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VENTURE CAPITAL: DEFINITION AND MAIN CHARACTERISTICS

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ВЕНЧУРНИЙ КАПІТАЛ: ВИЗНАЧЕННЯ ТА КЛЮЧОВІ

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Abstract. In this paper we describe definition and main characteristics of venture capital.

Key words: innovative activity, venture capital, venture capital financing, risk capital.

Анотація. У роботі розглядають визначення та ключові характеристики венчурного капіталу.

Ключові слова: інноваційна діяльність, венчурний капітал, венчурне фінансування, ризиковий капітал.

Growth-oriented entrepreneurial ventures represent an important power in an economy – they create innovations and dynamics, new jobs, income and, not least, wealth. Although growth-oriented entrepreneurial ventures, or “gazelles”, can be found in all industry sectors and locations (urban as well as rural), there are some indications that the ventures with the highest growth potential are often characterized as knowledge-based and technologically driven – primarily based on intangible assets, operating in rapidly developing fields and with no documented history [1]. One of the main problems facing these growth-oriented entrepreneurial ventures is to

raise capital for the growth of the business and gaining access to the competence, experience and networks necessary for growth which most entrepreneurs are lacking.

However, it is not an easy task to provide a generally accepted definition of venture capital – the number of definitions is almost as great as the number of authors writing articles on the subject.

Venture capital is a specific form of industrial finance – part of a more broadly based private equity market, i.e. investments (with private equity) made by institutions, firms and wealthy individuals in ventures that are not quoted on a stock market, and which have the potential to grow and become significant players on the international market (Mason and Harrison, 1999; Isaksson, 2006). The private equity market can be divided into two different parts :

- 1) venture capital, which is primarily devoted to equity or equity-linked investments in young growth-oriented ventures;

- 2) private equity, which is devoted to investments that go beyond venture capital – covering a range of other stages and established businesses including, for example, management buy-outs, replacement capital and turnarounds.

Venture capital is a subset of risk capital, in which the risk taken by the investor is offset by participation in the future success of the firm as part owner.

Venture capital is often, especially in Europe, seen as synonymous with “private equity”. In this connection, venture capital refers to investments (with private equity) made by institutions, firms and wealthy individuals in the early and expansion-stages of the newly established firm. The terminology of private equity is, also covering a range of other stages (Bridge financing, Replacement capital, Rescue/Turnaround, etc.), which goes beyond venture capital.

Among most professional venture capital organisations, venture capital is defined as a subset of private equity – focusing on earlier stage investments.

The European Private Equity and Venture Capital Association (EVCA) defines venture capital as “Professional equity co-invested with the entrepreneur to fund an early stage (seed and start-up) or expansion venture. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment.”,

and private equity as equity capital provided to enterprises not quoted on a stock market [2].

Private equity is divided into three subgroups, informal venture capital, formal venture capital and other private equity. Formal venture capital is also sometimes referred to as “classic venture capital” and “other private equity” is sometimes only referred to as “private equity”.

Venture capital is not the only source of finance for start-up firms. When seen in relation to other financing options and the total amount of capital invested in all firms, then venture capital as an asset or equity class becomes marginal. Furthermore, many firms start up without the need for venture capital.

While some firms wish to access venture capital and are unable to, others avoid it for fear of deleterious consequences such as forced growth overextending the firm or the investor taking over. The reason why venture capital has attracted such attention is mainly due to the important impact it has on young firms’ high growth potential, as evident with many new technology based firms. Venture capital can be the only (and maybe the best) alternative for many of these firms [3].

A venture capital has five main characteristics:

1. A venture capital is a financial intermediary, meaning that it takes the investors’ capital and invests it directly in portfolio companies. This characteristic defines VCs as financial intermediaries. This is similar to a bank, because just as a bank takes money from depositors and then loans it to businesses and individuals, a venture capital fund takes money from its investors and makes equity investments in portfolio companies.

2. A venture capital invests only in private companies. This means that once the investments are made, the companies cannot be immediately traded on a public exchange. This characteristic defines venture capital as a type of private equity. Although the definitions of “private company” and “public company” have some nuances, the key distinction is that a public company’s securities can be traded in a formal market, like the NYSE or the NASDAQ, whereas a private company’s securities cannot. Any company that is publicly traded in the United States must also

file regular reports with the Securities and Exchange Commission (SEC) detailing its financial position and material changes to its business.

3. A venture capital takes an active role in monitoring and helping the companies in its portfolio. This characteristic is central to the success of any venture capital. Without it, a venture capital would only be providing capital, and his success (or failure) would be entirely due to his ability to choose investments. Although success can be entirely built on these choices, the comparative advantage of the venture capital would be greatly improved if the investor could also help the company directly.

4. A venture capital's primary goal is to maximize its financial return by exiting investments through a sale or an initial public offering (IPO). This characteristic is the requirement to exit and the focus on financial return, is a key distinction between venture capital and strategic investing done by large corporations. As a perpetual entity, a corporation can afford to take stakes in other businesses with the intention of earning income, forming long-term alliances, and providing access to new capabilities. It is possible for the corporation to maintain this stake indefinitely.

5. A venture capital invests to fund the internal growth of companies. This characteristic refers to "internal growth", by which we mean that the investment proceeds are used to build new businesses, not to acquire existing businesses. Although the legendary venture capital investments tend to be those adventurous venture capital s who backed "three guys in a garage", the reality of venture capital investing is much more varied. As a simple classification, we divide portfolio companies into three stages: early-stage, mid-stage (also called expansion-stage), and late-stage [p. 3, 4].

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