals have had prior investment experience, often as equity research analysts; others have a Master in Business Administration (MBA) degrees. Venture capital professionals also tend to concentrate in a particular industry. A venture capitalist that specializes in healthcare, for example, may have had prior experience as a healthcare industry analyst.

Once due diligence has been completed, the firm or the investor will pledge an investment of capital in exchange for equity in the company. These funds may be provided all at once, but more typically the capital is provided in rounds. The firm or investor then takes an active role in the funded company, advising and monitoring its progress before releasing additional funds.

The investor exits the company after a period of time, typically four to six years after the initial investment, by initiating a merger , acquisition or initial public offering (IPO).

A Day In The Life

Like most professionals in the financial industry, the venture capitalist tends to start his or her day with a copy of *The Wall Street Journal*, the *Financial Times* and other respected business publications .
Venture capitalists that specialize in an industry tend to also subscribe to the trade journals and papers that are specific to that industry. All of this information is often digested each day along with breakfast.

For the venture capital professional, most of the rest of the day is filled with meetings. These meetings have a wide variety of participants, including other partners and/or members of his or her venture capital firm, executives in an existing portfolio company, contacts within the field of specialty and budding entrepreneurs seeking venture capital.

At an early morning meeting, for example, there may be a firm-wide discussion of potential portfolio investments. The due diligence team will present the pros and cons of investing in the company. An "around the table" vote may be scheduled for the next day as to whether or not to add the company to the portfolio.

An afternoon meeting may be held with a current portfolio company. These visits are maintained on a regular basis in order to determine how smoothly the company is running and whether the investment made by the venture capital firm is being utilized wisely. The venture capitalist is responsible for taking evaluative notes during and after the meeting and circulating the conclusions among the rest of the firm.

After spending much of the afternoon writing up that report and reviewing other market news, there may be an early dinner meeting with a group of budding entrepreneurs who are seeking funding for their venture. The venture capital professional gets a sense of what type of potential the emerging company has, and determines whether further meetings with the venture capital firm are warranted.

After that dinner meeting, when the venture capitalist finally heads home for the night, they may take along the due diligence report on the company that will be voted on the next day, taking one more chance to review all the essential facts and figures before the morning meeting.

Trends in Venture Capital

The first venture capital funding was an attempt to kickstart an industry. To that end, Doriot adhered to a philosophy of actively participating in the startup's progress. He provided funding, counsel, and connections to entrepreneurs.

An amendment to the SBIC Act in 1958 led to the entry of novice investors, who provided little more than money to investors.[9] The increase in funding levels for the industry was accompanied by a corresponding increase in the numbers for failed small businesses.[16] Over time, VC industry participants have coalesced around Doriot's original philosophy of providing counsel and support to entrepreneurs building businesses.

Growth of Silicon Valley

Due to the industry's proximity to Silicon Valley, the overwhelming majority of deals financed by venture capitalists are in the technology industry. [17] But other industries have also benefited from VC funding. Notable examples are Staples and Starbucks, which both received venture money. [18] [19] Venture Capital is also no longer the preserve of elite firms. Institutional investors and established companies have also entered the fray. For example, tech behemoths Google and Intel have separate venture funds to invest in emerging technology. [20] [21] Starbucks also recently announced a $100 million venture fund to invest in food startups. [22]

With an increase in average deal sizes and the presence of more institutional players in the mix, venture capital has matured over time. The industry now comprises an assortment of players and investor types who invest in different stages of a startup's evolution, depending on their appetite for risk.

Hit From the 2008 Financial Crisis

The 2008 financial crisis was a hit to the venture capital industry because institutional investors, who had become an important source of funds, tightened their purse strings. [23] The emergence of unicorns, or startups that are valued at more than a billion dollars, has attracted a diverse set of players to the industry. Sovereign funds and notable private equity firms have joined the hordes of investors seeking return multiples in a low-interest rate environment and participated in large ticket deals. Their entry has resulted in changes to the venture capital ecosystem.

Growth in Dollars

Data from the NVCA and PitchBook indicated that VC firms funded US$131 billion across 8949 deals in 2018.

That figure represented a jump of more than 57% from the previous year. But the increase in funding did not translate into a bigger ecosystem as deal count, or the number of deals financed by VC money fell by 5%. Late-stage financing has become more popular because institutional investors prefer to invest in less-risky ventures (as opposed to early-stage companies where the risk of failure is high). Meanwhile, the share of angel investors has remained constant or declined over the years.

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