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The importance of venture capital in innovative investment projects

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Abstract

Innovation makes it possible to produce more products with less materials and resources, which in turn leads to economic growth. The main problem of financing innovative projects is the high risk of returns and long payback. Most of these projects do not have enough guarantee funds, their resources are limited, and only their own ideas and technologies are the backbone. Due to the high risk of innovative projects, it is necessary to use venture capital to finance them.

Key words: Venture capital, venture business, innovation, "valley of death".

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In the modern world, as the population grows, the role of technological innovations in meeting human needs increases, as they change the world economy and contribute to the economic growth of countries.

Innovation and entrepreneurship are the kernels of a capitalist economy. New businesses, however, are often highly-risky and cost-intensive ventures. As a result, external capital is often sought to spread the risk of failure. In return for taking on this risk through investment, investors in new companies are able to obtain equity and voting rights for cents on the potential dollar. Venture capital, therefore, allows startups to get off the ground and founders to fulfill their vision.

Venture business involves financing new ideas, progressive scientific and technical developments and bringing them down to a suitable level for sale, i.e. commercialization. Venture business requires a lot of knowledge, a lot of money, and a lot of guts, but if successful, it can be hugely profitable. This type of business does not actually exist in our country, because we do not have the experience of working with new technologies and risky investments, as well as the financial infrastructure.

Venture capital (VC) is a form of private equity and a type of financing that investors provide to startup companies and small businesses that are believed to have long-term growth potential. Venture capital generally comes from well-off investors, investment banks, and any other financial institutions.

However, it does not always take a monetary form; it can also be provided in the form of technical or managerial expertise. Venture capital is typically allocated to small companies with exceptional growth potential, or to companies that have grown quickly and appear poised to continue to expand. Venture capital funds manage pooled investments in high-

growth opportunities in startups and other early-stage firms and are typically only open to accredited investors.

One important difference between venture capital and other private equity deals, however, is that venture capital tends to focus on emerging companies seeking substantial funds for the first time, while private equity tends to fund larger, more established companies that are seeking an equity infusion or a chance for company founders to transfer some of their ownership stakes.

Venture capital is a subset of private equity (PE). While the roots of PE can be traced back to the 19th century, venture capital only developed as an industry after the Second World War.

Harvard Business School professor Georges Doriot is generally considered the "Father of Venture Capital." He started the American Research and Development Corporation (ARD) in 1946 and raised a $3.5 million fund to invest in companies that commercialized technologies developed during WWII. ARDC's first investment was in a company that had ambitions to use x-ray technology for cancer treatment. The $200,000 that Doriot invested turned into $1.8 million when the company went public in 1955. [3]

A series of regulatory innovations further helped popularize venture capital as a funding avenue.

The first one was a change in the Small Business Investment Act (SBIC) in 1958. It boosted the venture capital industry by providing tax breaks to investors. In 1978, the Revenue Act was amended to reduce the capital gains tax from 49% to 28%.

Then, in 1979, a change in the Employee Retirement Income Security Act (ERISA) allowed pension funds to invest up to 10% of their assets in small or new businesses. This move led to a flood of investments from rich pension funds.

The capital gains tax was further reduced to 20% in 1981.

These three developments catalyzed growth in venture capital and the 1980s turned into a boom period for venture capital, with funding levels reaching $4.9 billion in 1987. The dot-com boom also brought the industry into sharp focus as venture capitalists chased quick returns from highly-valued Internet companies. According to some estimates, funding levels during that period went as high as $30 billion. But the promised returns did not materialize as several publicly-listed Internet companies with high valuations crashed and burned their way to bankruptcy. [5]

The 2008 financial crisis was a hit to the venture capital industry because institutional investors, who had become an important source of funds, tightened their purse strings. The emergence of startups that are valued at more than a billion dollars, has attracted a diverse set of players to the industry. Sovereign funds and notable private equity firms have joined the hordes of investors seeking return multiples in a low-interest-rate environment and participated in large ticket deals. Their entry has resulted in changes to the venture capital ecosystem. Arthur Rock, an investment banker at Hayden, Stone & Co. in New York City helped facilitate that deal and subsequently started one of the first VC firms in Silicon Valley.

Venture Capital has some advantages and disadvantages. Advantages are:

Business expertise. Aside from the financial backing obtaining venture capital financing can a start-up or young business with a valuable source of guidance and consultation. This can help with a variety of business decisions, including financial management and human resource management.

Additional resources. In a number of critical areas, including legal, tax and personnel matters, a VC firm can provide active support, all the more important at a key benefits.

Connections. Venture capitalists are typically well connected in the business community. Using these connections can have huge benefits.

The main disadvantages are: Loss of control and minority ownership status.

Venture capital provides funding to new businesses that do not have access to stock markets and do not have enough cash flow to take debts. This arrangement can be mutually beneficial: businesses get the capital they need to bootstrap their operations, and investors gain equity in promising companies.

There are also other benefits to a VC investment. In addition to investment capital, VCs often provide mentoring services to help new companies establish themselves, and provide networking services to help them find talent and advisors. A strong VC backing can be leveraged into further investments.

On the other hand, a business that accepts VC support can lose creative control l over its future direction. VC investors are likely to demand a large share of company equity, and they may start making demands of the company's management as well. Many VCs are only seeking to make a fast, high-return payoff and may pressure the company for a quick exit.

Venture capital can be broadly divided according to the growth stage of the company receiving the investment. Generally speaking, the younger a company is, the greater the risk for investors.

The stages of VC investment are: Pre-Seed: This is the earliest stage of business development when the founders try to turn an idea into a concrete business plan. They may enroll in a business accelerator to secure early funding and mentorship; Seed Funding: This is the point where a new business seeks to launch its first product. Since there are no revenue streams yet, the company will need VCs to fund all of its operations; Early-Stage funding: Once a business has developed a product, it will need additional capital to ramp up production and sales before it can become self-funding. The business will then need one or more funding rounds, typically denoted incrementally as Series A, Series B, etc.

The main problem of financing innovative projects is the high risk of returns and long payback. Most of these projects do not have enough guarantee funds, their resources are limited, and only their own ideas and technologies are the backbone. The problem of financing such enterprises has received the concept of "valley of death" in economics. This is manifested in the fact that between the product project part and its launch on the market for a long time there are problems in terms of financing, which lead to large cash gaps and, as a result, insolvency, which threatens the existence of the project. The cause of the "valley of

death" is the different goals of investors and businessmen (developers), the former strive for quick profit, and the latter are focused on obtaining scientific results.

For small businesses, or for up-and-coming businesses in emerging industries, venture capital is generally provided by high net worth individuals (HNWIs)—also often known as “angel investors"—and venture capital firms. The National Venture Capital Association (NVCA) is an organization composed of hundreds of venture capital firms that offer to fund innovative enterprises.

Common occurrence among angel investors is co-investing, in which one angel investor funds a venture alongside a trusted friend or associate, often another angel investor.

While both provide money to startup companies, venture capitalists are typically professional investors who invest in a broad portfolio of new companies and provide hands-on guidance and leverage their professional networks to help the new firm. Angel investors, on the other hand, tend to be wealthy individuals who like to invest in new companies more as a hobby or side-project and may not provide the same expert guidance. Angel investors also tend to invest first and are later followed by VCs.

Due to the industry's proximity to Silicon Valley, the overwhelming majority of deals financed by venture capitalists are in the technology industry—the internet, healthcare, computer hardware and services, and mobile and telecommunications. But other industries have also benefited from VC funding.

Venture capital is also no longer the preserve of elite firms. Institutional investors and established companies have also entered the fray. For example, tech behemoths Google and Intel have separate venture funds to invest in emerging technology. In 2019, Starbucks also announced a $100 million venture fund to invest in food startups.

Data from the NVCA and PitchBook indicate that venture-backed companies have attracted a record $330 billion in 2021, compared to the total of $166 billion seen in 2020—which was already a record. Large and late-stage investments remain the main drivers behind the strong performance: Mega-deals of $100 million or more have already hit a new high-water mark. [4]

Another noteworthy trend is the increasing number of deals with non-traditional VC investors, such as mutual funds, hedge funds, corporate investors, and crossover investors. Meanwhile, the share of angel investors has gotten more robust, hitting record highs, as well.

Late-stage financing has become more popular because institutional investors prefer to invest in less-risky ventures (as opposed to early-stage companies where the risk of failure is high).

Innovation and entrepreneurship are the kernels of a capitalist economy. New businesses, however, are often highly-risky and cost-intensive ventures. As a result, external capital is often sought to spread the risk of failure. In return for taking on this risk through investment, investors in new companies are able to obtain equity and voting rights for cents

on the potential dollar. Venture capital, therefore, allows startups to get off the ground and founders to fulfill their vision.

New companies often don't make it, and that means early investors can lose all of the money that they put into it. A common rule of thumb is that for every 10 startups, three or four will fail completely. Another three or four either lose some money or just return the original investment, and one or two produce substantial returns.

Depending on the stage of the company, its prospects, how much is being invested, and the relationship between the investors and the founders, VCs will typically take between 25 and 50% of a new company's ownership.

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