International Journal of Economics and Financial Management (IJEFM)
E-ISSN 2545-5966 P-ISSN 2695-1932 Vol 9. No. 6 2024 www.iiardjournals.org Online Version

Navigating the Venture Capital Landscape: A Deep Dive into Funding, Usage, and Investment Drivers

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DOI: 10.56201/ijefm.v9.no6.2024.pg145.152

Abstract
Venture capital financing plays a crucial role in supporting the formation and growth of innovative startups and emerging businesses. Among many factors venture capital in recent times have emerged as large providers of finance. Using literature review this research paper aims to provide an in-depth understanding of the venture capital financing process, the factors that influence venture capital investments, and the opportunities and challenges associated with this form of funding. Selection of venture capital firms, arrangement for proposals, pitching ideas, and negotiation are the common steps for getting VC deals. Both macro and firm level factors influence VC investments. To name few GDP growth, government policies, industrial production, owner characteristics, management team, revenue growth mainly affect the nature of financing.

Keywords: *Startup, Venture Capital, Valuation, Finance Mechanism, Investments*

1. Introduction

Finance is an important component of survival, growth, and development of startups influencing every aspect of business. Initially funds are needed to get off the ground which often comes from personal savings, loans and family & friends, after successful seed stage cash flow is used for daily operations such as paying salary, rent, and payment to suppliers. Further finance is utilized for expansion and diversification of activities. funds are mostly used in increasing production, and entering into markets.

From securing funding to scaling the business and managing risks. Effective financial management is essential for both survival and long term success. banks, private equity, angel investors, government, crowdfunding platforms to name few are providers of finance at different stages. Among all these venture capital has been the major financial source after early stage. VC is a crucial form of funding and support of founders in different ways. It provides substantial funding that startups need to scaleup, expand and accelerate growth. Apart from funds VC experts are good in managing risks by adding valuable guidance in decision making process to founders. Moreover, receiving VC support offer quality signals to other investors. they provide supportive mechanism in multiple ways by aligning vision, often sacrificing short term goals. It has also been observed that startups with VC mentorship innovate better products.

With all these there are challenges founders face while dealing with VC managers to acquire funds. The paper studies the gap in literature to offer a holistic view of state of affairs of venture capital financing. It summarises all aspects of venture capital i.e. kinds, process of funding, valuation, factors influencing investments from VC, it ends with concluding advantages, usage and applicability of venture capitalists.

2. Objectives of the study

The study tries to bridge the gap by identifying VC as a common form of startup funding. The specific objectives are as follows:

1. To understand Venture Capital funding process and their mechanism.
2. To analyse the usage of Venture capital financing.
3. To identify the factors influencing Venture Capital investments.

3. Research methodology

The study is based on literature reviews made from the past studies. It uses literature reviews, survey reports to arrive at objective. Literature surrounding venture capitalists are collected and summarized to find out the role of Venture Capital financing in startup development.

4. Meaning and usage of venture capital

Venture capitalists in the simplest terms are intermediaries between borrowers and lenders of fund. Venture capitalists pool large amount of funds from lenders to put money in firms having capacity to generate large returns after considerable time. They are special category of investors investing in innovative firms. normal investors have limited expertise in financial market they only invest money in firms. while VC experts manage their funds smartly in innovative firms. Venture capital are means of providing capital to firms who may not have necessary financial means (Gompers and Lerner, 1998). The experts aim to optimally utilize funds by investing in profitable portfolio companies. Investment in startups requires criteria of consistent revenue, growth and good profit margin. Startups are systematically evaluated in the light of current market conditions. founders pitch business proposals with their current performance in front of VC managers. Among those only 10% of pitching proposals are picked for investment (Maier and Walker, 2007).

Investment allocation problem and decision making problem are solved by VC experts. Portfolio managers in VC teams are competent enough to take risk and maximize return. They avoid risk by guidance, mentoring to startup founders at crucial stages. They perform activities of monitoring important strategic decisions by controlling equity rights (Gompers and Lerner, 1998). Knowledge shares by VC managers helps in building organisations and development of business. Knowledge shared is a result of their own experience of portfolio companies in which either they have worked or mentored.

5. **Kinds of Venture Capital** – At a later stage with huge amount of finance at their disposal. VC are one of the most important components of startup ecosystem. The functioning of

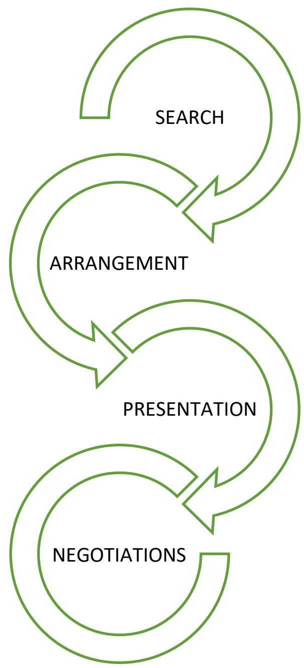
VC is similar but it becomes pervasive to study their types for linking with their contribution in growth. Following are the kinds of venture capital**:**

a. **Traditional venture capital** – These are the oldest form of VC funds started in Silicon Valley, USA. These VC's finance both tech and non tech startups in different stages. Their focus is mainly on maturing startups which have developed some % of traction (Robb and Robinson, 2014). By taking a fixed stake in exchange of finance, they provide mentorship support and take important strategic decisions.
b. **Corporate VC**- These VC funds are managed, operated, controlled and owned by big corporate houses. Corporate VC investments are established by corporations in entrepreneurial ventures. The motive of investment lies in high return and vested strategic interest relating to technology and market (Dushnitsky and Terox, 2006). Corporate VC target innovative startup in their own line of business for future strategic operations. corporates feel that their in-house research is incapable of sound innovation: so, they take the benefit from investing. Also, in case of Fintech startups innovation generates increasing user VC that is difficult for traditional financial institutions. Companies give access to technical, market and business knowledge (Maula and Murray, 2001). They engage in strategic partnership and provide complimentary resources to portfolio companies. VC add value to management capabilities having sound knowledge in building organizations. Startups benefit from a large pool of resources provided by companies whether financial or infrastructural.
c. **Foreign VC** – VCs located outside India but invest in ventures in India are called as Foreign VC. They help in introducing sophisticated technology outside the scope of Indian firms. They offer more customers and suppliers than domestic VC firms (Makela and Maula, 2005). They help in endorsement for ventures by providing legitimacy (Makela and Maula, 2005).

6. Process of financing through VC

The fig. depicts the whole process of receive funding from VC

Fig. 1: Representation of VC funding process



a. **Searching suitable VC**- Different VC add different kinds of values bringing some special kind of services for portfolio companies. VC have preferences in certain industry, area , and sectors in the line of business they have funded earlier. The level of success achieved and % of success among portfolio companies indicates the performance of VC. Number of exits serves the primary criteria to determine the effectiveness of its services. Startup screen VC from where they can easily secure funds. There are high chances of rejecting proposal by VC due to its regulatory norms concerned with wealth maximization for its investors.
b. **Arrangement for proposal** – The next step is to make arrangements for proposal and pitching place for prospective investment. It consists of meeting with VC managers and arriving at a time of schedule discussions for presenting proposal. Founders either personally visit premises VC office or through video conferencing chalk out plans for delivering business plan. A specified date and time are arrived for presentation may be in virtual mode or physical mode. Events are good place for presenting business proposals to large number of VC managers.
c. **Presenting business plan**- Presentation of plans is most crucial step in securing VC deals. Idea/ business proposals are pitched to VC managers in an event or in office premises. Onus on the founders is to present their full model along with its future revenue growth forecasts. Selection of firm for deal is largely based on the way a proposal is delivered. Presentation follows questions session between the parties.
d. **Negotiation**- Most of startups fail are unable to reach the final stage of deal. Final stage ends signing of term sheet. Term sheet is a written agreement between VC and startup founders containing provisions relating to financial obligations among the parties. These provisions are related to funds, valuation, important terms of contract, equity stake

surrendered, directors, to be appointed and other material issues. Founders must be vigilant before making any commitment as it may hamper their future growth prospects.

7. Methods of valuation

Negotiations forms an important part in VC deal. Mainly term sheet recognizes future intrinsic values of startup that is possible assuming the current market conditions to be stable. Mostly, Revenue drives the primary agenda to determine value of startups. Depending on the value a certain percentage of stake is given to VC till its disposal in stock market or any other place. Following methods are discussed of valuation:

a. **Discounted cash flow method**- This technique screens estimated project cost and returns. The expected cash flow in future is discounted at a nominal rate. Value is arrived after the estimation of cash flow that firm brings in future based on the past trends. The method is recognized as complex and inaccurate. Calculating value at a discounted rate is biased and inaccurate.

b. **Earning multiple method-** The earning multiple approach is based on idea that assets can be sold at similar prices. It evaluates similar companies using standardized financial metrics, some of the most commonly used equity multiples includes P/E multiple, price to book, price to sales. Multiplier is calculated by dividing the market value of total assets or estimated value of an asset by specific component of financial statement.

Earning multiplier = Market value / specific item of B/S or P/L A/C

The approach assumes that ratio can be applicable to various companies operating within the same line of business. Firms having low earnings in initial years makes the technique problematic for evaluation.

c. **Net assets method**- This is the easiest and simplest method of startup valuation where the value of tangible assets is used to calculate value of startups. Net assets method suffers from ignoring growth prospects of firm focusing only on net assets, New firms may not have tangible assets backing on innovative ideas. Startups with comprehensive business plan but lack of tangible assets will suffer from lower valuations.

d. **Venture capital method**- Exit price is estimated by VC by taking into account the investment period and risk associated with projects after disposal of investments. So, Post money valuation method is used by considering the time and risk investors are willing to take. Return on investment is estimated keeping in mind the market return on similar assets. This method reflects whole process of financing where managers are looking for exit between 3 to 7 years. This method suffers from biasness which makes it difficult to be justified.

Lack of efficient pricing mechanism augments to the problem of negotiation between founders and VC. There is no mandatory rule or polices for following a particular method making the valuation process cumbersome. valuation examines negotiation between parties depending on their bargaining power. Startup valuation process can be said as more of an art less science (Messica, 2008).

8. Factors influencing VC investments

The factors affecting VC investments can be subdivided into two categories:

a. Macro level approach
b. Firm level approach

i. **Macro level approach-** Macro level deals with factors that affect the whole economy in financing. Developing economies like India have received large amounts of VC investments compared to other countries attributable to many factors like, higher GDP growth, Progressive government policies, large consumer base etc. some of the factors are discussed as below:

a. **Entrepreneurial activities -**Level of entrepreneurial activities positively and significantly affects VC investments in the economy (Roman and Pottelsberghe, 2004). It can be observed from influx of huge VC investments in India in recent years.
b. **Research and innovation activities**- VC managers invest willingly in business models which are disruptive in nature. Disruption is the result of advancement in core research related to technology products or services. Research and innovation positively impact quantum of VC investments (Baygan and Freudenberg, 2000).
c. **GDP growth**- Extent and trend of GDP growth pattern influences VC financing in the country. Countries having upward GDP trend indicates favorable economic environments for investment (Herif and Gazdox, 2011).
d. **Business cycle**- Economy experiences wide fluctuations in business cycle i.e. depression, recession, normal and boom. The current situation of business cycle affects VC investments (Ning and Wang, 2015). During recession economy suffers from losses which are uncertain creating an environment of uncertainty.
e. **FDI inflows-** Higher the FDI inflows better are the chances of VC investments. In India where FDI inflows have gone into record heights, at the same point of time India has received good amount of VC deals. FDI inflows positively influences VC investments (Schroden, 2009).
f. **Industrial production**- Production in the economy effects VC investments. VC are thought to be enhanced pickers in choosing right path for allocation of resources.
g. **Government policies** – Policies implemented by government creates conducive environment for financial deals. congenial policies by the government spread the message of positive stance to investors leading to higher investments.

ii. **Firm level approach** – Firm level factors are specific affecting investment only in particular industry or firm. These are described below:

a. **Quality of management team**- The process of evaluation starts with screening management team. Competency reflected by founders during the presentation builds confidence. Managements team performance and their ability is an imperative aspect in VC investments (Feeney et al., 1999).
b. **Owner characteristics-** Traditional VC rely on owner/founder features for making investment decisions. Owner characteristics impact the business performance which includes track record, integrity, commitment are valuable resources in business projects (Feeney et a., 1999).
c. **Geographical proximity**-VC consider geographical closeness a key factor in investment, Geographical closeness supports VC managers in effective monitoring and other board services (Lerner, 1995).

d. **Innovativeness-** Innovative ideas give competitive advantage to firms may be for products/services/ideas. Being new chances of imitation reduces. Innovative business models have greater hope for VC investments. (Hellaman and puri, 2000). Innovativeness can be judged from patents registered.
e. **Social capital**- Strong network ties between founders gives advantages of information sharing. Information asymmetry is major problem as startups have no compulsion of submitting annual reports. Trust, faith becomes the major factor for ascertaining performance. Social capital supports assessment of VC financing (Sher and Sun. 2021).
f. **Entrepreneurial knowledge**- Entrepreneurs background shows evidence of founder's skills and the level of expertise. VC look for strong knowledge while investing in managing a business (Rajan, 2012).
g. **Startup experience-** Experience in startups is quite different from experiences in normal business. Innovation, technology, scalability is handled by startup founders effectively. Prior startup experience positively affects VC financing (Beckman et al., 2007).
h. **Activity in social media**- Social media has become a source of networking. these networks may turn into social capital. Use of social media influences overall firm performance and VC financing (Nigam et al., 2020).
i. **Revenue**- It is an accepted fact that VC prefers startup which have developed some amount of traction which means they must hold some market share. Startups revenue model attracts VC. Evaluation process involves sales in the past. Sales/revenue positively affects VC funding (Felin et al., 2007).

9. Conclusion

There are mainly 2 kinds of venture capital i.e. traditional VC and corporate VC. Traditional VC are common fund providers acting as an intermediary between borrowers and lenders of funds. Corporate VC are backed by big companies investing for strategic purpose. VC funding process starts with searching for VC, arrangement for proposal, presentation/pitching ideas and business proposals and finally negotiating the deal. Each and every step is crucial for receiving funds. Only 10% firms are selected for further rounds of financing.

Valuation is a subjective concept differing widely among investors. there are huge differences in method of valuation and process of computing the value of startups. investors have their own preference in evaluating a startup valuation. Some chose revenue as a common criteria and for some other assets forms the basis for valuation. GDP growth, business cycle, FDI inflows, industrial production and government policies impact financing of VC from economy point of view. At micro level owner characteristics, geographical proximity, entrepreneurial knowledge, experience, presence in social media, and revenue affects firm's chances of getting VC deals.

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