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VENTURE CAPITAL AND BANK FINANCE FOR ENTREPRENEURIAL FIRMS

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Abstract:

Venture capital finance and bank loans are a common source of finance for entrepreneurial firms. Both sources of finance are some common and different features for investing capital in the entrepreneurial firms. Because entrepreneurial firms are usually small and have high risk of failure, both venture capital finance and bank loans require careful monitoring of entrepreneurs and entrepreneurial venture projects before selecting for investing the capital. An entrepreneurial firm seeks financing from one of the two sources those from a venture capital institutions or a bank. Once funded, the possible conflicts arise between the entrepreneur and the financiers of bank or finance institution. The common tension between both that the entrepreneur's desire to keep the firm going in order to maintain their control with the anticipated returns along with growth and the bank or finance institution's desire to the liquidate of their investments with a proper returns on investment. In this paper, the researchers would explain the common and different features in venture capital finance and bank finance for entrepreneurial firms and develop a simple descriptive model that captures these differences.

Index Terms: Entrepreneurial, High Risk, Conflicts, Liquidate, Venture Capital & Bank Loans

1. Introduction:

Venture Capital funding is an important source for entrepreneurial ventures in developing countries. Venture Capital finance has been playing a significant strategic role in India in the sectors of Information Technology, Telecommunications, Pharmaceuticals, Biotechnology, Media/ Entertainment, Services Sector, Industrial Products and Real Estate. Since Venture Capital is based on equity financing rather than debt financing development avoids financial instability typically associated with debt financing. The world debt crisis provided the need for alternative forms of financing that will promote growth and development while maintaining order and stability. Further Venture Capitalists along with financial assistance, they help in efficiency of business processes, Opens up new business opportunities for entrepreneurs and helps scale up business rapidly. The Venture Capitalist provides not only finance and also strategic assistance to the investee company and actively participates in its management team. Venture Capital is a form of equity financing in which the investor actively participates when the venture is financed. The Venture Capitalist must be an expert in both management and finance, and in the specific industry to which the venture belongs. In addition, he must be involved in the detailed operations of the investee company. Theoretically, such arrangements can be most rewarded in environments where uncertainty and asymmetry of information most prevail. It is precisely such environments that traditional methods of financing, e.g. banks loans or public capital markets, fail to accommodate well. This implies that young companies, which operate in a highly uncertain environment, might face prohibitive costs in obtaining external capital. If such companies were able to obtain Venture Capital, however, their financial constraints could be significantly relieved.

Venture capital finance and bank loans are a common source of finance for entrepreneurial firms. There are some common features of financing between conventional finance by bank and venture capital which are a most of the distinction features are explained in the table: 1 An entrepreneurial firm seeks financing from one of the two sources those from a venture capital institutions or a bank. Once funded, the possible conflicts arise between the entrepreneur and the conventional banker or venture capital financial institution. The common tension between both that the entrepreneur's desire to keep the firm going in order to maintain their control with the anticipated returns along with growth and the bank or finance institution's desire to the liquidate of their investments with a proper returns on investment.

The points of distinction between conventional financing by a bank and venture capital are tabulated below:

Table 1

S. No	Points of Differences	Bank Financing	Venture Capital
1.	Form of Financing	Debt /Loan	Private equity
2.	Collateral	Secured	Unsecured
3.	Nature of Investment	Short-term or Long-term	Long-Term
4.	Primary Focus	Debt Servicing capacity of the investee company	Growth and Potential of the venture project
5.	Return	In the form of Interest	In the form of Dividend
6.	Target Return	Around 15% p.a.	Initial Less than 25%. Later Above 50%
7.	Objective/Expectation	Prompt Interest payment and Loan Repayment of Debt/Loan	Capital Gains than Profits
8.	Participation Level	Don't participate in Management Team	Active Participation in Management Team
9.	Management Team Deputation	No any Team Deputation	Management Team Deputation
10.	Risk	Very Less	Very High
11.	Borrowers	Well to do The Entrepreneurs	New and First Generation Entrepreneurs
12.	Management Type	Well Established Management	New Management
13.	Nature of firms	Small, Medium and Large scale firms	Small and Medium Scale firms only
16.	Involvement of financiers	No Involvement	Continuous Involvement
17.	Exit	Only through Retirement of Loan	Options: IPO, Mergers & Acquisition, MBI/MBO
18.	Stage of Financing	Fledging and Establishment stages	Seed, Start-up, Fledging and Establishment stages

2. Need of Venture Capital:

There are entrepreneurs and many other people who come up with innovative bright ideas of product which may be having high potential in the market but lack of capital for the venture investment. The new or first generation entrepreneurs are not able to raise the capital from conventional bankers/lenders due to lack of collateral facilities. What this Venture Capital does to facilitate and enable the seed or start up phase. In such a case the venture capital business system paved the way to the new or first generation entrepreneurs. When there is an ownership relation between the Venture Capitalists and entrepreneurs, their mutual interest for returns will increase the firm's motivation to increase profits. Venture capital system will make an investment in such a new venture after that venture capitalist will depute the expert management team to lead the business this type of facility is required to the new entrepreneurs at the initial or beginning along with capital. Capital and management which essential for the especially the entrepreneurs if they are technocrats in the beginning after that the entrepreneurs will earn the knowledge and experience. This knowledge and experience will help the entrepreneurs to lead the business independently and successfully.

3. Venture Capital Investment Philosophy:

The basic principal underlying Venture Capital invests in high risk projects with the anticipation of high returns. These funds are then invested in several fledging enterprises, which require funding, but are unable to access it through the conventional sources such as banks and financial institutions. Typically first generation entrepreneurs start such enterprises. Such enterprises generally do not have any major collateral to offer as security, hence banks and financial institutions are averse to funding them. Venture Capital funding may be by way of investment in the private equity form of the new enterprise or a combination of conditional debt and private equity, though equity is the most preferred route. Since most of the ventures financed through this route are in the new areas of the probability of success is very low. All projects financed may not give a high return. Some projects fail and some give moderate or high returns. The investment, however, is a long-term capital as such projects normally take 5 to 10 years to generate substantial returns in the beginning and later good amount of returns. Venture Capitalists' offer "more than money" to the venture and seek to add value to the investee companies by active participation in its management. They monitor and evaluate the project on a continuous basis. Venture capital system is driven by wealth maximization.

4. Venture Capital Investment Process:

The evaluation of the proposed ventures is the most crucial aspect of the operation of Venture Capital Firms. Because the investment will generally be in small firms with a direct involvement of the Venture Capitalists, and because these firms will be new without past performance, venture evaluation cannot be subjected to a very high degree of quantitative analysis. What evaluation criteria are being followed by the venture capitalist when the venture capital activity is in infancy stage? The following are the six sequential steps involved in a venture capital investment process:

- ✓ Deal origination
- ✓ Screening
- ✓ Evaluation or due diligence
- ✓ Deal structuring
- ✓ Post- investment activity
- ✓ Exit

5. Investment of Venture Capital:

Table No: 2 Industry wise Cumulative Investment Details of SEBI Registered Venture Capital Funds (VCF) in India as on 2009 to 2012

(Rs. in Crore)

Sectors of Economy	2009	2010	2011	2012
Information technology	782	533	578	770
Telecommunications	767	858	1185	1182
Pharmaceuticals	802	460	469	550
Biotechnology	389	187	188	216
Media/ Entertainment	965	802	911	1101
Services Sector	1991	1215	1443	2137
Industrial Products	1301	783	1110	1224
Real Estate	6753	8155	9373	10159
Others	11143	10029	12336	14218
Total	**24893**	**23023**	**27592**	**31556**

Source: SEBI

6. The Advantages of Venture Capital Finance:

The most obvious advantage to accepting venture capital funds is that it places capital at a company's disposal, especially because there are often no repayment obligations during the term of the capital investment. This financing requires neither the payment of dividends nor personal guarantees or collateral from the entrepreneur. The capital provided by the venture capital firm also increases the capital base of the startup, which improves the startup's net asset value, making the company more attractive to bank financing or future investors.

Startups that receive venture capital also often experience many intangible benefits. Venture capital firms have reputations for being highly selective, so the receipt of venture capital funding often strengthens a startup's reputation among customers, other investors, and suppliers. Venture capital firm resources, including access to managerial specialists, accounting, taxation, and legal experts, industrial contacts, strategic partnerships, and access to new technologies accompany the investment. In many instances, at least one of the members of the venture capital firm will take part on the startup's board of directors, which provides structure and management to the fledgling company. Venture capital investors provide insight and stability to startup companies, often through their own experiences.

7. Disadvantages of Venture Capital Finance:

While there are many advantages to venture capital funding, it is not always appropriate for every startup endeavor. Because the venture capital firm will often have investors sit on the board of directors for the startup, the entrepreneur will likely experience ownership dilution. Venture capital is also ultimately more expensive than debt financing because the firm typically takes an ownership stake in the startup, commonly referred to as an "equity position". This means, in effect, that the venture capital firm is not just placing capital at the disposal of the startup, but that it is a part owner. This has important ramifications if the company increases in value, because, unlike a simple loan, the stake the venture capital firm has in the company increases in value if the value of the company should increase. Had the startup used debt financing instead, it would only owe the amount of the loan plus interest, which would undoubtedly be a smaller amount than the firm's ownership stake.

8. Conclusion and Suggestion:

In our paper, there is suggested that venture capital differs from bank finance by greater use of equity features and by more active monitoring. Both types of finance use covenants to restrict the borrower's behavior and provide additional levers of control in the event that the firm performs poorly. These covenants often restrict the ability of the firm to seek financing elsewhere, which ties to yet another common feature: the use of capital rationing through staged financing and credit limits as means of controlling borrowers' ability to continue and grow their business. Although start-ups and venture capital finance are often linked in the public eye, bank loans are a more common source of finance for entrepreneurial firms. Both sources share some common and different features. Because entrepreneurial firms are usually small and have high risk of failure, both venture capital and bank loans require careful monitoring of borrowers. Despite these similarities, there are significant differences between these two types of financing. Whereas banks lend to a wide variety of firms, firms with venture capital finance tend to have very risky and positively skewed return distributions, with a high probability of weak or even negative returns and a small probability of extremely high returns. Whereas bank loans usually take the form of pure debt, venture capitalists almost always employ convertible securities or a combination of debt and equity. Banks' monitoring and control rights are typically far less intensive than those of venture capitalists, and focus on avoiding or minimizing bad outcomes. If the firm is to be financed, the firm must be given incentive to monitor the firm's situation in order to reduce the conflicts. Banks are less skilled at monitoring than venture capitalists; banks can only determine whether or not the firm should be liquidated, whereas venture capitalists can also learn whether a safe or risky continuation strategy is best.

Venture capital is just one of many ways startups can acquire crucial financing to grow and succeed in the marketplace. Though a VC firm's capital and resources may feel like a panacea to a startup's financial troubles, it is important to look at the full picture. Only one out of every hundred companies is likely to receive funding, and a high percentage of those companies still fail. Many entrepreneurs who receives venture capital funds cites ownership dilution as a major deterrent to establishing a relationship with VC firms, as well as the ultimate loss in profits for the company due to the firm's ownership stake. Thus, it is crucial that a startup considering entering the venture capital funding look at not just the available capital.

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