CHAPTER 3

INVESTMENT STRATEGY AND VENTURE CAPITAL

This chapter provides a basic explanation of what is an investment strategy as well as a comprehensive background of the concept of venture capital and its nature. This information will serve as a starting point for the empirical research developed in Chapter 5.

3.1 Investment Strategy

According to An investment strategy is a plan that an investor uses when deciding how to allocate capital among several options that offer diverse potential returns and risks. The strategy must take into account factors such as the investor's tolerance for risk, goals, entry considerations and horizons (Bloomberg LP's website).

In order to illustrate how traditional venture capitalists define their own investment strategies, an example from the Bank of Ireland Venture Capital is placed below:

> *"BoI Venture Capital (BOIVC) seeks to invest in companies with strong management teams, sound business models, defensible competitive advantages and internationally traded products.*
> *Our maximum investment in any portfolio company is €2 million with a maximum initial investment of €1.25 million.*
> *As a generalist Fund we look to maintain a diversified portfolio providing expansion capital to internationally traded dynamic growth companies.*
> *BOIVC sources deals through a network of professional and personal relationships with corporate finance houses, private equity firms, accountants and emergent entrepreneurs.*

> *BOIVC will either act as the sole sponsor or lead, co-lead or participate in a syndicate.*

Investment exits are typically targeted to occur within 4-7 years, but we will maintain flexible time horizons to maximize investment return".

Comparing the definition of investment strategy found at Bloomberg L.P.'s website with the investment strategy of Bank of Ireland Venture Capital, it's evident that all elements mentioned in the theoretical concept are included in the company's scheme.

By considering specific amounts that the company is willing to invest in a particular start-up company, the BOIVC is partly defining its risk tolerance. Entry criterion is included in the characteristics that the start-up must have such as internationally traded products and a good business model. A horizon refers in the example to the 4-7 years that the investment is expected to be realized.

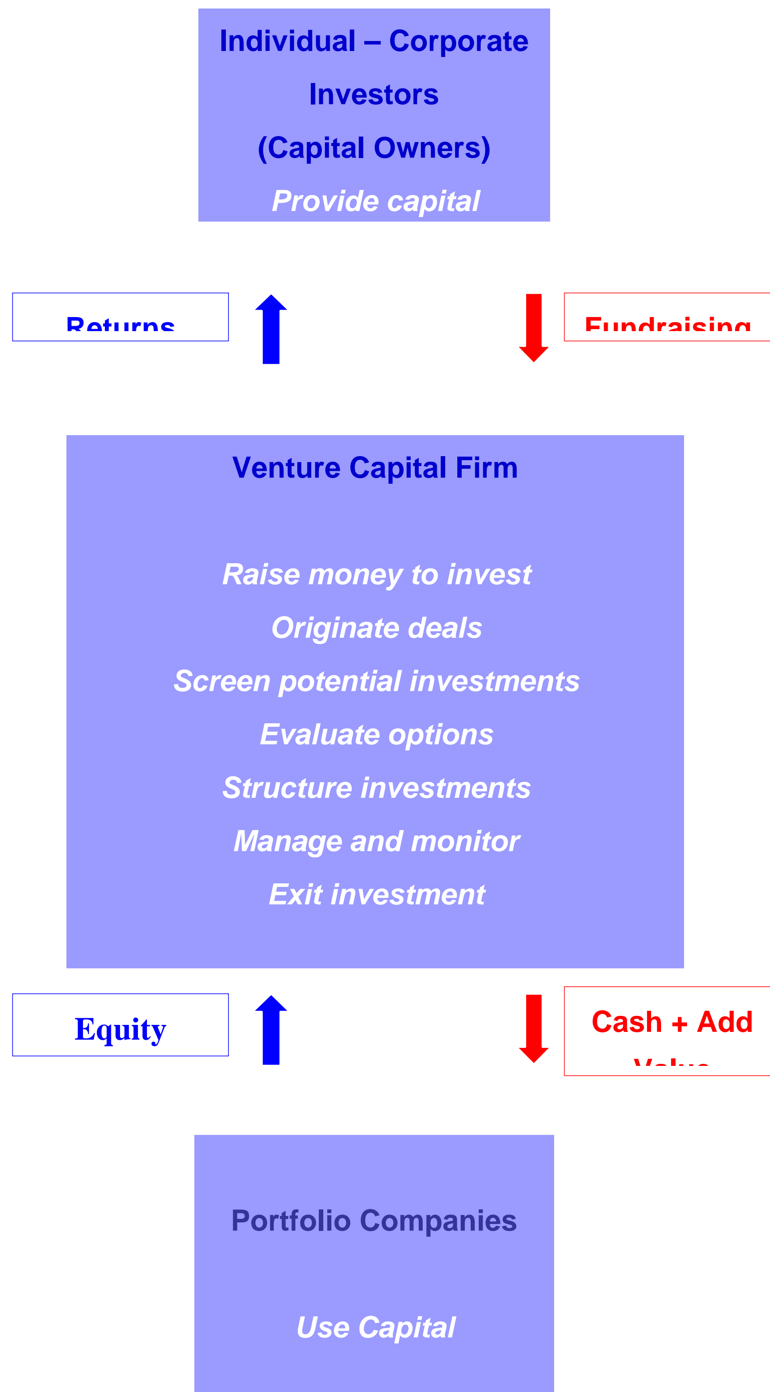
This paper will consider those elements that BOIVC includes in its venture capital investment strategy by evidently, going deeper into them.

3.2 Venture Capital

3.2.1 The Venture Capital concept

Among several forms of investment in the real world, there is one special type called Venture Capital. Finding an universal definition for it is almost impossible. A traditional definition of venture capital is "equity-linked investments in young, privately held companies, where the investor is as often active as a director, an advisor, or even a manager of the firm" (Zider, 1998). Robinson (1997) includes the factor of long-term horizon in venture capital as they affirm that investors must wait from five to ten years to obtain significant returns. But one of the unique characteristics of this type of investment is that generally venture capitalists have an active and participative involvement in the invested enterprise. A diagram describing the relationship between all players is shown below:

Figure 1. Framework of Venture Capital



Source: Fredriksen, 1991

But theory also points out an important constraint in venture capital investments. In general terms, the venture capitalist and the entrepreneur will pursue somewhat different goals. While the venture capitalist is only interested in his monetary returns, the entrepreneur also pursues other goals such as fulfillment of his entrepreneurial

idea or scientific interest in developing a new product or even the prestige of running his own business. (Sahlman, 1990)

3.2.2 Existence of Venture Capital

Many start-up companies may have high potential to generate significant returns under a specific period of time, though this potential is very hard to predict (Bygrave and Timmons, 1992). However, due to lack of reliable and sufficient information about these enterprises and the high sensitivity to capital and market conditions, the uncertainty level surrounding these entrepreneurial organizations is extremely high. Thus, the most valuable assets a start-up's future depends on are commonly intangible. Therefore, the risk incurred with investing in them is also very high (Gompers and Lerner, 1999).

In normal market conditions this situation will provide elevated financial transaction costs that will become barriers for both demand and supply of capital. In most of cases, commercial loans can not be granted to this type of enterprises as they do not meet the minimum requirements that banks ask for tangible collateralized loans; also, in several countries, legal regulations prohibit banks to provide financing to such high-risk enterprises (Gompers and Lerner, 1999).

This is where venture capital enters the stage, since it's a form of risk capital investment in which investors agree to tolerate a high degree of risk and that has mechanisms to deal with asymmetric information from the invested start-up company, but under the assumption that they can obtain a high return as well (Gompers and Lerner, 1999).

However, one of the most important aspects of venture capital is that investors are likely to provide an added-value to the invested enterprise beside the injection of capital. Commonly, venture capitalists supply financial and non-financial assistance (Larsson and Roosvall, 2000). In addition they usually offer the entrepreneurs access to a wide and selected network of professionals, customers, suppliers and even other venture capitalists (Gompers and Lerner, 1999). According to the Taiwan

Venture Capital Association (TVCA) this is also one of the main reasons for entrepreneurs to seek venture capital investors.

3.2.3 Players in the Venture Capital industry

An illustration of the venture capital industry and the firms involved in it was provided by Bob Zider in the Harvard Business Review (1998). He said, “the venture capital industry has four main players: entrepreneurs who need funding, investors who want higher return, investment bankers who need companies to sell and the venture capitalists who make money for themselves by making a market for the other three”.

In the other hand, Williams and Robbie, 1998 affirm that venture capitalists can be labeled depending on the sources of their investment capital:

- **Captives:**

  Captive venture capitalists are generally part of banks or insurance companies. Their main course of business is not the venture capital but they also participate by allocating part of their capital into this form of investment.

- **independent firms:**

  Independent firms must seek funding through third parties, establishing the so-called limited partnerships.

- **Government-related venture capital firms:**

  Institutions in which governments are the primary stakeholder.

- **Angels**

Individuals with entrepreneurial experience or management experience as a company executive. Many Angels are entrepreneurs that have sold their own business and are willing to use their own money to finance start-up companies just like venture capital firms do.

3.2.4 Starting Venture Capital Operations

Independent firms involved in Venture Capital establish investment funds from a variety of limited partners. These funds usually have a fixed life term (specified in the initial contract); however, the fund's life can be extended if its investment operations are considered a success).

After setting up the fund, collected money is used to invest in new venture companies according to the fund's purposes and objectives. After this initial stage, the funds are focused almost exclusively on moving the businesses.

In normal conditions, venture capitalists form new funds for different ventures before an existing fund's capital is exhausted, traditionally having the original partners participating again in the new fund. This will allow them to safeguard and probably increase the knowledge and contacts associated with previous successful ventures.

3.2.5 Stages of Venture Capital Investments

The Taiwan Venture Capital Association (TVCA) divided the venture capital investments into 5 stages. These are:

- **Seed Stage.**
  Investment done in firms which do not operate a complete process of commercial operations and are mostly still immersed in research and product development. Traditionally this kind of companies is managed by their original founders and product developers.

- **Start-up Stage.**

  Venture capital investments allocated in enterprises that might have already accomplished the product development phase and which main needs of funds would be utilized to carry on with the commercial manufacturing of the new product(s) and sales. Therefore it's common to see a significant proportion of the investment capital funneling into marketing activities (Larsson and Roosval, 2000).

- **Expansion Stage.**

  Traditionally, these corporations require resources for the enlargement and development of their business which in many times might have already proved to boast a high potential. In several cases, funds are wanted for marketing, further product upgrading and even for rescue/turnaround situations. This is mostly because the growth rate of production and sales are increasing rapidly, which increases the demand for extra operational capital (Larsson and Roosval, 2000).

- **Mezzanine Stage.**

  Referring to firms that already completed a few profitable years and are almost in condition to launch its own Initial Public Offering (IPO). Typically, resources are necessary to enhance the firm's listing prospects, usually so structured to be repaid from proceeds of a public offering or to establish the floor price for public offer.

- **Turnaround Stage.**

  When venture capitalists invest in an enterprise with a specific operational or financial difficulty with the main purpose of improving its business conditions.

3.2.6 Venture Capitalists' activities

3.2.6.1 Deal Flow creation

Venture capitalists tend to possess a wide network that traditionally help them identify new possibilities for investments, by referring start-up companies requiring financial and non-financial resources for their further development. Literature also points out

other methods to seek companies such as active search done by the venture capitalist itself. Cold calls meaning enterprises that directly contact the venture capital companies are another common method of acquaintance.

3.2.6.2 Examination and evaluation of potential candidates

Once the venture capitalist finds target companies, a complex process of analysis is done in order to determine whether that enterprise has the enough potential to become a portfolio company. The parameters of analysis vary among each venture capital company, depending on their investment strategy. According to Bob Zider (Harvard Business Review, 1998), a pervasive criterion for venture capitalists to predict ideal entrepreneurs is as follows:

- Business immersed in a high-potential growth sector.
- Tells a compelling story and is presentable to outside investors.
- Recognizes the need for to an IPO for liquidity.
- Has a good reputation and can provide references that show competence and skill.
- Understands the need for a team with variety of skills.
- Works diligently toward a goal but maintains flexibility.
- Gets along with the investor group.
- Understands the cost of capital and typical deal structures and is not offended by them.
- Is sought after many other venture capital companies.
- Has realistic expectations about process and outcomes.

3.2.6.3 Deal Structuring

This phase is the point where both the venture capitalist and the entrepreneurs match their rationale in a suitable deal for each other, including factors such as enterprise valuation, the financial instrument to be acquired by the venture capitalist (common stocks, preferred stocks, convertible bonds, etc.) and whether all funds will be

allocated from the beginning, percentage of the firm to be bought by the venture capitalists and others.

But essentially in countries like the United States, venture capitalists tend to structure the investment deal into various stages. Staging involves periodic capital inflows to the entrepreneurs, in accordance to recurrent performance reviews. In theory, investment staging facilitates monitoring, because a more closely monitored investment will have lower information asymmetry before and at the time of exit (Gompers, 1995).

3.2.6.4 Post-investment Monitoring

This stage starts just as the investment deal is fully agreed. In general terms, the monitoring takes places by quarterly reporting and board of directors' supervision. But usually, larger investments will be monitored in a more active way than smaller investments (Wright & Robbie, 1998). The main purpose of this step is to supervise the health of the start-up company and its business in order to protect the investment previously placed by the venture capitalist.

3.2.6.5 Become an active investor in the firm

Even though several venture capitalists do not follow this approach (depending on their investment strategy), commonly, these type of investors take a participative role in the entrepreneurship's business (Zider, 1998). For example:

- Active membership of the board of directors.
- Recruiting management and key technical personnel.

- Developing business strategies.
- Serving as a consultant in several business disciplines.
- Constantly monitoring the portfolio company's performance.

Previous research suggest that venture capitalists that manage their stake in entrepreneurial firms with a more active role, tend to be more beneficial to the eventual success of those enterprises (Gompers and Lerner, 1996).

3.2.6.6 Investment realization through an exit strategy

A common belief is that all venture capitalists design an *exit strategy* long time before they even invest in an start-up company (Sahlman, 1990). Actually, some researchers (Williams and Robbie, 1998) have suggested that an exit viability is a factor concerning the investment criteria of venture capitalists, thus, this stage is definitely a point to consider before they place funds into an start-up company.

After allocating capital in the entrepreneurial firm for several years (depending on the investment stage), the venture capitalist must decide the way to exit, in order to realize the investment placed in it. Relatively successful firms are either merged with or acquired by another firm or even can become publicly traded companies through an Initial Public Offering (Sahlman, 1990). Other exit methods can be buy-backs, secondary sales and write-offs.

Venture capitalists who have previously taken firms public find it easier to secure commitments from investors and establish new funds. Several researchers suggest an evident relationship between newly committed venture capital funds and IPO activities. When the IPO market is hot, new funds flow into the venture capital industry easily. (Sahlman, 1990).