VENTURE CAPITAL

"I call my invention 'The Wheel,' but so far I've been unable to attract any venture capital."

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BRIEF EXPLANATION OF VENTURE CAPITAL

Venture Capital is investing in companies that have undeveloped or evolving products or revenue. It lays particular stress on entrepreneurial attempts and less mature businesses. Venture Capitalists are those who are desirous to accept high risk in order to attain a much more higher rate of return. A Venture Capital fund invests for a very long term, has a relatively small number of "stocks," and seeks very high returns.

If we try to explain Venture Capital financing from both perspectives of the investor side and the entrepreneur side, we should ask and answer those two questions: What does an Investor (also known as a Venture Capitalist) have and what does an entrepreneur have? Venture Capitalists have funds, or they have the ability to raise capital. They have experience in building companies creating wealth from the very beginning of a company up to the exit event. They have associates to help in formation of the company's network. On the other hand, entrepreneurs have avant-garde ideas, processes or products. They have the needed skill and practice to build and retain this business

The Venture Capitalists invests in companies, because they are looking for opportunities of gaining considerably higher returns than in stock market returns. And entrepreneurs just need the money to fully cash in on the opportunity of their product/service. Thus, the Venture Capital industry makes these two counterparties to come together and meet each other's needs.

There are four stages in Venture Capital financing. They can be summarized as:

- **Seed stage:** Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.
- **Start-up stage:** Financing for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but have not sold their products commercially and will not yet be generating a profit.
- **Expansion stage:** Financing for growth and expansion of a company which is breaking even or trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital. This stage includes bridge financing and rescue or turnaround investments.
- **Replacement Capital:** Purchase of shares from another investor or to reduce gearing via the refinancing of debt.

WHAT IS THE AIM OF VENTURE CAPITAL FINANCING?

Investors are interested in Venture Capital by the anticipation of earning higher yields than they can by investing in publicly traded firms. Likewise, entrepreneurs may be attracted by the feasibility of higher returns on their human and financial assets. In that point of view, the aim of Venture Capital financing is to increase the value of innovating companies, to allow today's "emerging" companies to advance into tomorrow's leading firms – by that means providing investors with noteworthy returns on their investment. Venture Capital firms invest in a lot of different new ventures, at least one of which should be successful. Apart from financing the new company, Venture Capital firms usually bring in their experience in the field and a network of relations – social capital. Venture capital is an important source of equity for start-up companies.

VCs want two things:

- **Equity:** because if and when the business achieves considerable success, that equity stake will be worth the invested capital.
- **Control:** because VCs want to reduce the risk that the entrepreneur will run a promising idea into the ground.

Depending on the main purpose of financing, there exists three major types VC investors :

- **Investors concerned with economic gain:** These investors are motivated by the prospect of a large economic reward, especially if the company gains public recognition. Entrepreneurs who seek these types of Venture Capitalists should not only stress the purpose of their business idea(s) but also mention shareholder percentages and ROI in their pitch and business plans.
- **Hedonistic Investors:** These investors are attracted to investing because of the thrill associated with risky ventures. They also believe that the entrepreneur's concepts are worthwhile and desire to help the entrepreneur market their innovative ideas. Thus, new business owners who seek funding from these investors should have a well-prepared, convincing pitch and business plan.
- **Altruistic Angel Investors:** These investors take pleasure in helping young companies thrive and enjoy promoting community development and job growth. Entrepreneurs who seek capital from these types of investors should perhaps stress the advantages of economic growth in communities and economically sound technologies.

At first glance, Venture Capital investors basically look for six important components when agreeing on an investment:

1) **The promise of a large ROI:** VC investors seek a profitable return on an investment since their investments tend to be highly risky.

2) **The rationale behind every investment:** Entrepreneurs should give VC investors a legitimate reason to invest in their company and cherish the skills and expertise a VC investor will bring to their enterprise.

3) **A promising pitch and convincing business proposal:** VC investors want to see an entrepreneur's business plan, detailing the ideas and objectives of their company. This business plan should include any financial projections, comprehensive marketing plans, concise details about the target industry, and who the prospective consumers will be.

4) **Proper business structure and organization:** An entrepreneur's business must be properly structured for investment. This includes the investor's percentage of ownership as part of the business deal. Investors are also likely to be involved in company operations through active mentoring, management, or being a member of the board. Most investors will expect this type of formal agreement, as well as a large return on investment, in exchange for providing the new company with the needed business capital.

5) **A well-defined exit strategy:** The entrepreneur and Venture Capital investor should agree upon a time frame for the investment. This means that for a given period of time, the VC investor will provide the needed capital, expect to be actively involved in a company, and will anticipate an exit after that phase comes to an end. The most common exit strategy of a VC investor is through the sale or merger of a company.

The aim for the entrepreneur of using Venture Capital financing is obvious; to raise money for his/her business (at whichever state it is, either start-up or expansion). However, it should be asked that why an entrepreneur prefers raising money by using Venture Capital in place of other forms of financing. First of all, Venture Capitalists can provide large sums of equity finance and bring a wealth of expertise to the business. Also, if you successfully attract a VC to your business, you're likely to find it easier to secure further funding from other sources. Secondly, the right Venture Capitalists can bring valuable skills, contacts and experience to the business and can assist with strategy and key decision making. In Venture Capital financing, investors have a vested interest in the business' success, i.e. its growth, profitability and increase in value.

Besides, investors are often prepared to provide follow-up funding as the business grows. On top of them, since Venture Capital investment is considered as long-term investment, entrepreneurs are not supposed to pay interest or principal back, at least not at the short-run. However, there are certain handicaps of Venture Capital financing.

WHAT ARE SOME FORMS OF FINANCING USED BY VENTURE CAPITALISTS?

A venture financing can be structured using one or more of several types of securities ranging from straight debt-to-debt with equity features (e.g., convertible debt or debt with warrants) to common stock. Each type of security offers certain advantages and disadvantages to both the entrepreneur and the investor. The characteristics of entrepreneur's situation and current market forces will impact the type and mix of security package that is right for both parties.

TYPES OF SECURITIES

Senior debt: It is usually for long-term financing for high-risk companies or special situations such as bridge financing. Bridge financing is designed as temporary financing in cases where the company has obtained a commitment for financing at a future date, which funds will be used to retire the debt. It is used in construction, acquisitions, anticipation of a public sale of securities, etc.

Subordinated debt: It is subordinated to financing from other financial institutions, and is usually convertible to common stock or accompanied by warrants to purchase common stock. Senior lenders consider subordinated debt as equity. This increases the amount of funds that can be borrowed, thus allowing greater leverage.

Preferred stock: It is usually convertible to common stock. The venture's cash flow is helped because no fixed loan or interest payments need to be made unless the preferred stock is redeemable or dividends are mandatory. Preferred stock improves the company's debt to equity ratio. The disadvantage is that dividends are not tax deductible.

Common stock: It is usually the most expensive in terms of the percent of ownership given to the Venture Capitalist. However, sale of common stock may be the only feasible alternative if cash flow and collateral limits the amount of debt the company can carry.

While each of these securities has unique characteristics, they can be grouped into two categories: debt or equity. In structuring a venture financing, the primary question is whether the financing should be in the form of debt or equity.

DISADVANTAGES OF DEBT TO A COMPANY

From a company's viewpoint, there are two potential disadvantages to debt.

1. An excessive amount of debt can strain a company's credit standing, thereby reducing its flexibility in meeting future long-term financing requirements on a favorable basis. It can also negatively affect a company's ability to obtain short-term credit. Of course, the form of debt the venture financing takes makes a difference. For example, subordinated debt will have less impact on borrowing capacity than senior debt.

2. The Venture Capitalist has the option of calling his loan if the company is in default of the loan agreement. This remedy, which is not available to him under other financing agreements, puts him in a better position to influence the company's affairs when it is in default.

ADVANTAGES OF DEBT TO A VENTURE CAPITALIST

From the Venture Capitalist's point of view, there are three principal advantages to debt.

1. There is a greater likelihood that the Venture Capitalist will get his principal back and, at least, a small return. Many of the companies in the average Venture Capitalist's portfolio are referred to as "the living dead." Needless to say, their performance has turned out to be disappointing. In some cases, these companies are able to repay principal with interest but have limited appeal to potential acquirers or the public. As a result, a Venture Capitalist with an investment in such a company's common stock may be unable to recover his investment within a reasonable period, if at all.

2. As previously discussed, under certain circumstances the Venture Capitalist is in a better position to influence the company's affairs.

3. The Venture Capitalist has a senior claim. However, it should be emphasized that the meaningfulness of a senior claim depends on the marketability of a company's assets and the amount of equity it has to cushion its creditors' position. For example, in the case of a start-Lip situation with little or no equity, a senior claim means little or nothing

PERCENTAGE OF OWNERSHIP NEEDED

While the difference may not be great, depending on the particular circumstances of the company, a debt position involves less risk than an equity position for the Venture Capitalist. Accordingly, a company should not have to relinquish as much ownership when a financing is in the form of debt. However, this advantage must be weighed against the disadvantages of debt.

No matter how the venture financing is structured, it must be priced so that it is attractive to the Venture Capitalist. There is no clear-cut answer as to how much ownership a company will have to relinquish to make a financing attractive. Broadly speaking, the greater the potential return perceived by the Venture Capitalist, the less ownership he will demand. In other words, if a company has a patented product which a Venture Capitalist thinks is revolutionary and highly marketable, he will undoubtedly settle for less ownership than he would in the case of 4 company with a relatively less attractive product. Thus, his ultimate position will be a business judgment based on his potential return.

Before the entrepreneurs enter negotiations with the Venture Capitalist, one should determine what the company is worth and how much of the company one want to sell. The following procedure can be used to get a rough idea of how much ownership the entrepreneur will have to give up to make the financing attractive.

1. **Estimation of the risk associated with the venture financing.** If the investment is very risky, the Venture Capitalist may be looking for a return as high as 15 times his investment over five years. Conversely, if a relatively low degree of risk is involved, the Venture Capitalist may be satisfied with doubling or tripling his investment over five years.

2. **Making a reasonable estimate of the price/earnings ratio applicable to comparable publicly held companies:** The market value of the company can then be projected by multiplying forecasted annual earnings by the estimated price/earnings ratio for comparable companies.

3. **Dividing the estimate of the total value of return the Venture Capitalist wants by the projected market value of the company:** This yields the percentage ownership the Venture Capitalist will need, as oil the future date, to realize his desired return. It is important to note that any equity financing required during the interim period must be considered in making these calculations.

WHAT ARE REQUIREMENTS FOR DEVELOPING THE USE OF VENTURE CAPITAL FINANCING?

The criteria for Venture Capital investment is as follows:

- Identifiable Competitive Advantage
- High Growth Potential High Growth Potential
- Attractive Valuation Relative to Potential
- Well Defined Exit Alternatives

There are some relevant questions to check whether a company is worth-investment:

- Does the company serve a market that is large enough and is fast growing enough to be interesting and promising?
- Does the company's product or service have a clear, differentiated advantage in its marketplace?
- Does the company, through intellectual property or other means, have sufficient barriers to the entry of other competitors who can duplicate their advantage?
- Does the company have a skilled, honest, realistic, seasoned management team with the ability to carry out the business plan and with the ability to responsively weather unanticipated problems and opportunities that arise along the voyage to success?
- Are the company's customers pleased with the product or service, or with its early versions, and are they likely to become repeat customers?
- Is the valuation of the company and the terms of the offered equity investment attractive enough to warrant the risk involved in the investment?
- Of all of the above, the need for a strong management team is by far the most critical. For a venture opportunity to be attractive there must be a positive answer to all of these questions. But venture investors will spend most of their effort verifying the quality of the team of managers who will be spending their money.

- Once you have traversed all of these hurdles, you're ready to focus on the terms and methods of closing the deal. Once again, a company will turn to its expert legal and financial advisers for help with terms, documents, and closing.

COMPARISON OF COSTS OF VENTURE CAPITAL WITH OTHERS FORMS OF FINANCING

Advantages of a Venture Capital

- Financing expertise and strategic support Financing expertise and strategic support
- Confidentiality
- Independence of the capital markets volatil Independence of the capital markets volatil
- Bridge financing to a future succesful IPO Bridge financing to a future succesful IPO

However, there are certain handicaps of Venture Capital financing compared to other forms of finance. Giving up an equity stake, for example, may not "feel" like a big sacrifice in the beginning, but in fact it's a huge concession. That's because equity holders are entitled to a percentage of a company's cash flows forever--as opposed to, say, payments over the life of a bank loan. From a cost-of-capital perspective, giving away preferred stock costs entrepreneurs the worst of two worlds. Like bondholders, preferred stockholders charge interest on their money, and they get paid before common equity holders in a sale. The second major issue is control. Ideally, most entrepreneurs want to be in charge--otherwise, they would choose to work for somebody else. If structured properly, loans or even common stock arrangements usually allow founders to maintain significant control. VCs, on the other hand, want a firm hand--if not two--on the wheel.

VC Firms adopt an active management style in the portfolio companies and works collaboratively with the management to design and implement the post-acquisition value-creation strategies, whose successful application has resulted in immense competitive advantages for portfolio companies. VC Firms create value through hands-on management and aggressive follow-up of performance and execution of business plan through board membership and steering committees.

Steering committee meetings where value-creation strategies as well as ad-hoc financial and operational issues of the portfolio companies are discussed, are held weekly or every other week. Recommendations developed by the Steering Committee are presented to the Board of Directors, which meets monthly, for assessment. VC Firms' value-creation strategies take on many forms whose examples can be traced with respect to all of the portfolio companies:

I. Industry Consolidation:

Most of the industries in Turkey display a fragmented structure, offering lucrative inorganic growth opportunities through consolidation.

II. New Market Expansion:

VC Firms expect its portfolio companies not only to be dominant players in the local market but also to have the vision to become regional or global players, provided that they have a suitable business concept for internationalization, in order to mitigate risks related to over-exposure to one single geographic market. VC Firms do not only financially support international expansion, but also plays a key role to support company management to identify the right market and the mode of entry.

III. Strategic Redirecting:

Management Team's years of past experience in various fields including operations and consulting enables the investment team to engage in a guiding role whilst assessment of portfolio companies' strategies with a focus on competitive advantage creation.

IV. Operational Improvement:

Operational improvement is one of the most widely and successfully applied value creation strategies by VC Firms and enables the portfolio companies to adopt systems and approaches that will continue to create value after VC Firms' exit. Operational improvement is achieved by improvement of existing or as the case may be, introduction of new management information and reporting systems and also development and implementation of new IT infrastructure, which are standard applications by VC Firms for its portfolio companies, to a greater extent particularly for investments completed recently.

V. Reinforce Management Team:

Despite the scarcity of result-oriented management talent that can deliver VC expectations, due to its local presence and experience, VC Firms not only successfully creates its own pool of capable executives, but also establishes relationships with a vast network of consultants and recruiting firms. For example, CFO's can be selected and brought in for all of the portfolio companies by VC Firms.

VI. Corporate Governance, Transparency and Restructuring:

VC Firms place great emphasis on the transparency, ethics and also efficiency of principals and procedures concerning the management of its portfolio companies. In order to establish financial and operational discipline, VC Firms restructures internal operational processes, policies and procedures, particularly those regarding personnel, expenses-allowances and procurement, immediately after entry, which has been the case especially for investments completed more recently.