JETIR.ORG ISSN: 2349-5162 | ESTD Year : 2014 | Monthly Issue

JOURNAL OF EMERGING TECHNOLOGIES AND INNOVATIVE RESEARCH (JETIR)
An International Scholarly Open Access, Peer-reviewed, Refereed Journal

A study on advantages and unique characteristics of venture capital

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Abstract: The United States is the birthplace of the asset class known as venture capital, which has recently caught the eye of policymakers around the world. However, a consistent definition and comprehension of the notion remain elusive. This paper aims to introduce the concept of venture capital, describe its features, and review some of the profits such investments can bring to the economy as a whole by analysing the correlation between venture capital and economic growth and individual businesses through an examination of the impact on their portfolios.

Keywords: venture capital, venture capital fund, growth, venture financing, macro-economy, impact, value-added.

Introduction:

Capital inflows for the growth of creative activities are best fostered in the present environment, and venture money is king when it comes to financing new ideas [1]. In industrialized nations, venture capital's role as an innovator-funding mechanism has been widely praised. There are a number of systemic issues in the country that limit the growth of conditions favourable to active entrepreneurship and innovation, and the government has established a number of laws and decrees to address these issues [2].

Private equity investments, such as venture capital investments, are made in companies with a need for financial backing [3]. Businesses typically need seed money to get off the ground (or expansion). The "idea phase" refers to a potential investment window for venture capital. If a venture capitalist thinks an entrepreneur has a good idea for a company, the VC may invest in the company.

Equity investments that are not publicly traded are known as "private equity". As a rule, limited partnership agreements are used to raise financing for private equity deals, giving backers the benefits of restricted liability and portfolio diversification.

Private equity (PE) funds achieve a portfolio of venture capital investment projects, each of which the PE fund focuses on [4]. For instance, ten separate venture capital initiatives on autonomous vehicles would attract the attention of an AI-focused private equity fund.

Since the rest of the world is becoming increasingly interested in this phenomenon, the fact that private equity is sometimes lumped in with venture capital, despite the fact that the two primary organizations on each side of the Atlantic that deal with the venture capital industry seem to have different definitions in terms of the stages of investing (Fig. 1). The term "enterprise capital," as it is used in this study, refers to "professional equity co-invested with entrepreneur to fund an early-stage or expansion firm" (EVCA Glossary1). In exchange for taking on a greater amount of danger, the investor hopes to get a larger rate of return. Private equity includes venture capital. Private equity, when referred to investments in later stage deals in the United States, is commonly synonymous with buyouts [5]. For the sake of clarity, we've tabulated the two methodologies; note that "private equity" includes "venture capital investments" throughout this document.

Venture capital is crucial to the success of new businesses in India. Historically, developmental financial firms like IDBI, ICICI, & State Financial Corporations may have engaged in venture capital activity. These organizations favored private businesses that used loan financing. In the past, venture capital came primarily from public fundraising. A great deal of this resource's success was dependent on the whims of the market. Furthermore, smaller enterprises with feasible initiatives found it difficult to raise capital from the public since the minimum paid up capital ratios for listing at the stock exchanges were raised. Long-term fiscal policy and the Seventh Five-Year Plan both acknowledged the importance of venture capital in India. A group formed in 1973 to study the growth of small and medium-sized businesses recommended increased VC funding for startups and innovative technologies. It wasn't until 1988, when ICICI and UTI sponsored the creation of Technology Development & Information Company of India Ltd. (TDICI), that venture capital investing in India could be considered to have begun. Credit Capital Finance Corporation (CFC), Bank of India (BI), Asian Development Bank (ADB), and Commonwealth Development Corporation (BICDF) collaborated to launch the first private VC fund (Credit Capital Venture Fund). Financial firms with ties to the governments of Gujarat and other states simultaneously launched both Gujarat Venture Finance Ltd. and APIDC Venture Capital Ltd. High-net-worth individuals, pension funds, and international institutional investors provided the bulk of these funds.

Capital for private company investments is pooled by venture capital firms, and the screening, evaluation, and selection of promising startups involved in the creation of novel goods and technologies is entrusted to fund managers with the requisite experience and incentives. After making an investment, VCs take a hands-on approach, adding value to their portfolio firms by coaching and monitoring in preparation for selling their holdings at a profit. For the most part, venture capitalists invest in a portfolio of firms with the knowledge that a portion of those companies will fail, but in the expectation that the returns on the successful companies will more than make up for the write-offs and provide substantial returns for the investors [6]. When you include in the potential for loss, you can immediately appreciate how crucial it is to have a skilled fund manager who can screen and choose companies, create value during the administration period, and find the optimum exit possibilities. There is a consensus that Venture Capital is necessary for businesses that either I cannot be financed by conventional

means owing to risky growing alternatives and knowledge asymmetry between both the bank and the entrepreneur, or (ii) are created by entrepreneurs who perceive a need and appreciate the opportunity to collaborate with professionals to swiftly advance their enterprise.

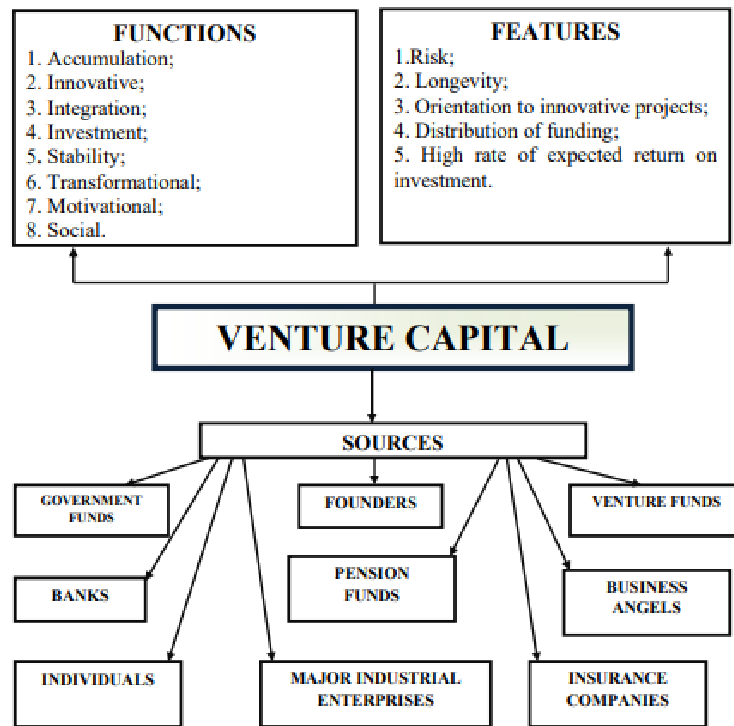

Figure 1: Features, roles, and funding mechanisms of the primary types of venture capital

What goes into an investment of venture capital?

The following are the six stages of the venture capital procedure. 1. Origination of a Deal 2. Screening 3. Investigation and Due Care 4. Deal structuring 5. Follow-up actions 6. Exist

- Origination of a Deal:

A deal flow is the stream of potential investments that a venture capitalist (VC) can consider funding. It's possible for a deal to start from a number of different places. System of Referrals, System of Active Search, and Intermediaries. The referral system is crucial to the success of the company [7]. Parent companies, trading partners, industry groups, friends, etc. may suggest deals to VCFs. Active search via networks, trade fairs, seminars, seminars, international tours, etc., also contributes to the transaction flow. In advanced economies like the United States, venture capitalists often work through intermediaries who act as matchmakers between venture capital funds (VCFs) and aspiring business owners.

- Screening:

Before diving into a more thorough examination, VCFs perform a preliminary screening of all projects using a set of high-level criteria. The venture capitalist may, for instance, choose to invest only in initiatives related to

technologies, products, or markets with which they are already familiar throughout the screening process. Broad screening criteria could include include investment amount, geography, and financing stage.

- Investigation and Due Care:

The term "due diligence" is used to describe the process of investigating and analyzing an investment proposal. Investors in new businesses look to the quality of the business's founders before considering the merits of the company's product, market, or technology. For the purpose of evaluating the potential risk and return on the endeavor, most investors in the business plan [8][11]. A comprehensive overview of the venture is laid forth in a business plan. Investors from VCFs in India take into account the following factors while assessing businesses: Initial Assessment: A brief description of the prospective enterprise from the applicant is needed to determine initial suitability. Subsequent to the initial assessment, a more in-depth analysis of the proposal is conducted. VCFs in India look for entrepreneurs with the following qualities: honesty, foresight, ambition, managerial chops, and a keen eye for business. Risks associated with proposed projects are evaluated by VCFs in India. These risks include those associated with the product, the market, the technology, and the entrepreneur. As can be seen in Figure, the ultimate choice is made in light of the predicted risk-return trade-off.

- Deal structuring:

Deal details, including investment size, structure, and cost, are discussed and agreed upon between the venture capitalist as well as the venture business. The phrase "deal structuring" is used to describe this step. The agreement also includes the venture capitalist's authority to exercise control over the venture firm and, if necessary, replace its management, as well as the power to make buyback arrangements, acquire the company, issue initial public offerings (IPOs), etc [9]. The ownership stake of the entrepreneur and the goals to be attained are both outlined in the earned out agreement.

- Follow-up actions:

The position of the venture capitalist typically shifts to that of a partner & collaborator once the deal has been formed and agreement confirmed. He helps to determine the business's course of action, too. The venture capitalist's policy will dictate the extent to which he gets involved. However, it might not be in their best interest for a venture capitalist to be hands-on with the business [10]. In the event of a financial or managerial crisis, the venture investor may step in and even replace the company's leadership.

- Exit:

Investors seeking returns from venture capital firms often target a liquidity event between five and ten years after making a first investment. They're helpful in steering the business in the direction of specific exit strategies. The following are some possible routes out of a business: 1. To begin with, IPOs (IPOs) 2., a company is purchased by another 3. The promoter buying shares from the VC, or 4. A third party buying shares from the VC.

Characteristics of Venture Capital Investing

- **Illiquid**

Investments in venture capital are typically made for the long term and lack the liquidity of publicly traded stocks or bonds. Venture capital funds, in contrast to those listed on public exchanges, do not provide for a rapid return on investment. The long-term profitability of venture capital investments is heavily reliant on the outcome of an initial public offering.

- **Budgeting for the future horizon**

The time between the original investment and any payoff is generally quite lengthy in venture capital deals. Due to the system's intrinsic latency, liquidity risk increases. Because of the greater than average liquidity risk associated with VC investments, the returns on these investments are typically very high.

- **Big gap between the market price and the private price.**

Private funds hold VC assets instead of trading them like other investment vehicles on a regulated market. Therefore, it is impossible for a single market participant to assess the investment's worth. The venture capitalist is similarly in the dark about his investment's true worth. Because of this, IPOs are frequently the topic of speculation from investors on both the buy and sell sides.

- **Businesses do not have access to comprehensive market data.**

Most venture capital goes to companies whose cutting-edge products aim to shake up established industries. These initiatives have the potential to yield enormous profits, but they also carry enormous dangers. For this reason, startup founders and venture capitalists frequently operate in the dark.

- **Incompatibility between Startups and Venture Capitalists**

Entrepreneurs and investors can have opposite aims for a business. The entrepreneur may care more about the method (or means) than the investor does about the return (i.e., the end).

- **Fund managers and venture capitalists don't mesh well**

It's possible for a fund management and an investor to have divergent goals for a given investment. The contract that the fund management agrees to sign has a major impact on the interest rate differential. For instance, many managers of venture capital funds are compensated not for the returns they generate but for the size of the fund itself. These kind of fund managers are notorious for taking unnecessary financial risks.

Why Venture Capital?

In an opinion piece for the New York Times, Thomas Friedman argued that the administration should use the bailout money to provide $1 million to each of the topmost twenty American Venture Capital firms so that they can fund the greatest ideas that come their way. Why, therefore, is Venture Capital still seen as the magic bullet

by so many, including an increasing number of governments and regional administrations round the world, despite the fact that it is so dangerous, as we discussed above, and that it demands so much time and such specialised skills? The short answer is that VCs don't only bring money to the table; they also contribute business acumen, which they use to sift through potential investments, select the most promising ideas and companies, and then utilize their connections to help those businesses grow and eventually sell. Here we'll examine not only the broader implications, but also the influence on the portfolio firms individually.

- Global advantages

Looking back, in 2000, US VC funding reached 1.1% of the country's GDP, & today the United States is still the global top, with less than 0.2% of its GDP invested in venture capital. Although only a small fraction of all businesses, venture-backed companies account for 21% of US GDP and employ 11% of the private sector workforce in the US (National Venture Capital Association, 2009). Although VC investment in Europe is a far lesser contributor to GDP (just 0.053% in 2008, according to a telephone interview with Zornitsa Pavlova, previous head of research at the European Venture Capital Association), it has a considerable effect on the creation of new jobs in the region. For lack of more recent research, it is useful to reference data from the European Venture Capital Association (EVCA) (2005), which found that venture-backed companies in Europe experienced annual employment growth of 30.5% between 1997 and 2004, which is nearly forty times the annual increase of total employment in the EU 25-member states between 2000 and 2004. To add, the average number of employees at venture-backed companies climbed by more than 25%, with 73% of those companies reporting such growth. According to the same study, venture-backed companies spend an average of €3.4m annually on R&D activities, with an average R&D expenditure per employee of €50,500. This is six times more than the R&D expenditure per worker of the 500 companies in the EU 25 with the highest spending on research and development which is €8,500. In addition, one-third of the surveyed workforce at venture-backed companies was engaged in R&D, with thirteen percent holding a PhD or its equivalent. Therefore, Venture Capital is not only producing employment, but also employment opportunities for the most highly educated individuals, thus reducing or eliminating the brain drain. Brander, Du, and Hellmann's 2010 examination of the research leads them to the conclusion that Venture Capital also has the effect of encouraging innovation. Investments in start-ups, or "venture capital," have been shown to increase capacity and positively impact innovation in recent years. Venture capitalists are guiding the innovation strategy of their portfolio firms toward commercial success. Deutsche Bank Research discovered that a rise in investment in private equity of 0.1% of GDP is statistically associated with an increase in real economic growth of 0.2 percentage points (pp) if the assets are done at the buyout stage, 0.4 percentage points (pp) if the investments are done at the venture-capital stage, and 1 percentage point (pp) if the investments are done at the early-stages. The research shows how much money entrepreneurs could make with Venture Capital's help. The German economy could benefit from a 0.2 percentage point boost in growth if venture capital investments there reached the European average. To achieve this goal, however, Germany's venture capital market would have to more than double from 0.056% of GDP to 0.113% of GDP without compromising the quality of funding, which is unachievable in the near future.

- Minor but significant effect

It is interesting to examine the micro-level impact of venture capital, to see how VCs help the companies wherein they invest in addition to the documented macro-level influence. And their help is primarily aimed in two ways: giving finance and delivering value to the portfolio companies. The very nature of venture capital investment is to provide capital for expansion. So much so that many people still think that this is all Venture Capitalists do, despite the fact that this misconception has serious negative effects on both the venture capital industry (which fails to capitalize on opportunities because its full benefits are unknown) and the entrepreneurs who secure venture capital financing. It's to be anticipated that VCs will exert considerable influence over the use of both their initial investment and subsequent profits. It is becoming increasingly accepted that the time and effort put in by successful VCs in the form of coaching and oversight far outweighs the monetary value of their investments, despite the fact that the entrepreneur (who is, by definition, accustomed to making decisions independently) may find these "intrusions" of the VCs to be unsettling at times. However, entrepreneurs, who are often of the "I know it all" personality type, see the need for funding as much greater than the need for guidance and mentoring. As a result, they look to venture capitalists for funding, with the expectation that the investors' involvement and rights will be kept to a minimum.

- Capital Donors

Many new businesses fail because they are unable to secure funding and hence never make it through the "valley of death." Banks are hesitant to participate in startups because they lack the necessary skills to evaluate the concepts and the risk profile associated with investing in such intriguing but incipient companies, and because startups have few tangible assets that could serve as collateral damages for bank funding. Therefore, Venture Capitalists are helping business owners by providing them with funding in exchange for a share in the company.

- Improvement of the portfolio firms' worth

While banks could be willing to finance new businesses, their role as debt holders means they have fewer incentives to encourage risk-taking, new ideas, and a more aggressive approach to doing business than do venture capitalists. Also crucial to the success of an early-stage investment are the Venture Capitalists' advisory services, knowledge, and connections. Venture capitalists' involvement in portfolio companies varies widely, from giving business contacts & brand-equity to offering strategic counsel and, in some situations, even becoming fully integrated into the everyday operations of the company.

- Innovativeness, Impact, and the Future

The importance of Venture Capital in bringing ideas to market has been established in the literature for some time now. The development of absorptive ability is aided by Venture Capital, as has been demonstrated by recent studies. There is some fascinating information to be gleaned from contrasting the results of public investment with those of private venture funding. According to Da Rin and Penas, VCs strategically steer their portfolio businesses toward innovative activities that lead to the buildup of absorptive capacity, as well as toward more sustained internal R&D initiatives. They observed that public money plays a different role than private venture

financing since it loosens budgetary limitations without providing any additional strategic assistance. These findings shed new light on how crucial venture capital is in propelling businesses to implement effective innovation strategies.

Conclusion:

However, the concept of venture capital remains abstract and little understood. In this paper, we attempted to do so by reviewing the definitions of venture capital on both sides of the Atlantic. We then narrowed our focus to analyze the impact of venture capital on both macroeconomic factors like economic growth and entrepreneurial ecosystem development and microeconomic factors like the companies' success after receiving not only financing but also other types of value-added services from VCs. In light of our findings, which indicate that Venture Capital is an asset class with the potential to make substantial contributions to development, more study is needed to determine what stops Venture Capital funds from producing the desired benefits in various parts of the world.

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