World Encyclopedia of Entrepreneurship

Edited by

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Venture capital (VC) represents a financing option for entrepreneurs whereby funds are provided by an investor, to a recipient, as either seed money, start-up funds or expansion funding to start, or grow, a business (Jeng and Wells, 2000). Generally, a firm providing venture capital is a privately owned company representing the interests of multiple individual wealthy investors with the primary purpose of maximizing return on investment over time (Burton and Scherschmidt, 2004; de Bettignies and Brander, 2007). Though an award of VC funding is difficult to achieve, funds from venture capitalists are especially desirable for entrepreneurs due to the relative flexibility of the equity finance structure and available repayment options. We describe, briefly, the history of venture capital, the similarities and differences between alternative funding options, as well as the procurement process for entrepreneurs.

Since 1977, bank lending has remained fairly constant while VC investments are 100 times larger in 2001 than they were in 1997 (Ueda, 2002). An organization called American Research and Development, founded in Massachusetts in 1946, is considered to be the first modern venture capital company, and since then VC firms have specialized in matching investment capital with ventures that are screened and deemed worthy of investment (Allen, 1969; Jeng and Wells, 2000). In general, the venture capital process is described as having five main steps: (1) deal origination, (2) deal screening, (3) deal evaluation, (4) deal structuring and (5) post-investment activities (Tyebjee and Bruno, 1984). Due to the growth in VC funding, and the involved process of both receiving and utilizing VC funding, it is no surprise that academic interest in the domain of venture capitalism has grown considerably in recent years.

The activities, investments, structure and impact of VC firms across countries, industries, as well as between firm stages is well documented within the literature on venture capital (for example, Jeng and Wells, 2000; Pintado et al., 2007; Sheu and Lin, 2007). Additionally, much empirical evidence examines the actual impact of VC funding by comparing, over time, firms that receive VC funding with firms that do not receive VC funding (for a review see Brau et al., 2004). Extant research, ultimately, is not conclusive regarding the overall impact of VC funding. Research exists to support, as well as to refute, the conclusion that the investment of VC funding improves financial viability and survival of a firm over time (Brau et al., 2004).

Business ventures have several financing options available to them when seeking capital. These options often include (1) family and friends, (2) bank loans, (3) angels, and (4) venture capital (Pintado et al., 2007; Van Auken, 2001). Venture capital is distinct from these alternative financing options in important ways. Personal funds, or funds from family and friends are often quite limited and are generally exhausted on business expenses during the early stages of the investment-seeking process. Bank loans provide an alternative to using personal, family or friend's funds, but there are important differences between bank funding and VC funding.
Similar to VC firms, banks do evaluate new ventures and the risks that are associated with supplying capital. However, bank loans can be very small and VC firm investments typically start at very large amounts (Gompers and Lerner, 2006). Additionally, banks are often viewed as passive investors who focus on the financial health of the venture and receive a fixed return on their investment. Venture capital firms, however, are active investors. Venture capital firms often gain a level of ownership of the venture through equity financing and they actively participate in the management of the venture in an attempt to earn a return greater than that of a fixed loan (Gompers et al., 1998). In this process VC firms generally provide guidance and expertise to the recipient of the capital investment. This large amount of capital, time and energy that VC firms invest, though appealing to new ventures endeavoring to grow, make VC funding more difficult to obtain than bank loans.

‘Angels’, wealthy individuals who funds start-ups out of their own funds, represent another alternative funding option for entrepreneurs (Gompers, 1994). The scope of ‘angel’ financing is limited by the wealth of these individuals and this option is not a readily available, or generally viable, source for large amounts of capital (Jeng and Wells, 2000).

The process of procuring VC funding is an exhaustive endeavor with limited chances of success. First, the entrepreneur must have an idea or an existing venture that appeals to a VC firm. The entrepreneur has two options available to them when seeking VC capital (Schwienbacher, 2007). The first is to find a VC firm that is interested in the idea before a venture is created. This option alleviates the entrepreneur from wasting the effort on an idea that will not receive funding. The second option is to spend the time and effort on creating the venture and then seeking the investment of a VC firm to expand and grow.

If interest has been gained from a VC firm in a new venture, the new venture will be vetted thoroughly by the VC firm while negotiations take place. When negotiating with a bank for a loan the entrepreneur may not be compelled to share all the pertinent information regarding the venture. When negotiating with a VC firm there is rarely a case of asymmetric information between the entrepreneur and VC firm (that is, transparency theory, signaling theory; Ueda, 2004). The VC firm will consider the attractiveness of the opportunity (for example market size, technology, competition), the top management team, and the terms of the investment contract (Kaplan and Stromberg, 2001) during their negotiations with the entrepreneur. If the VC firm determines that the criteria for investing in the new venture are satisfactory, capital will likely be provided to the new venture.

As bank loans are provided with respective interest rates, VC financing comes with a price that some entrepreneurs may view as distasteful. If an entrepreneur attains financing from a VC firm, that entrepreneur is likely giving the VC firm a predetermined amount of ownership of the venture and, therefore, a portion of the control of the venture. Venture capital firms are sometimes allowed such rights as allocation of cash flow, voting, board and other control rights (Kaplan and Stromberg, 2001). However, while some control may be surrendered, VC financing can have benefits for a new venture as well. Venture capital firms will often provide assistance in fund-raising, strategic analysis and management recruiting (Gorman and Sahlman, 1989), all working for the goal of growing the venture.

While attaining venture capital for an entrepreneur can be, and usually is, a challenging
risks that are associated with the venture and the new venture. Therefore, venture capital firms invest, though usually on a smaller scale, in new venture development projects.

Also, because of the limited available capital, the Gründer's own funds, represent a significant source of capital (Jeng and Wiltbank, 1998). The scope of this source limits the Gründer's ability to expand and grow. When negotiating with venture capitalists, it is important to have all the pertinent information available and make the decision based on this. Additionally, the Gründer should be aware that there are numerous opportunities for growth and that the Gründer should make the most of these opportunities.

The goal of the Gründer is to expand and grow. This can be achieved through the use of venture capital. However, the Gründer must be aware of the costs associated with the venture and the venture's ability to generate these costs. Additionally, the Gründer must be aware of the risks associated with the venture and the venture's ability to generate these risks.