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Venture capital -
An introduction into the nature of venture capital

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1. INTRODUCTION

This paper shall be an introduction into venture capital. The reader shall be given a general idea what venture capital is and what importance it has. The presented figures about the US and Europe have been exclusively taken from the Internet from different sources and may therefore lack comparability. Data about other, less developed regions appeared to be very rare.

2. THE NATURE OF VENTURE CAPITAL

2.1. WHAT IS VENTURE CAPITAL?

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 start-up companies. This investment can occur at different stages in a company's life cycle - from start-up and early stage development, through expansion and acquisitions.

Venture capital provides long-term, committed, risk sharing equity capital, to help unquoted companies grow and compete. It seeks to increase a company's value to its owners, without taking day-to-day management control.

Venture capital investors not only provide capital, but experience, contacts and advice when required, which sets venture capital apart from other sources of business capital.

2.2 VENTURE CAPITAL AND PRIVATE EQUITY

Among different countries, there are variations by what is meant by venture capital and private equity. In Europe, these terms are generally used interchangeable and venture capital thus includes management buy-outs and buy-ins (MBO/MBI). This is in contrast to the US, where MBOs and MBIs are not

classified as venture capital. This difference has to be put into account when interpreting the figures.

2.3. VENTURE CAPITAL PROVIDER

Professionally managed venture capital firms generally are private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves. According to the NVCA (www.nvca.com), currently, in the US over 50% of investments in venture capital come from institutional public and private pension funds, who try to diversify their portfolio with this investment class. Nevertheless there are companies, who exclusively invest in venture capital. Beside that, government affiliated investment programs exist that help start up companies.

2.4 IMPORTANCE OF VENTURE CAPITAL

Institutional investors will allocate 2-3% of their institutional portfolio for investment in alternative assets such as venture capital as part of their overall asset allocation. They expect higher rewards for the higher risk. Some say that venture capitalists have nurtured the growth of America's high technology and entrepreneurial communities in the last decades, resulting in significant job creation, economic growth and international competitiveness. Examples of US companies who have received venture capital early in their development are Apple, Compaq, Intel, Microsoft, Sun Microsystems. Today they all belong to the top companies of the world's high-tech industry. (www.ventureone.com/research/venturedata/index.htm).

2.5 HISTORY OF VENTURE CAPITAL

In the early days of venture capital investment, in the 1950s and 1960s, individual investors were the archetypal venture investors. Then the venture firms developed, becoming more and more important. Venture capital has grown from a small investment pool in the 1960s and early 1970s to mainstream asset

class that is a viable and significant part of the institutional and corporate investment portfolio. Nowadays, individual investors ("business angels") are becoming a potent and increasingly larger part of the early stage and start-up venture life cycle, while venture firms usually invest at later stages.

2.6 THE NEED FOR VENTURE CAPITAL

Entrepreneurs may look for venture capital, because they lack the capital to make their business grow. Banks are often unwilling to provide capital, unless there are no securities. Venture capitalists are willing to provide capital, expecting high returns for the high risk. Without this venture capital, many small enterprises won't be able to finance their growth, expansion, of even the start-up of the business.

2.7 SPECIAL FORMS OF INVESTING

2.7.1 CORPORATE VENTURING

This is usually called direct investing in portfolio companies by venture capital programs or subsidiaries of non-financial corporations. The difference is that corporate venturing is usually performed with corporate strategic objectives in mind while other venture investment vehicles have investment return of financial objectives as their primary goal. Siemens Venture Capital (SVC), a subsidiary of the German technology firm Siemens AG, has committed more than EURO 100 million to more than 20 capital funds, giving Siemens direct and indirect access to more than 300 companies at seed and early stage (www.siemens.com/svc). The advantage is obvious: All these firm are working in the same fields Siemens AG is working in, hence Siemens can now use their knowledge, make synergy or cost savings and controls potential competitors.

2.7.2 SECONDARY PARTNERSHIPS

These venture capital firms purchase the portfolios of investee company investments of an existing venture firm. This provides liquidity for the venture capital firm that invested first. Secondary partnerships seek to invest in undervalued companies.

3. HOW VENTURE CAPITAL FIRMS WORK

3.1 GENERAL

Venture capital firms are pools of capital, typically organized as a limited partnership that invests in companies that represent the opportunity for a high rate of return within three to seven years. They not only provide capital, but also support the management with their knowledge and contacts.
Some venture firms are successful by creating synergies between the various companies they has invested in.

3.2 FORM OF ORGANIZATION OF VENTURE CAPITAL FIRMS

The form of organization of the venture capital firm generally depends on liability, taxation issues and management responsibilities. In the US most venture capital firms are held as ‘limited partnerships’, followed by ‘limited liability partnerships’ and ‘limited liability companies’.

3.3 DIVERSIFICATION

Venture capitalists mitigate the risk of venture investing by developing a portfolio of young companies in a single venture fund. Many times they will co-invest with other professional venture capital firms. In addition, many venture partnerships will manage multiple funds simultaneously.

3.4 SCREENING

When considering an investment, the venture capitalists carefully screen the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective (see: 3.1). Going forward, they actively work with the company's management by contributing their experience and business savvy gained from helping other companies with similar growth challenges.

3.5 WHAT IS IMPORTANT TO A VENTURE CAPITAL FIRM?

According to a 1998 survey by Profit Dynamics Inc. (www.capital-connection.com/survey-chances.html) in the US, the 5 most important factors are:

1. Quality of the management team
2. Return on investment
3. Size of the company's market
4. Company's potential for growth
5. Proprietary, uniqueness or brand strength of the company's product

The most common reason why venture capital firms decline to invest in a company is a lack of an experienced, complete management team.

3.6 REASONS TO INVEST IN VENTURE CAPITAL FOR INSTITUTIONAL INVESTORS

- Superior, long term returns
- Portfolio diversification
- An opportunity to invest in high growth companies before their potential value is realized through flotation or sale.
- Venture capital investors' provision of both capital and experience creates and builds new companies and revitalizes others, leading to good returns.

- As the industry has developed and matured over the past years, venture capital managers have gained considerable experience, which has been reflected in improving returns

3.7 RISKS

- Total loss of invested money is possible. The risk is highest when investing in Seed and Start-up companies.
- IPO exit difficult in a “bear market”. That causes a dependancy on situation at the stock-exchanges.
- Dependency of the company owner.
- The goals of the venture capital firm may not be the same as the owner’s goals. Venture capital firm may only think until the exit, but not further. This may have a negative impact on the long-term objectives of the investee company.

3.8 INVESTMENT FOCUS OF VENTURE CAPITAL FIRMS

3.8.1 IN WHICH SECTORS DO VENTURE CAPITAL FIRMS INVEST

Generally, in all sectors. Most important is that the investee company grows rapidly. But growth rates in “old industries” like construction, mining, manufacturing is usually rather small, thus most venture capital is attracted by high-tech enterprises.

3.8.2 GENERALISTS AND SPECIALISTS

- *Generalists:* These venture capital firms invest in various industry sectors, or various geographic locations, or various stages of company life.
- *Specialists* focus on certain sectors, geographical areas, or certain stages of development.

3.9 INVESTMENT STAGES

Venture investing may be conducted in all stages of the business life cycle. The following stages can be distinguished:

1. *Seed investing*: There is an idea and a concept, but no management team, no prototype, no business plan, and no timetable.
2. *Early stage investing*: First and second stage development. The company is running, products or services are sold, close to break even.
3. *Expansion stage investing*: Investment in companies who wish to grow and expand. For example, to finance increased production capacity, marketing, or to provide additional working capital.
4. *Mergers and acquisitions, recapitalization:* Providing liquidity and exit for the company's founders to attract a merger or acquisition with another company.

3.10 EXITS

An exit is the act of divesting oneself of a portfolio investment. The venture firm will seek to sell the investment in the portfolio company after some years. Depending on the investment focus and strategy of the venture firm this will be after 3 to 7 years. According to the BVCA (www.bvca.com), the majority of exists in the UK continue to be through trade sales.

3.10.1 TYPES OF EXISTS

The five types of exits are:

- Buy back (Shares are bought back by the previous owners).
- Trade sale, e.g. mergers and acquisitions (Shares are sold to a strategic investor, usually a larger company).
- Secondary purchase (Shares are sold to another venture capital firm).
- Going-public (Shares are sold at the time of the IPO or afterwards.
- Writing the company off.

3.10.1.1 INITIAL PUBLIC OFFERING (IPO)

Basically, an IPO or flotation is the process in which a business owned by one or several individuals is converted into a business owned by many. It involves the offering of part ownership of the company to the public through the sale of dept or more commonly, equity securities (stock) (www.ventureA.com). Although flotations are defined as "exits", many venture capital firms retain an investment in these companies after flotation and through flotation achieve a recognized value for their shareholdings. (www.bvca.com)

4. FACTS AND FIGURES ABOUT VENTURE CAPITAL

4.1. VENTURE CAPITAL IN THE USA

A survey by Profit Dynamics Inc. in the US in 1998 showed that venture capital firms eventually invest in roughly 7 out of 1,000 companies that contact them. They receive an average of more than 20 business plans per week - almost 1,100 per year - and state that they invest in, on the average, 7.2 companies each year (www.capital-connection.com/survey-chances.html).

US Venture Capital Investments by Year: (# - No figures available)

Year	Total number of deals	Information Technologies	Health care	Total amount invested (US$ million)	Total amount raised (US$ million)	Average amount per deal (US$ million)
1995	1166	648	323	#	6285	#
1996	1693	969	422	#	9153	#
1997	1848	1086	431	11200	11599	6.061
1998	1972	1172	403	12500	14322	6.339
1999	2969	1605	421	35600	36513	11.991

Source: VentureOne (www.ventureone.com/research/venturedata/stats/index.htm)

According to VentureOne in 1999:

- Internet deals account for over two third 1999 investments, total 25 billion US$ up more than 300% to 1998

- 248 venture-backed companies completed IPO, raising US$ 19.43 billion. Internet companies attracted 69% of the total amount raised at IPO.

4.2 VENTURE CAPITAL IN EUROPE

European Private Equity Investments by country (ECU million):

Country	1997	1998	% Growth
UK	4428	7105	60
Germany	1326	1948	47
France	1248	1777	42
Netherlands	760	1059	39
Italy	603	933	55
Other countries	1328	1678	26
Total	9703	14500	49

4.2.1 ADDITIONAL FIGURES 1998
(European Private Equity Update, EVCA):

- 14.5 billion EURO disbursed in over 7600 companies
- Average investment size: up 15% to 2.3 million ECU.
- Number of investments overall: up 22%.
- 27.8% of overall investments took place in high-tech sector increased by 75%.
- Stage distribution by number of investments in 1998:

  Expansion: 41.7%
  Start-up: 27.2%
  Buyout: 20.5%
  Replacement: 7.5%
  Seed: 3.1%
- Fundraising: 20.3 billion ECU, up 1.7%.
- Banks (28% of total) and pension funds (24%) remain the biggest sources of capital, followed by Corporate Investors (10%).

4.2.2 THE ECONOMIC IMPACT OF VENTURE CAPITAL IN EUROPE

The survey "The Economic Impact of Venture Capital in Europe" conducted in 1996 by the EVCA (www.evca.com/publications.html) shows the following findings. Over the 4 year period 1991-1995, venture-backed companies'

- Sales rose on average by 35% annually, twice as fast as the top 500 European companies.
- Employment increased by an average of 15% per year versus only 2% for the top European companies.
- Investment in plant, property and capital equipment grew by an average of 25% annually.
- R&D expenditure represented on average 8.6% of total sales compared to 1.3% for the top European companies.
- Exports rose on average by 30% per year.
- Venture capital investors are active partners providing more than finance. According to managers of investee companies, the three main contributions made by venture capital investors, other than finance, were financial advice, assistance on corporate strategy and acting as a sounding board for ideas.
- 81% of managers surveyed in the above study believed that their company would not have existed or would have grown less rapidly without venture capital

4.2.3 VENTURE CAPITAL IN THE UK

The UK High technology performance measurement survey 1998 by the BVCA (www.bvca.co.uk/publications.html) had the following findings:

1. Early stage investments produced the best internal rates of return (28.3% pa)
2. The average time an investment is held for is 4.6 years, with early stage the shortest exit time (3.6 years) and expansion the longest (5 years).
3. The net returns of venture capital funds raised between 1980 and 1998 in the UK measured to 31 December 1998, were

- One year: 31.1%
- Three year: 28.8% p.a.
- Five year: 22.1% p.a.
- Ten year: 13.1% p.a.

4.3 OTHER CONTRIES

It was hardly possible to find any figures about the venture capital industry in other countries than the US and Europe in the Internet. This may be interpreted as an underdevelopment.

4.3.1 VENTURE CAPITAL IN CENTRAL AND EASTERN EUROPE

Venture capital in Central and Eastern Europe is less developed than in Western Europe. Oresa Ventures (www.oresaventures.com/europe.html) describes the situation as follows:

Compared to Western Europe, the venture capital industry in Central and Eastern Europe (CEE) is still very young. It is characterized by smaller deals of $1-15m compared to Western Europe, which often exceed $500m. Apart from privatization of state-owned assets, the venture capital sector in CEE has been focused on start-ups and expansion capital.

The private equity market in Central and Eastern Europe has almost doubled over a four-year period, from 4.6bn Euro in 1995 to over 8bn Euro committed in 1998. Private equity money is increasingly being invested in newly established companies, with less going into the privatization of state-owned assets, partly because privatization has been largely carried out in Central Europe and partly due to a more vibrant private sector with higher-quality management teams.

4.3.2 SOUTH AFRICA

The Johannesburg Stock Exchange has launched the “Emerging enterprise zone”, a meeting place for capital seekers and providers in the Internet to address the problem of capital access. (www.eez.co.za).

5. Summary

Venture capital firms provide not only financial support to the investee companies, but also advice and connections. For the investee companies, venture capital is an important source of equity. Venture capital firms have on the other hand the chance of high returns. Negative factors are the dependency of the investee company and the high risk for the venture capital firm. The owners loose control, in order to get money to grow.

The venture capital industry grew enormously in recent years. Biggest markets are the US, and within Europe the UK. A stock-exchange boom, making a common exit, the IPO, profitable and easy supports the growth of venture capital.

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