
INTRODUCTION

MEANING OF VENTURE CAPITAL

The National Venture Capital Association defines venture capital as: "Money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors."

Venture capital (also known as VC or Venture) is a type of private equity capital typically provided to early-stage, high-potential, growth companies in the interest of generating a return through an eventual realization event such as an IPO or trade sale of the company. Venture capital investments are generally made as cash in exchange for shares in the invested company.

Venture capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms.

A venture capitalist (also known as a VC) is a person or investment firm that makes venture investments, and these venture capitalists are expected to bring managerial and technical expertise as well as capital to their investments. A venture capital fund refers to a pooled investment vehicle (often an LP or LLC explained below) that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans.

Venture capital is most attractive for new companies with limited operating history that are too small to raise capital in the public markets and are too immature to secure a bank loan or complete a debt offering. In exchange for the high risk that venture capitalists assume by investing in smaller and less mature companies, venture capitalists usually get significant control over company decisions, in addition to a significant portion of the company's ownership (and consequently value).

A **limited partnership** is a form of partnership similar to a general partnership, except that in addition to one or more *general partners* (GPs), there are one or more *limited partners* (LPs).

The GPs are, in all major respects, in the same legal position as partners in a conventional firm, i.e. they have management control, share the right to use partnership property, share the profits of the firm in predefined proportions, and have joint and several liability for the debts of the partnership.

As in a general partnership, the GPs have actual authority as agents of the firm to bind all the other partners in contracts with third parties that are in the ordinary course of the partnership's business. As with a general partnership, "An act of a general partner which is not apparently for carrying on in the ordinary course the limited partnership's activities or activities of the kind carried on by the limited partnership binds the limited partnership only if the act was actually authorized by all the other partners." (United States Uniform Limited Partnership Act § 402(b).)

Like shareholders in a corporation, LPs have limited liability, meaning they are only liable on debts incurred by the firm to the extent of their registered investment and have no management authority. The GPs pay the LPs a return on their investment (similar to a dividend), the nature and extent of which is usually defined in the partnership agreement.

Limited partnerships are distinct from limited liability partnerships, in which all partners have limited liability.

A **limited liability company** (abbreviated **L.L.C.** or **LLC**) in the law of the vast majority of the United States is a legal form of business company offering limited liability to its owners. Often incorrectly called a "limited liability corporation" (instead of company), it is a hybrid business entity having characteristics of both a corporation and a partnership. It is often more flexible, the owners have limited liability for the actions and debts of the company, and it is suitable for smaller companies with a single owner. The primary

corporate characteristic is limited liability while the primary partnership characteristic is the availability of pass-through income taxation.

Financial partnerships

'Financial Partnerships', as we define, are long-term investments made by institutional investors like private equity and venture capital funds and by high net worth individual angel investors through the acquisition of equity or equity linked securities of companies, which have bright growth prospects but lack adequate financial funds. Venture capital and private equity investments have been the most rapidly growing means of financing. Financial partnerships play a critical role in the transfer of funds into promising firms and projects specifically in the countries, where bank financing is scarce, capital markets are volatile or unavailable. In addition to their financing function, the funds also provide managerial support and business contacts to the investee companies. Funds diversify their risks by investing in a number of companies.

History of private equity and venture capital

The history of private equity and venture capital and the development of these asset classes has occurred through a series of boom and bust cycles since the middle of the 20th century. Within the broader private equity industry, two distinct sub-industries, leveraged buyouts and venture capital experienced growth along parallel although interrelated tracks.

Since the origins of the modern private equity industry in 1946, there have been four major epochs marked by three boom and bust cycles. **The early history of private equity** — from 1946 through 1981 — was characterized by relatively small volumes of private equity investment, rudimentary firm organizations and limited awareness of and familiarity with the private equity industry. **The first boom and bust cycle** — from 1982 through 1993 — was characterized by the dramatic surge in leveraged buyout activity financed by junk bonds and culminating in the massive buyout of RJR Nabisco before the near collapse of the leveraged buyout industry in the late 1980s and early 1990s. **The second boom and bust cycle** (from 1992 through 2002) emerged out of the ashes of the

savings and loan crisis, the insider trading scandals, the real estate market collapse and the recession of the early 1990s. This period saw the emergence of more institutionalized private equity firms, ultimately culminating in the massive Dot-com bubble in 1999 and 2000. **The third boom and bust cycle** (from 2003 through 2007) came in the wake of the collapse of the Dot-com bubble—leveraged buyouts reach unparalleled size and the institutionalization of private equity firms is exemplified by the Blackstone Group's 2007 initial public offering.

In its early years through roughly the year 2000, the history of the private equity and venture capital asset classes is best described through a narrative of developments in the United States as private equity in Europe consistently lagged behind the North American industry. With the second private equity boom in the mid-1990s and liberalization of regulation for institutional investors in Europe, the emergence of a mature European private equity market has occurred.

The early history of private equity relates to one of the major periods in the **history of private equity and venture capital**.

The origins of the modern private equity industry trace back to 1946 with the formation of the first venture capital firms. The thirty-five year period from 1946 through the end of the 1970s was characterized by relatively small volumes of private equity investment, rudimentary firm organizations and limited awareness of and familiarity with the private equity industry.

Pre-history

Investors have been acquiring businesses and making minority investments in privately held companies since the dawn of the industrial revolution. Merchant bankers in London and Paris financed industrial concerns in the 1850s; most notably Credit Mobilier, founded in 1854 by Jacob and Isaac Pereire, who together with New York based Jay Cooke financed the United States Transcontinental Railroad.

Andrew Carnegie sold his steel company to J.P. Morgan in 1901 in arguably the first true modern buyout

Later, J. Pierpont Morgan's J.P. Morgan & Co. would finance railroads and other industrial companies throughout the United States. In certain respects, J. Pierpont Morgan's 1901 acquisition of Carnegie Steel Company from Andrew Carnegie and Henry Phipps for \$480 million represents the first true major buyout as they are thought of today.

Due to structural restrictions imposed on American banks under the Glass-Steagall Act and other regulations in the 1930s, there was no private merchant banking industry in the United States, a situation that was quite exceptional in developed nations. As late as the 1980s, Lester Thurow, a noted economist, decried the inability of the financial regulation framework in the United States to support merchant banks. US investment banks were confined primarily to advisory businesses, handling mergers and acquisitions transactions and placements of equity and debt securities. Investment banks would later enter the space, however long after independent firms had become well established.

With few exceptions, private equity in the first half of the 20th century was the domain of wealthy individuals and families. The Vanderbilts, Whitneys, Rockefellers and Warburgs were notable investors in private companies in the first half of the century. In 1938, Laurance S. Rockefeller helped finance the creation of both Eastern Air Lines and Douglas Aircraft and the Rockefeller family had vast holdings in a variety of companies. Eric M. Warburg founded E.M. Warburg & Co. in 1938, which would ultimately become Warburg Pincus, with investments in both leveraged buyouts and venture capital.

It was not until after World War II that what is considered today to be true private equity investments began to emerge marked by the founding of the first two venture capital firms in 1946: American Research and Development Corporation. (ARDC) and J.H. Whitney & Company.

ARDC was founded by Georges Doriot, the "father of venture capitalism" (former dean of Harvard Business School), with Ralph Flanders and Karl Compton (former president of MIT), to encourage private sector investments in businesses run by soldiers who were returning from World War II. ARDC's significance was primarily that it was the first institutional private equity investment firm that raised capital from sources other than wealthy families although it had several notable investment successes as well. ARDC is credited with the first major venture capital success story when its 1957 investment of \$70,000 in Digital Equipment Corporation (DEC) would be valued at over \$355 million after the company's initial public offering in 1968 (representing a return of over 500 times on its investment and an annualized rate of return of 101%). Former employees of ARDC went on to found several prominent venture capital firms including Greylock Partners (founded in 1965 by Charlie Waite and Bill Elfers) and Morgan, Holland Ventures, the predecessor of Flagship Ventures (founded in 1982 by James Morgan). ARDC continued investing until 1971 with the retirement of Doriot. In 1972, Doriot merged ARDC with Textron after having invested in over 150 companies.

J.H. Whitney & Company was founded by John Hay Whitney and his partner Benno Schmidt. Whitney had been investing since the 1930s, founding Pioneer Pictures in 1933 and acquiring a 15% interest in Technicolor Corporation with his cousin Cornelius Vanderbilt Whitney. By far, Whitney's most famous investment was in Florida Foods Corporation. The company, having developed an innovative method for delivering nutrition to American soldiers, later came to be known as Minute Maid orange juice and was sold to The Coca-Cola Company in 1960. J.H. Whitney & Company continues to make investments in leveraged buyout transactions and raised \$750 million for its sixth institutional private equity fund in 2005.

Before World War II, venture capital investments (originally known as "development capital") were primarily the domain of wealthy individuals and families. One of the first steps toward a professionally managed venture capital industry was the passage of the Small Business Investment Act of 1958. The 1958 Act officially allowed the U.S. Small Business Administration (SBA) to license private "Small Business Investment

Companies" (SBICs) to help the financing and management of the small entrepreneurial businesses in the United States. Passage of the Act addressed concerns raised in a Federal Reserve Board report to Congress that concluded that a major gap existed in the capital markets for long-term funding for growth-oriented small businesses. Additionally, it was thought that fostering entrepreneurial companies would spur technological advances to compete against the Soviet Union. Facilitating the flow of capital through the economy up to the pioneering small concerns in order to stimulate the U.S. economy was and still is the main goal of the SBIC program today. The 1958 Act provided venture capital firms structured either as SBICs or Minority Enterprise Small Business Investment Companies (MESBICs) access to federal funds which could be leveraged at a ratio of up to 4:1 against privately raised investment funds. The success of the Small Business Administration's efforts are viewed primarily in terms of the pool of professional private equity investors that the program developed as the rigid regulatory limitations imposed by the program minimized the role of SBICs. In 2005, the SBA significantly reduced its SBIC program, though SBICs continue to make private equity investments.

Early venture capital and the growth of Silicon Valley (1959 - 1981)

During the 1960s and 1970s, venture capital firms focused their investment activity primarily on starting and expanding companies. More often than not, these companies were exploiting breakthroughs in electronic, medical or data-processing technology. As a result, venture capital came to be almost synonymous with technology finance.

It is commonly noted that the first venture-backed startup was Fairchild Semiconductor (which produced the first commercially practicable integrated circuit), funded in 1959 by what would later become Venrock Associates. Venrock was founded in 1969 by Laurance S. Rockefeller, the fourth of John D. Rockefeller's six children as a way to allow other Rockefeller children to develop exposure to venture capital investments.

It was also in the 1960s that the common form of private equity fund, still in use today, emerged. Private equity firms organized limited partnerships to hold investments in which the investment professionals served as general partner and the investors, who were

passive limited partners, put up the capital. The compensation structure, still in use today, also emerged with limited partners paying an annual management fee of 1-2% and a carried interest typically representing up to 20% of the profits of the partnership.

The growth of the venture capital industry was fueled by the emergence of the independent investment firms on Sand Hill Road, beginning with Kleiner, Perkins, Caufield & Byers and Sequoia Capital in 1972. Located, in Menlo Park, CA, Kleiner Perkins, Sequoia and later venture capital firms would have access to the burgeoning technology industries in the area. By the early 1970s, there were many semiconductor companies based in the Santa Clara Valley as well as early computer firms using their devices and programming and service companies. Throughout the 1970s, a group of private equity firms, focused primarily on venture capital investments, would be founded that would become the model for later leveraged buyout and venture capital investment firms. In 1973, with the number of new venture capital firms increasing, leading venture capitalists formed the National Venture Capital Association (NVCA). The NVCA was to serve as the industry trade group for the venture capital industry. Venture capital firms suffered a temporary downturn in 1974, when the stock market crashed and investors were naturally wary of this new kind of investment fund. It was not until 1978 that venture capital experienced its first major fundraising year, as the industry raised approximately \$750 million. During this period, the number of venture firms also increased. Among the firms founded in this period, in addition to Kleiner Perkins and Sequoia, that continue to invest actively, are:

- *TA Associates*, a venture capital firm (and later leveraged buyouts as well), originally part of the Tucker Anthony brokerage firm, founded in 1968;
- *Mayfield Fund*, founded by early Silicon Valley venture capitalist Tommy Davis in 1969;
- *Apax Partners*, the firm's earliest predecessor, the venture capital firm Patricof & Co. was founded in 1969 and subsequently merged with Multinational Management Group (founded 1972) and later with Saunders Karp & Megrue (founded 1989);

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- *New Enterprise Associates* founded by Chuck Newhall, Frank Bonsal and Dick Kramlich in 1978;
 - *Oak Investment Partners* founded in 1978; and
 - *Sevin Rosen Funds* founded by L.J. Sevin and Ben Rosen in 1980.

Venture capital played an instrumental role in developing many of the major technology companies of the 1980s. Some of the most notable venture capital investments were made in firms that include:

- *Tandem Computers*, an early manufacturer of computer systems, founded in 1975 by Jimmy Treybig with funding from Kleiner, Perkins, Caufield & Byers.
- *Genentech* a biotechnology company, founded in 1976 with venture capital from Robert A. Swanson.
- *Apple Inc.*, a designer and manufacturer of consumer electronics, including the Macintosh computer and in later years the iPod, founded in 1978. In December 1980, Apple went public. It's offering of 4.6 million shares at \$22 each sold out within minutes. A second offering of 2.6 million shares quickly sold out in May 1981.
- *Electronic Arts*, a distributor of computer and video games found in May 1982 by Trip Hawkins with a personal investment of an estimated \$200,000. Seven months later in December 1982, Hawkins secured \$2 million of venture capital from Sequoia Capital, Kleiner, Perkins and Sevin Rosen Funds.
- *Compaq*, 1982, Computer manufacturer. In 1982, venture capital firm Sevin Rosen Funds provided \$2.5 million to fund the start-up of Compaq, which would ultimately grow into one of the largest personal computer manufacturers before merging with Hewlett Packard in 2002.

- *Federal Express*, Venture capitalists invested \$80 million to help founder Frederick W. Smith purchase his first Dassault Falcon 20 airplanes.
- *LSI Corporation* was funded in 1981 with \$6 million from noted venture capitalists including Sequoia Capital. A second round of financing for an additional \$16 million was completed in March 1982. The firm went public on May 13, 1983, netting \$153 million, the largest technology IPO to that point.

Early history of leveraged buyouts (1955-1981)

McLean Industries and public holding companies

Although not strictly private equity, and certainly not labeled so at the time, the first leveraged buyout may have been the purchase by Malcolm McLean's McLean Industries, Inc. of Pan-Atlantic Steamship Company in January 1955 and Waterman Steamship Corporation in May 1955. Under the terms of the transactions, McLean borrowed \$42 million and raised an additional \$7 million through an issue of preferred stock. When the deal closed, \$20 million of Waterman cash and assets were used to retire \$20 million of the loan debt. The newly elected board of Waterman then voted to pay an immediate dividend of \$25 million to McLean Industries.

Similar to the approach employed in the McLean transaction, the use of publicly traded holding companies as investment vehicles to acquire portfolios of investments in corporate assets would become a new trend in the 1960s popularized by the likes of Warren Buffett (Berkshire Hathaway) and Victor Posner (DWG Corporation) and later adopted by Nelson Peltz (Triarc), Saul Steinberg (Reliance Insurance) and Gerry Schwartz (Onex Corporation). These investment vehicles would utilize a number of the same tactics and target the same type of companies as more traditional leveraged buyouts and in many ways could be considered a forerunner of the later private equity firms. In fact, it is Posner who is often credited with coining the term "leveraged buyout" or "LBO"

Posner, who had made a fortune in real estate investments in the 1930s and 1940s, acquired a major stake in DWG Corporation in 1966. Having gained control of the company, he used it as an investment vehicle that could execute takeovers of other companies. Posner and DWG are perhaps best known for the hostile takeover of Sharon Steel Corporation in 1969, one of the earliest such takeovers in the United States. Posner's investments were typically motivated by attractive valuations, balance sheets and cash flow characteristics. Because of its high debt load, Posner's DWG would generate attractive but highly volatile returns and would ultimately land the company in financial difficulty. In 1987, Sharon Steel sought Chapter 11 bankruptcy protection.

Warren Buffett, who is typically described as a stock market investor rather than a private equity investor, employed many of the same techniques in the creation of his Berkshire Hathaway conglomerate as Posner's DWG Corporation and in later years by more traditional private equity investors. In 1965, with the support of the company's board of directors, Buffett assumed control of Berkshire Hathaway. At the time of Buffett's investment, Berkshire Hathaway was a textile company, however, Buffett used Berkshire Hathaway as an investment vehicle to make acquisitions and minority investments in dozens of the insurance and reinsurance industries (GEICO) and varied companies including: American Express, The Buffalo News, the Coca-Cola Company, Fruit of the Loom, Nebraska Furniture Mart and See's Candies. Buffett's value investing approach and focus on earnings and cash flows are characteristic of later private equity investors. Buffett would distinguish himself relative to more traditional leveraged buyout practitioners through his reluctance to use leverage and hostile techniques in his investments.

KKR and the pioneers of private equity

The industry that is today described as private equity was conceived by a number of corporate financiers, most notably Jerome Kohlberg, Jr. and later his protégé, Henry Kravis. Working for Bear Stearns at the time, Kohlberg and Kravis along with Kravis' cousin George Roberts began a series of what they described as "bootstrap" investments.

They targeted family-owned businesses, many of which had been founded in the years following World War II and by the 1960s and 1970s were facing succession issues. Many of these companies lacked a viable or attractive exit for their founders as they were too small to be taken public and the founders were reluctant to sell out to competitors, making a sale to a financial buyer potentially attractive. Their acquisition of Orkin Exterminating Company in 1964 is among the first significant leveraged buyout transactions. In the following years, the three Bear Stearns bankers would complete a series of buyouts including Stern Metals (1965), Incom (a division of Rockwood International, 1971), Cobblers Industries (1971) and Boren Clay (1973) as well as Thompson Wire, Eagle Motors and Barrows through their investment in Stern Metals. Although they had a number of highly successful investments, the \$27 million investment in Cobblers ended in bankruptcy.

By 1976, tensions had built up between Bear Stearns and Kohlberg, Kravis and Roberts leading to their departure and the formation of Kohlberg Kravis Roberts in that year. Most notably, Bear Stearns executive Cy Lewis had rejected repeated proposals to form a dedicated investment fund within Bear Stearns and Lewis took exception to the amount of time spent on outside activities. Early investors included the Hillman Family. By 1978, with the revision of the ERISA regulations; the nascent KKR was successful in raising its first institutional fund with approximately \$30 million of investor commitments.

Meanwhile in 1974, Thomas H. Lee founded a new investment firm to focus on acquiring companies through leveraged buyout transactions, one of the earliest independent private equity firms to focus on leveraged buyouts of more mature companies rather than venture capital investments in growth companies. Lee's firm, Thomas H. Lee Partners, while initially generating less fanfare than other entrants in the 1980s, would emerge as one of the largest private equity firms globally by the end of the 1990s.

The second half of the 1970s and the first years of the 1980s saw the emergence of several private equity firms that would survive through the various cycles both in

leveraged buyouts and venture capital. Among the firms founded during these years were:

- *Cinven*, a European buyout firm, founded in 1977;
- *Forstmann Little & Company* one of the largest private equity firms through the end of the 1990s, founded in 1978 by Ted Forstmann, Nick Forstmann and Brian Little;
- *Clayton, Dubilier & Rice* founded originally as Clayton & Dubilier, in 1978;
- *Welsh, Carson, Anderson & Stowe* founded by Pat Welsh, Russ Carson, Bruce Anderson and Richard Stowe in 1979;
- *Candover*, one of the earliest European buyout firms, founded in 1980; and
- *GTCR* and *Thoma Cressey* (originally Golder Thoma & Cressey, later Golder Thoma Cressey & Rauner) founded in 1980 by Stanley Golder, who built the private equity program at First Chicago Corp. that backed Federal Express.

Management buyouts also came into existence in the late 1970s and early 1980s. One of the most notable early management buyout transactions was the acquisition of Harley-Davidson. A group of managers at Harley-Davidson, the motorcycle manufacturer, bought the company from AMF in a leveraged buyout in 1981, but racked up big losses the following year and had to ask for protection from Japanese competitors.

Regulatory and tax changes impact the boom

The advent of the boom in leveraged buyouts in the 1980s was supported by three major legal and regulatory events:

- *Failure of the Carter tax plan of 1977* - In his first year in office, Jimmy Carter put forth a revision to the corporate tax system that would have, among other results, reduced the disparity in treatment of interest paid to bondholders and dividends paid to stockholders. Carter's proposals did not achieve support from the business community or Congress and was not enacted. Because of the different tax treatment, the use of leverage to reduce taxes was popular among

private equity investors and would become increasingly popular with the reduction of the capital gains tax rate.

- *Employee Retirement Income Security Act of 1974 (ERISA)* - With the passage of ERISA in 1974, corporate pension funds were prohibited from holding certain risky investments including many investments in privately held companies. In 1975, fundraising for private equity investments cratered, according to the Venture Capital Institute, totalling only \$10 million during the course of the year. In 1978, the US Labour Department relaxed certain of the ERISA restrictions, under the "prudent man rule," thus allowing corporate pension funds to invest in private equity resulting in a major source of capital available to invest in venture capital and other private equity. Time reported in 1978 that fund raising had increased from \$39 million in 1977 to \$570 million just one year later. Additionally, many of these same corporate pension investors would become active buyers of the high yield bonds (or junk bonds) that were necessary to complete leveraged buyout transactions.
- *Economic Recovery Tax Act of 1981 (ERTA)* - On August 15, 1981, Ronald Reagan signed the Kemp-Roth bill, officially known as the Economic Recovery Tax Act of 1981, into law, lowering of the top capital gains tax rate from 28 percent to 20 percent, and making high risk investments even more attractive.

In the years that would follow these events, private equity would experience its first major boom, acquiring some of the famed brands and major industrial powers of American business.

The first private equity boom (1982 to 1993)

The decade of the 1980s is perhaps more closely associated with the leveraged buyout than any decade before or since. For the first time, the public became aware of the ability of private equity to affect mainstream companies and "corporate raiders" and "hostile takeovers" entered the public consciousness. The decade would see one of the largest

booms in private equity culminating in the 1989 leveraged buyout of RJR Nabisco, which would reign as the largest leveraged buyout transaction for nearly 17 years. In 1980, the private equity industry would raise approximately \$2.4 billion of annual investor commitments and by the end of the decade in 1989 that figure stood at \$21.9 billion marking the tremendous growth experienced.

Beginning of the LBO boom

Michael Milken, the man credited with creating the market for high yield "junk" bonds and spurring the LBO boom of the 1980s

The beginning of the first boom period in private equity would be marked by the well-publicized success of the Gibson Greetings acquisition in 1982 and would roar ahead through 1983 and 1984 with the soaring stock market driving profitable exits for private equity investors.

In January 1982, former US Secretary of the Treasury William E. Simon and a group of investors, which would later come to be known as Wesray Corp., acquired Gibson Greetings, a producer of greeting cards. The purchase price for Gibson was \$80 million, of which only \$1 million was rumored to have been contributed by the investors. By mid-1983, just sixteen months after the original deal, Gibson completed a \$290 million IPO and Simon made approximately \$66 million. Simon and Wesray would later complete the \$71.6 million acquisition of Atlas Van Lines. The success of the Gibson Greetings investment attracted the attention of the wider media to the nascent boom in leveraged buyouts.

Between 1979 and 1989, it was estimated that there were over 2,000 leveraged buyouts valued in excess of \$250 million^[24] Notable buyouts of this period (not described elsewhere in this article) include: Malone & Hyde (1984), Wometco Enterprises (1984), Beatrice Companies (1985), Sterling Jewelers (1985), Revco Drug Stores (1986), Safeway (1986), Southland Corporation (1987), Jim Walter Corp (later Walter Industries,

Inc., 1987), Blackrock (1988), Federated Department Stores (1988), Marvel Entertainment (1988), Uniroyal Goodrich Tire Company (1988) and Hospital Corporation of America (1989).

Because of the high leverage on many of the transactions of the 1980s, failed deals occurred regularly, however the promise of attractive returns on successful investments attracted more capital. With the increased leveraged buyout activity and investor interest, the mid-1980s saw a major proliferation of private equity firms. Among the major firms founded in this period were:

Bain Capital, Chemical Venture Partners, Hellman & Friedman, Hicks & Haas, (later Hicks Muse Tate & Furst, The Blackstone Group, Doughty Hanson, BC Partners, and The Carlyle Group.

Additionally, as the market developed, new niches within the private equity industry began to emerge. In 1982, Venture Capital Fund of America, the first private equity firm focused on acquiring secondary market interests in existing private equity funds was founded and then, two years later in 1984, First Reserve Corporation, the first private equity firm focused on the energy sector, was founded.

Venture capital in the 1980s

The public successes of the venture capital industry in the 1970s and early 1980s (e.g., DEC, Apple, Genentech) gave rise to a major proliferation of venture capital investment firms. From just a few dozen firms at the start of the decade, there were over 650 firms by the end of the 1980s, each searching for the next major "home run". While the number of firms multiplied, the capital managed by these firms increased only 11% from \$28 billion to \$31 billion over the course of the decade.

The growth the industry was hampered by sharply declining returns and certain venture firms began posting losses for the first time. In addition to the increased competition among firms, several other factors impacted returns. The market for initial public

offerings cooled in the mid-1980s before collapsing after the stock market crash in 1987 and foreign corporations, particularly from Japan and Korea, flooded early stage companies with capital.

In response to the changing conditions, corporations that had sponsored in-house venture investment arms, including General Electric and Paine Webber either sold off or closed these venture capital units. Additionally, venture capital units within Chemical Bank (today CCMP Capital) and Continental Illinois National Bank (today CIVC Partners), among others, began shifting their focus from funding early stage companies toward investments in more mature companies. Even industry founders J.H. Whitney & Company and Warburg Pincus began to transition toward leveraged buyouts and growth capital investments. Many of these venture capital firms attempted to stay close to their areas of expertise in the technology industry by acquiring companies in the industry that had reached certain levels of maturity. In 1989, Prime Computer was acquired in a \$1.3 billion leveraged buyout by J.H. Whitney & Company in what would prove to be a disastrous transaction. Whitney's investment in Prime proved to be nearly a total loss with the bulk of the proceeds from the company's liquidation paid to the company's creditors.

Although lower profile than their buyout counterparts, new leading venture capital firms were also formed including Draper Fisher Jurvetson (originally Draper Associates) in 1985 and Canaan Partners in 1987 among others.

Corporate raiders, hostile takeovers and greenmail

Although the "corporate raider" moniker is rarely applied to contemporary private equity investors, there is no formal distinction between a "corporate raid" and other private equity investments acquisitions of existing businesses. The label was typically ascribed by constituencies within the acquired company or the media. However, a corporate raid would typically feature a leveraged buyout that would involve a hostile takeover of the company, perceived asset stripping, major layoffs or other significant corporate restructuring activities. Management of many large publicly traded corporations reacted

negatively to the threat of potential hostile takeover or corporate raid and pursued drastic defensive measures including poison pills, golden parachutes and increasing debt levels on the company's balance sheet. Additionally, the threat of the corporate raid would lead to the practice of "greenmail", where a corporate raider or other party would acquire a significant stake in the stock of a company and receive an incentive payment (effectively a bribe) from the company in order to avoid pursuing a hostile takeover of the company. Greenmail represented a transfer payment from a company's existing shareholders to a third party investor and provided no value to existing shareholders but did benefit existing managers. The practice of "greenmail" is not typically considered a tactic of private equity investors and is not condoned by market participants.

Among the most notable corporate raiders of the 1980s were Carl Icahn, Victor Posner, Nelson Peltz, Robert M. Bass, T. Boone Pickens, Harold Clark Simmons, Kirk Kerkorian, Sir James Goldsmith, Saul Steinberg and Asher Edelman. Carl Icahn developed a reputation as a ruthless corporate raider after his hostile takeover of TWA in 1985. The result of that takeover was Icahn systematically selling TWA's assets to repay the debt he used to purchase the company, which was described as asset stripping. In 1985, Pickens was profiled on the cover of Time magazine as "one of the most famous and controversial businessmen in the U.S." for his pursuit of Unocal, Gulf Oil and Cities Services. In later years, many of the corporate raiders would be re-characterized as "Activist shareholders".

Many of the corporate raiders were onetime clients of Michael Milken, whose investment banking firm Drexel Burnham Lambert helped raise blind pools of capital with which corporate raiders could make a legitimate attempt to take over a company and provided high-yield debt financing of the buyouts.

Drexel Burnham raised a \$100 million blind pool in 1984 for Nelson Peltz and his holding company Triangle Industries (later Triarc) to give credibility for takeovers, representing the first major blind pool raised for this purpose. Two years later, in 1986,

Wickes Companies, a holding company run by Sanford Sigoloff raised a \$1.2 billion blind pool.

In 1985, Milken raised \$750 million for a similar blind pool for Ronald Perelman which would ultimately prove instrumental in acquiring his biggest target: The Revlon Corporation. In 1980, Ronald Perelman, the son of a wealthy Philadelphia businessman, and future "corporate raider" having made several small but successful buyouts, acquired MacAndrews & Forbes, a distributor of licorice extract and chocolate, that Perelman's father had tried and failed to acquire it 10 years earlier. Perelman would ultimately divest the company's core business and use MacAndrews & Forbes as a holding company investment vehicle for subsequent leveraged buyouts including Technicolor, Inc., Pantry Pride and Revlon. Using the Pantry Pride subsidiary of his holding company, MacAndrews & Forbes Holdings, Perelman's overtures were rebuffed. Repeatedly rejected by the company's board and management, Perelman continued to press forward with a hostile takeover raising his offer from an initial bid of \$47.50 per share until it reached \$53.00 per share. After receiving a higher offer from a white knight, private equity firm Forstmann Little & Company, Perelman's Pantry Pride finally was able to make a successful bid for Revlon, valuing the company at \$2.7 billion. The buyout would prove troubling, burdened by a heavy debt load. Under Perelman's control, Revlon sold four divisions: two were sold for \$1 billion, its vision care division was sold for \$574 million and its National Health Laboratories division was spun out to the public market in 1988. Revlon also made acquisitions including Max Factor in 1987 and Betrix in 1989 later selling them to Procter & Gamble in 1991. Perelman exited the bulk of his holdings in Revlon through an IPO in 1996 and subsequent sales of stock. As of December 31, 2007, Perelman still retains a minority ownership interest in Revlon. The Revlon takeover, because of its well-known brand, was profiled widely by the media and brought new attention to the emerging boom in leveraged buyout activity.

In later years, Milken and Drexel would shy away from certain of the more "notorious" corporate raiders as Drexel and the private equity industry attempted to move upscale.

RJR Nabisco and the Barbarians at the Gate

Leveraged buyouts in the 1980s including Perelman's takeover of Revlon came to epitomize the "ruthless capitalism" and "greed" popularly seen to be pervading Wall Street at the time. One of the final major buyouts of the 1980s proved to be its most ambitious and marked both a high water mark and a sign of the beginning of the end of the boom that had begun nearly a decade earlier. In 1989, KKR closed on a \$31.1 billion dollar takeover of RJR Nabisco. It was, at that time and for over 17 years, the largest leverage buyout in history. The event was chronicled in the book, *Barbarians at the Gate: The Fall of RJR Nabisco*, and later made into a television movie starring James Garner.

F. Ross Johnson was the President and CEO of RJR Nabisco at the time of the leveraged buyout and Henry Kravis was a general partner at Kohlberg Kravis Roberts. The leveraged buyout was in the amount of \$25 billion (plus assumed debt), and the battle for control took place between October and November 1988. KKR would eventually prevail in acquiring RJR Nabisco at \$109 per share marking a dramatic increase from the original announcement that Shearson Lehman Hutton would take RJR Nabisco private at \$75 per share. A fierce series of negotiations and horse-trading ensued which pitted KKR against Shearson Lehman Hutton and later Forstmann Little & Co. Many of the major banking players of the day, including Morgan Stanley, Goldman Sachs, Salomon Brothers, and Merrill Lynch were actively involved in advising and financing the parties.

After Shearson Lehman's original bid, KKR quickly introduced a tender offer to obtain RJR Nabisco for \$90 per share—a price that enabled it to proceed without the approval of RJR Nabisco's management. RJR's management team, working with Shearson Lehman and Salomon Brothers, submitted a bid of \$112, a figure they felt certain would enable them to outflank any response by Kravis's team. KKR's final bid of \$109, while a lower dollar figure, was ultimately accepted by the board of directors of RJR Nabisco. KKR's offer was guaranteed, whereas the management offer (backed by Shearson Lehman and Salomon) lacked a "reset", meaning that the final share price might have been lower than

their stated \$112 per share. Additionally, many in RJR's board of directors had grown concerned at recent disclosures of Ross Johnson' unprecedented golden parachute deal. TIME magazine featured Ross Johnson on the cover of their December 1988 issue along with the headline, "A Game of Greed: This man could pocket \$100 million from the largest corporate takeover in history. Has the buyout craze gone too far?" KKR's offer was welcomed by the board, and, to some observers, it appeared that their elevation of the reset issue as a deal-breaker in KKR's favor was little more than an excuse to reject Ross Johnson's higher payout of \$112 per share. F. Ross Johnson received \$53 million from the buyout.

At \$31.1 billion of transaction value, RJR Nabisco was by far the largest leveraged buyouts in history. In 2006 and 2007, a number of leveraged buyout transactions were completed that for the first time surpassed the RJR Nabisco leveraged buyout in terms of nominal purchase price. However, adjusted for inflation, none of the leveraged buyouts of the 2006 – 2007 period would surpass RJR Nabisco. Unfortunately for KKR, size would not equate with success as the high purchase price and debt load would burden the performance of the investment.

Interestingly, two years earlier, in 1987, Jerome Kohlberg, Jr. resigned from Kohlberg Kravis Roberts & Co. over differences in strategy. Kohlberg did not favor the larger buyouts (including Beatrice Companies (1985) and Safeway (1986) and would later likely have included the 1989 takeover of RJR Nabisco), highly leveraged transactions or hostile takeovers being pursued increasingly by KKR. The split would ultimately prove acrimonious as Kohlberg sued Kravis and Roberts for what he alleged were improper business tactics. The case was later settled out of court. Instead, Kohlberg chose to return to his roots, acquiring smaller, middle-market companies and in 1987, he would found a new private equity firm Kohlberg & Company along with his son James A. Kohlberg, at the time a KKR executive. Jerome Kohlberg would continue investing successfully for another seven years before retiring from Kohlberg & Company in 1994 and turning his firm over to his son.

As the market reached its peak in 1988 and 1989, new private equity firms were founded which would emerge as major investors in the years to follow, including: ABRY Partners, Collier Capital, Landmark Partners, Leonard Green & Partners and Providence Equity Partners.

LBO bust (1990 to 1992)

By the end of the 1980s the excesses of the buyout market were beginning to show, with the bankruptcy of several large buyouts including Robert Campeau's 1988 buyout of Federated Department Stores, the 1986 buyout of the Revco drug stores, Walter Industries, FEB Trucking and Eaton Leonard. Additionally, the RJR Nabisco deal was showing signs of strain, leading to a recapitalization in 1990 that involved the contribution of \$1.7 billion of new equity from KKR. Additionally, in response to the threat of unwelcome LBOs, certain companies adopted a number of techniques, such as the poison pill, to protect them against hostile takeovers by effectively self-destructing the company if it were to be taken over (these practices are increasingly discredited).

The collapse of Drexel Burnham Lambert

Drexel Burnham Lambert was the investment bank most responsible for the boom in private equity during the 1980s due to its leadership in the issuance of high-yield debt. The firm was first rocked by scandal on May 12, 1986, when Dennis Levine, a Drexel managing director and investment banker, was charged with insider trading. Levine pleaded guilty to four felonies, and implicated one of his recent partners, arbitrageur Ivan Boesky. Largely based on information Boesky promised to provide about his dealings with Milken, the Securities and Exchange Commission initiated an investigation of Drexel on November 17. Two days later, Rudy Giuliani, the United States Attorney for the Southern District of New York, launched his own investigation.

For two years, Drexel steadfastly denied any wrongdoing, claiming that the criminal and SEC cases were based almost entirely on the statements of an admitted felon looking to reduce his sentence. However, it was not enough to keep the SEC from suing Drexel in

September 1988 for insider trading, stock manipulation, defrauding its clients and stock parking (buying stocks for the benefit of another). All of the transactions involved Milken and his department. Giuliani began seriously considering indicting Drexel under the powerful Racketeer Influenced and Corrupt Organizations Act (RICO), under the doctrine that companies are responsible for an employee's crimes.

The threat of a RICO indictment, which would have required the firm to put up a performance bond of as much as \$1 billion in lieu of having its assets frozen, unnerved many at Drexel. Most of Drexel's capital was borrowed money, as is common with most investment banks and it is difficult to receive credit for firms under a RICO indictment. Drexel's CEO, Fred Joseph said that he had been told that if Drexel were indicted under RICO, it would only survive a month at most.

With literally minutes to go before being indicted, Drexel reached an agreement with the government in which it pleaded *nolo contendere* (no contest) to six felonies – three counts of stock parking and three counts of stock manipulation. It also agreed to pay a fine of \$650 million – at the time, the largest fine ever levied under securities laws. Milken left the firm after his own indictment in March 1989. Effectively, Drexel was now a convicted felon.

In April 1989, Drexel settled with the SEC, agreeing to stricter safeguards on its oversight procedures. Later that month, the firm eliminated 5,000 jobs by shuttering three departments – including the retail brokerage operation.

Meanwhile, the high-yield debt markets had begun to shut down in 1989, a slowdown that accelerated into 1990. On February 13, 1990 after being advised by Secretary of the Treasury Nicholas F. Brady, the SEC, the NYSE and the Federal Reserve, Drexel Burnham Lambert officially filed for Chapter 11 bankruptcy protection.

S&L and the shutdown of the Junk Bond Market

In the 1980s, the boom in private equity transactions, specifically leveraged buyouts, was driven by the availability of financing, particularly high-yield debt, also known as "*junk bonds*". The collapse of the high yield market in 1989 and 1990 would signal the end of the LBO boom. At that time, many market observers were pronouncing the junk bond market "finished." This collapse would be due largely to three factors:

- The collapse of Drexel Burnham Lambert, the foremost underwriter of junk bonds (discussed above).
- The dramatic increase in default rates among junk bond issuing companies. The historical default rate for high yield bonds from 1978 to 1988 was approximately 2.2% of total issuance. In 1989, defaults increased dramatically to 4.3% of the then \$190 billion market and an additional 2.6% of issuance defaulted in the first half of 1990. As a result of the higher perceived risk, the differential in yield of the junk bond market over U.S. treasuries (known as the "spread") had also increased by 700 basis points (7 percentage points). This made the cost of debt in the high yield market significantly more expensive than it had been previously. The market shut down altogether for lower rated issuers.
- The mandated withdrawal of savings and loans from the high yield market. In August 1989, the U.S. Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act of 1989 as a response to the savings and loan crisis of the 1980s. Under the law, savings and loans (S&Ls) could no longer invest in bonds that were rated below investment grade. Additionally, S&Ls were mandated to sell their holdings by the end of 1993 creating a huge supply of low priced assets that helped freeze the new issuance market.

Despite the adverse market conditions, several of the largest private equity firms were founded in this period including: Apollo Management, Madison Dearborn and TPG Capital.

The second private equity boom and the origins of modern private equity

Beginning roughly in 1992, three years after the RJR Nabisco buyout, and continuing through the end of the decade the private equity industry once again experienced a tremendous boom, both in venture capital (as will be discussed below) and leveraged buyouts with the emergence of brand name firms managing multi-billion dollar sized funds. After declining from 1990 through 1992, the private equity industry began to increase in size raising approximately \$20.8 billion of investor commitments in 1992 and reaching a high water mark in 2000 of \$305.7 billion, outpacing the growth of almost every other asset class.

Resurgence of leveraged buyouts

Private equity in the 1980s was a controversial topic, commonly associated with corporate raids, hostile takeovers, asset stripping, layoffs, plant closings and outsized profits to investors. As private equity reemerged in the 1990s it began to earn a new degree of legitimacy and respectability. Although in the 1980s, many of the acquisitions made were unsolicited and unwelcome, private equity firms in the 1990s focused on making buyouts attractive propositions for management and shareholders. According to The Economist, “[B]ig companies that would once have turned up their noses at an approach from a private-equity firm are now pleased to do business with them.” Additionally, private equity investors became increasingly focused on the long term development of companies they acquired, using less leverage in the acquisition. In the 1980s leverage would routinely represent 85% to 95% of the purchase price of a company as compared to average debt levels between 20% and 40% in leveraged buyouts in the 1990s and the first decade of the 21st century. KKR's 1986 acquisition of Safeway, for example, was completed with 97% leverage and 3% equity contributed by KKR, whereas KKR's acquisition of TXU in 2007 was completed with approximately 19% equity contributed (\$8.5 billion of equity out of a total purchase price of \$45 billion). Additionally, private equity firms are more likely to make investments in capital expenditures and provide incentives for management to build long-term value.

The Thomas H. Lee Partners acquisition of Snapple Beverages, in 1992, is often described as the deal that marked the resurrection of the leveraged buyout after several dormant years. Only eight months after buying the company, Lee took Snapple Beverages public and in 1994, only two years after the original acquisition, Lee sold the company to Quaker Oats for \$1.7 billion. Lee was estimated to have made \$900 million for himself and his investors from the sale. Quaker Oats would subsequently sell the company, which performed poorly under new management, three years later for only \$300 million to Nelson Peltz's Triarc. As a result of the Snapple deal, Thomas H. Lee, who had begun investing in private equity in 1974, would find new prominence in the private equity industry and catapult his Boston-based Thomas H. Lee Partners to the ranks of the largest private equity firms.

The following year, David Bonderman and James Coulter, who had worked for Robert M. Bass during the 1980s completed a buyout of Continental Airlines in 1993, through their nascent Texas Pacific Group, (today TPG Capital). TPG was virtually alone in its conviction that there was an investment opportunity with the airline. The plan included bringing in a new management team, improving aircraft utilization and focusing on lucrative routes. By 1998, TPG had generated an annual internal rate of return of 55% on its investment. Unlike Carl Icahn's hostile takeover of TWA in 1985, Bonderman and Texas Pacific Group were widely hailed as saviors of the airline, marking the change in tone from the 1980s. The buyout of Continental Airlines would be one of the few successes for the private equity industry which has suffered several major failures, including the 2008 bankruptcies of ATA Airlines, Aloha Airlines and Eos Airlines.

Among the most notable buyouts of the mid-to-late 1990s included: Duane Reade (1990 (1997)), Sealy Corporation (1997), KinderCare Learning Centers (1997), J. Crew (1997), Domino's Pizza (1998), Regal Entertainment Group (1998), Oxford Health Plans (1998) and Petco (2000).

As the market for private equity matured, so too did its investor base. The Institutional Limited Partner Association was initially founded as an informal networking group for

limited partner investors in private equity funds in the early 1990s. However the organization would evolve into an advocacy organization for private equity investors with more than 200 member organizations from 10 countries. As of the end of 2007, ILPA members had total assets under management in excess of \$5 trillion with more than \$850 billion of capital commitments to private equity investments.

The venture capital boom and the Internet Bubble (1995 to 2000)

In the 1980s, FedEx and Apple Inc. were able to grow because of private equity or venture funding, as were Cisco, Genentech, Microsoft and Avis. However, by the end of the 1980s, venture capital returns were relatively low, particularly in comparison with their emerging leveraged buyout cousins, due in part to the competition for hot startups, excess supply of IPOs and the inexperience of many venture capital fund managers. Unlike the leveraged buyout industry, after total capital raised increased to \$3 billion in 1983, growth in the venture capital industry remained limited through the 1980s and the first half of the 1990s increasing to just over \$4 billion more than a decade later in 1994.

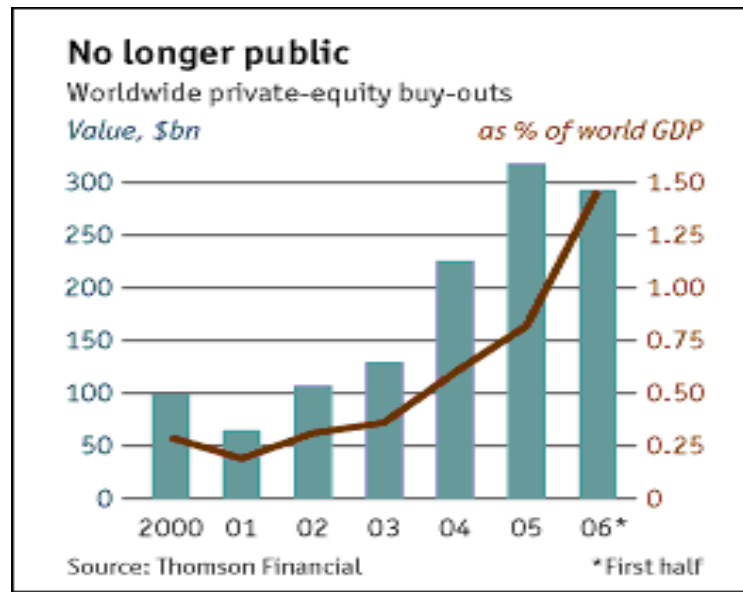
After a shakeout of venture capital managers, the more successful firms retrenched, focusing increasingly on improving operations at their portfolio companies rather than continuously making new investments. Results would begin to turn very attractive, successful and would ultimately generate the venture capital boom of the 1990s. Former Wharton Professor Andrew Metrick refers to these first 15 years of the modern venture capital industry beginning in 1980 as the "pre-boom period" in anticipation of the boom that would begin in 1995 and last through the bursting of the Internet bubble in 2000.

The late 1990s were a boom time for the venture capital, as firms on Sand Hill Road in Menlo Park and Silicon Valley benefited from a huge surge of interest in the nascent Internet and other computer technologies. Initial public offerings of stock for technology and other growth companies were in abundance and venture firms were reaping large windfalls. Among the highest profile technology companies with venture capital backing were Amazon.com, America Online, E-bay, Intuit, Macromedia, Netscape, Sun Microsystems and Yahoo!.

The bursting of the Internet Bubble and the private equity crash (2000 to 2003)

The Nasdaq crash and technology slump that started in March 2000 shook virtually the entire venture capital industry as valuations for startup technology companies collapsed. Over the next two years, many venture firms had been forced to write-off their large proportions of their investments and many funds were significantly "under water" (the values of the fund's investments were below the amount of capital invested). Venture capital investors sought to reduce size of commitments they had made to venture capital funds and in numerous instances, investors sought to unload existing commitments for cents on the dollar in the secondary market. By mid-2003, the venture capital industry had shriveled to about half its 2001 capacity. Nevertheless, PricewaterhouseCoopers' MoneyTree Survey shows that total venture capital investments held steady at 2003 levels through the second quarter of 2005.

Although the post-boom years represent just a small fraction of the peak levels of venture investment reached in 2000, they still represent an increase over the levels of investment from 1980 through 1995. As a percentage of GDP, venture investment was 0.058% percent in 1994, peaked at 1.087% (nearly 19x the 1994 level) in 2000 and ranged from 0.164% to 0.182 % in 2003 and 2004. The revival of an Internet-driven environment (thanks to deals such as eBay's purchase of Skype, the News Corporation's purchase of MySpace.com, and the very successful Google.com and Salesforce.com IPOs) have helped to revive the venture capital environment. However, as a percentage of the overall private equity market, venture capital has still not reached its mid-1990s level, let alone its peak in 2000.



Stagnation in the LBO market

Meanwhile, as the venture sector collapsed, the activity in the leveraged buyout market also declined significantly. Leveraged buyout firms had invested heavily in the telecommunications sector from 1996 to 2000 and profited from the boom which suddenly fizzled in 2001. In that year at least 27 major telecommunications companies, (i.e., with \$100 million of liabilities or greater) filed for bankruptcy protection. Telecommunications, which made up a large portion of the overall high yield universe of issuers, dragged down the entire high yield market. Overall corporate default rates surged to levels unseen since the 1990 market collapse rising to 6.3% of high yield issuance in 2000 and 8.9% of issuance in 2001. Default rates on junk bonds peaked at 10.7 percent in January 2002 according to Moody's. As a result, leveraged buyout activity ground to a halt. The major collapses of former high-fliers including WorldCom, Adelphia Communications, Global Crossing and WinStar were among the most notable defaults in the market. In addition to the high rate of default, many investors lamented the low recovery rates achieved through restructuring or bankruptcy.

Among the most affected by the bursting of the internet and telecom bubbles were two of the largest and most active private equity firms of the 1990s: Tom Hicks' Hicks Muse Tate & Furst and Ted Forstmann's Forstmann Little & Company. These firms were often cited as the highest profile private equity casualties, having invested heavily in technology and telecommunications companies. Hicks Muse's reputation and market position were both damaged by the loss of over \$1 billion from minority investments in six telecommunications and 13 Internet companies at the peak of the 1990s stock market bubble.^{[58][59][60]} Similarly, Forstmann suffered major losses from investments in McLeodUSA and XO Communications. Tom Hicks resigned from Hicks Muse at the end of 2004 and Forstmann Little was unable to raise a new fund. The treasurer of the State of Connecticut, sued Forstmann Little to return the state's \$96 million investment to that point and to cancel the commitment it made to take its total investment to \$200 million. The humbling of these private equity titans could hardly have been predicted by their investors in the 1990s and forced fund investors to conduct due diligence on fund managers more carefully and include greater controls on investments in partnership agreements.

Deals completed during this period tended to be smaller and financed less with high yield debt than in other periods. Private equity firms had to cobble together financing made up of bank loans and mezzanine debt, often with higher equity contributions than had been seen. Private equity firms benefited from the lower valuation multiples. As a result, despite the relatively limited activity, those funds that invested during the adverse market conditions delivered attractive returns to investors. Meanwhile, in Europe LBO activity began to increase as the market continued to mature. In 2001, for the first time, European buyout activity exceeded US activity with \$44 billion of deals completed in Europe as compared with just \$10.7 billion of deals completed in the US. This was a function of the fact that just six LBOs in excess of \$500 million were completed in 2001, against 27 in 2000.

As investors sought to reduce their exposure to the private equity asset class, an area of private equity that was increasingly active in these years was the nascent secondary

market for private equity interests. Secondary transaction volume increased from historical levels of 2% or 3% of private equity commitments to 5% of the addressable market in the early years of the new decade. Many of the largest financial institutions (e.g., Deutsche Bank, Abbey National, UBS AG) sold portfolios of direct investments and “pay-to-play” funds portfolios that were typically used as a means to gain entry to lucrative leveraged finance and [[mergers and acquisitions]] assignments but had created hundreds of millions of dollars of losses. Some of the most notable financial institutions to complete publicly disclosed secondary transactions during this period include: Chase Capital Partners (2000), National Westminster Bank (2000), UBS AG (2003), Deutsche Bank (MidOcean Partners) (2003) Abbey National (2004) and Bank One (2004).

The third private equity boom and the Golden Age of Private Equity (2003-2007)

As 2002 ended and 2003 began, the private equity sector, had spent the previous three two and a half years reeling from major losses in telecommunications and technology companies and had been severely constrained by tight credit markets. As 2003 got underway, private equity began a five year resurgence that would ultimately result in the completion of 13 of the 15 largest leveraged buyout transactions in history, unprecedented levels of investment activity and investor commitments and a major expansion and maturation of the leading private equity firms.

The combination of decreasing interest rates, loosening lending standards and regulatory changes for publicly traded companies would set the stage for the largest boom private equity had seen. The Sarbanes Oxley legislation, officially the Public Company Accounting Reform and Investor Protection Act, passed in 2002, in the wake of corporate scandals at Enron, WorldCom, Tyco, Adelphia, Peregrine Systems and Global Crossing among others, would create a new regime of rules and regulations for publicly traded corporations. In addition to the existing focus on short term earnings rather than long term value creation, many public company executives lamented the extra cost and bureaucracy associated with Sarbanes-Oxley compliance. For the first time, many large corporations saw private equity ownership as potentially more attractive than remaining

public. Sarbanes-Oxley would have the opposite effect on the venture capital industry. The increased compliance costs would make it nearly impossible for venture capitalists to bring young companies to the public markets and dramatically reduced the opportunities for exits via IPO. Instead, venture capitalists have been forced increasingly to rely on sales to strategic buyers for an exit of their investment.

Interest rates, which began a major series of decreases in 2002 would reduce the cost of borrowing and increase the ability of private equity firms to finance large acquisitions. Lower interest rates would encourage investors to return to relatively dormant high-yield debt and leveraged loan markets, making debt more readily available to finance buyouts. Additionally, alternative investments also became increasingly important as investors sought yield despite increases in risk. This search for higher yielding investments would fuel larger funds and in turn larger deals, never thought possible, became reality.

Certain buyouts were completed in 2001 and early 2002, particularly in Europe where financing was more readily available. In 2001, for example, BT Group agreed to sell its international yellow pages directories business (Yell Group) to Apax Partners and Hicks, Muse, Tate & Furst for £2.14 billion (approximately \$3.5 billion at the time), making it then the largest non-corporate LBO in European history. Yell later bought US directories publisher McLeodUSA for about \$600 million, and floated on London's FTSE in 2003.

Resurgence of the large buyout

Marked by the two-stage buyout of Dex Media at the end of 2002 and 2003, large multi-billion dollar U.S. buyouts could once again obtain significant high yield debt financing and larger transactions could be completed. The Carlyle Group, Welsh, Carson, Anderson & Stowe, along with other private investors, led a \$7.5 billion buyout of QwestDex. The buyout was the third largest corporate buyout since 1989. QwestDex's purchase occurred in two stages: a \$2.75 billion acquisition of assets known as Dex Media East in November 2002 and a \$4.30 billion acquisition of assets known as Dex Media West in 2003. R. H. Donnelley Corporation acquired Dex Media in 2006. Shortly after Dex Media, other larger buyouts would be completed signaling the resurgence in private

equity was underway. The acquisitions included *Burger King* (by Bain Capital), *Jefferson Smurfit* (by Madison Dearborn), *Houghton Mifflin* (by Bain Capital, the Blackstone Group and Thomas H. Lee Partners) and TRW Automotive by the Blackstone Group.

In 2006 USA Today reported retrospectively on the revival of private equity:

LBOs are back, only they've rebranded themselves private equity and vow a happier ending. The firms say this time it's completely different. Instead of buying companies and dismantling them, as was their rap in the '80s, private equity firms... squeeze more profit out of underperforming companies.

But whether today's private equity firms are simply a regurgitation of their counterparts in the 1980s... or a kinder, gentler version, one thing remains clear: private equity is now enjoying a "Golden Age." And with returns that triple the S&P 500, it's no wonder they are challenging the public markets for supremacy.

By 2004 and 2005, major buyouts were once again becoming common and market observers were stunned by the leverage levels and financing terms obtained by financial sponsors in their buyouts. Some of the notable buyouts of this period include: Dollarama (2004), Toys "R" Us (2004), The Hertz Corporation (2005), Metro-Goldwyn-Mayer (2005) and SunGard (2005).

Age of the mega-buyout

David Rubinstein, the head of the Carlyle Group, the largest private equity firm (by investor commitments) during the 2006-07 buyout boom.

As 2005 ended and 2006 began, new "largest buyout" records were set and surpassed several times with nine of the top ten buyouts at the end of 2007 having been announced in an 18-month window from the beginning of 2006 through the middle of 2007. Additionally, the buyout boom was not limited to the United States as industrialized countries in Europe and the Asia-Pacific region also saw new records set. In 2006, private

equity firms bought 654 U.S. companies for \$375 billion, representing 18 times the level of transactions closed in 2003. Additionally, U.S. based private equity firms raised \$215.4 billion in investor commitments to 322 funds, surpassing the previous record set in 2000 by 22% and 33% higher than the 2005 fundraising total. However, venture capital funds, which were responsible for much of the fundraising volume in 2000 (the height of the dot-com bubble), raised only \$25.1 billion in 2006, a 2% percent decline from 2005 and a significant decline from its peak. The following year, despite the onset of turmoil in the credit markets in the summer, saw yet another record year of fundraising with \$302 billion of investor commitments to 415 funds.

Among the largest buyouts of this period included: Georgia-Pacific Corp (2005), Albertson's (2006), Equity Office Properties (2006), Freescale Semiconductor (2006), GMAC (2006), HCA (2006), Kinder Morgan (2006), Harrah's Entertainment (2006), TDC A/S (2006), Sabre Holdings (2006), Travelport (2006), Alliance Boots (2007), Biomet (2007), Chrysler (2007), First Data (2007) and TXU (2007).

Publicly traded private equity

Although there had previously been certain instances of publicly traded private equity vehicles, the convergence of private equity and the public equity markets attracted significantly greater attention when several of the largest private equity firms pursued various options through the public markets. Taking private equity firms and private equity funds public appeared an unusual move since private equity funds often buy public companies listed on exchange and then take them private. Private equity firms are rarely subject to the quarterly reporting requirements of the public markets and tout this independence to prospective sellers as a key advantage of going private. Nevertheless, there are fundamentally two separate opportunities that private equity firms pursued in the public markets. These options involved a public listing of either:

- A *private equity firm* (the management company), which provides shareholders an opportunity to gain exposure to the management fees and carried interest earned by the investment professionals and managers of the private equity firm. The most

notable example of this public listing was completed by The Blackstone Group in 2007

- A *private equity fund* or similar investment vehicle, which allows investors that would otherwise be unable to invest in a traditional private equity limited partnership to gain exposure to a portfolio of private equity investments.

In May 2006, Kohlberg Kravis Roberts raised \$5 billion in an initial public offering for a new permanent investment vehicle (KKR Private Equity Investors or KPE) listing it on the Euronext exchange in Amsterdam (ENXTAM: KPE). KKR raised more than three times what it had expected at the outset as many of the investors in KPE were hedge funds seeking exposure to private equity but could not make long term commitments to private equity funds. Because private equity had been booming in the preceding years, the proposition of investing in a KKR fund appeared attractive to certain investors. However, KPE's first-day performance was lackluster, trading down 1.7% and trading volume was limited. Initially, a handful of other private equity firms and hedge funds had planned to follow KKR's lead but shelved those plans when KPE's performance continued to falter after its IPO. KPE's stock declined from an IPO price of €25 per share to €18.16 (a 27% decline) at the end of 2007 and a low of €11.45 (a 54.2% decline) per share in Q1 2008. KPE disclosed in May 2008 that it had completed approximately \$300 million of secondary sales of selected limited partnership interests in and undrawn commitments to certain KKR-managed funds in order to generate liquidity and repay borrowings.

Schwarzman's Blackstone Group completed the first major IPO of a private equity firm in June 2007.

On March 22, 2007, the Blackstone Group filed with the SEC to raise \$4 billion in an initial public offering. On June 21, Blackstone swapped a 12.3% stake in its ownership for \$4.13 billion in the largest U.S. IPO since 2002. Traded on the New York Stock Exchange under the ticker symbol BX, Blackstone priced at \$31 per share on June 22, 2007.

Less than two weeks after the Blackstone Group IPO, rival firm Kohlberg Kravis Roberts filed with the SEC in July 2007 to raise \$1.25 billion by selling an ownership interest in its management company. KKR had previously listed its KKR Private Equity Investors (KPE) private equity fund vehicle in 2006. The onset of the credit crunch and the shutdown of the IPO market would dampen the prospects of obtaining a valuation that would be attractive to KKR and the flotation was repeatedly postponed.

Meanwhile, other private equity investors were seeking to realize a portion of the value locked into their firms. In September 2007, the Carlyle Group sold a 7.5% interest in its management company to Mubadala Development Company, which is owned by the Abu Dhabi Investment Authority (ADIA) for \$1.35 billion, which valued Carlyle at approximately \$20 billion. Similarly, in January 2008, Silver Lake Partners sold a 9.9% stake in its management company to the California Public Employees' Retirement System (CalPERS) for \$275 million.

Additionally, Apollo Management completed a private placement of shares in its management company in July 2007. By pursuing a private placement rather than a public offering, Apollo would be able to avoid much of the public scrutiny applied to Blackstone and KKR. In April 2008, Apollo filed with the SEC to permit some holders of its privately traded stock to sell their shares on the New York Stock Exchange.¹ In April 2004, Apollo raised \$930 million for a listed business development company, Apollo Investment Corporation (NASDAQ: AINV), to invest primarily in middle-market companies in the form of mezzanine debt and senior secured loans, as well as by making direct equity investments in companies. The Company also invests in the securities of public companies.

Historically, in the United States, there had been a group of publicly traded private equity firms that were registered as business development companies (BDCs) under the Investment Company Act of 1940. Typically, BDCs are structured similar to real estate investment trusts (REITs) in that the BDC structure reduces or eliminates corporate income tax. In return, REITs are required to distribute 90% of their income, which may

be taxable to its investors. As of the end of 2007, among the largest BDCs (by market value, excluding Apollo Investment Corp, discussed earlier) are: American Capital Strategies (NASDAQ: ACAS), Allied Capital Corp((NASDAQ:ALD), Ares Capital Corporation (NASDAQ:ARCC), Gladstone Investment Corp (NASDAQ:GAIN) and Kohlberg Capital Corp (NASDAQ:KCAP).

Secondary market and the evolution of the private equity asset class

In the wake of the collapse of the equity markets in 2000, many investors in private equity sought an early exit from their outstanding commitments. The surge in activity in the secondary market, which had previously been a relatively small niche of the private equity industry, prompted new entrants to the market, however the market was still characterized by limited liquidity and distressed prices with private equity funds trading at significant discounts to fair value.

Beginning in 2004 and extending through 2007, the secondary market transformed into a more efficient market in which assets for the first time traded at or above their estimated fair values and liquidity increased dramatically. During these years, the secondary market transitioned from a niche sub-category in which the majority of sellers were distressed to an active market with ample supply of assets and numerous market participants. By 2006 active portfolio management had become far more common in the increasingly developed secondary market and an increasing number of investors had begun to pursue secondary sales to rebalance their private equity portfolios. The continued evolution of the private equity secondary market reflected the maturation and evolution of the larger private equity industry. Among the most notable publicly disclosed secondary transactions (it is estimated that over two-thirds of secondary market activity is never disclosed publicly): CalPERS (2008), Ohio Bureau of Workers' Compensation (2007), MetLife (2007), Bank of America (2006 and 2007), Mellon Financial Corporation (2006), American Capital Strategies (2006), JPMorgan Chase, Temasek Holdings, Dresdner Bank and Dayton Power & Light.

The Credit Crunch and post-modern private equity (2007 – 2008)

In July 2007, turmoil that had been affecting the mortgage markets, spilled over into the leveraged finance and high-yield debt markets. The markets had been highly robust during the first six months of 2007, with highly issuer friendly developments including PIK and PIK Toggle (interest is "Payable In Kind") and covenant light debt widely available to finance large leveraged buyouts. July and August saw a notable slowdown in issuance levels in the high yield and leveraged loan markets with only few issuers accessing the market. Uncertain market conditions led to a significant widening of yield spreads, which coupled with the typical summer slowdown led to many companies and investment banks to put their plans to issue debt on hold until the autumn. However, the expected rebound in the market after Labor Day 2007 did not materialize and the lack of market confidence prevented deals from pricing. By the end of September, the full extent of the credit situation became obvious as major lenders including Citigroup and UBS AG announced major writedowns due to credit losses. The leveraged finance markets came to a near standstill. As a result of the sudden change in the market, buyers would begin to withdraw from or renegotiate the deals completed at the top of the market, most notably in transactions involving: Harman International (announced and withdrawn 2007), Sallie Mae (announced 2007 but withdrawn 2008), Clear Channel Communications (2007) and BCE (2007).

Additionally, the credit crunch has prompted buyout firms to pursue a new group of transactions in order to deploy their massive investment funds. These transactions have included Private Investment in Public Equity (or PIPE) transactions as well as purchases of debt in existing leveraged buyout transactions. Some of the most notable of these transactions completed in the depths of the credit crunch include Apollo Management's acquisition of the Citigroup Loan Portfolio (2008) and TPG Capital's PIPE investment in Washington Mutual (2008).

*Responses to private equity***1980s reflections of private equity**

Although private equity rarely received a thorough treatment in popular culture, several films did feature stereotypical "corporate raiders" prominently. Among the most notable examples of private equity featured in motion pictures included:

- *Wall Street* – The Notorious "corporate raider" and "greenmailer" Gordon Gekko represents a synthesis of the worst features of various famous private equity figures intends to manipulate an ambitious young stockbroker to takeover failing but decent airline. Although Gekko makes a pretense of caring about the airline, his intentions prove to be to destroy the airline, strip its assets and lay off its employees before raiding the corporate pension fund. Gekko would become a symbol in popular culture for unrestrained greed (with the signature line, "Greed, for lack of a better word, is good") that would be attached to the private equity industry.
- *Other People's Money* – A self-absorbed corporate raider "Larry the Liquidator" (Danny DeVito), sets his sights on New England Wire and Cable, a small-town business run by family patriarch Gregory Peck who is principally interested in protecting his employees and the town.
- *Pretty Woman* – Although Richard Gere's profession is incidental to the plot, the selection of the corporate raider who intends to destroy the hard work of a family run business by acquiring the company in a hostile takeover and then sell off the company's parts for a profit (compared in the movie to an illegal chop shop). Ultimately, the corporate raider is won over and chooses not to pursue his original plans for the company.

Contemporary reflections of private equity and private equity controversies

Carlyle group featured prominently in Michael Moore's 2003 film Fahrenheit 9-11. The film suggested that The Carlyle Group exerted tremendous influence on U.S. government

policy and contracts through their relationship with the president's father, George H. W. Bush, a former senior adviser to the Carlyle Group. Additionally, Moore cited relationships with the Bin Laden family. The movie quotes author Dan Briody claiming that the Carlyle Group "gained" from September 11 because it owned United Defense, a military contractor, although the firm's \$11 billion Crusader artillery rocket system developed for the U.S. Army is one of the only weapons systems canceled by the Bush administration.

Over the next few years, attention intensified on private equity as the size of transactions and profile of the companies increased. The attention would increase significantly following a series of events involving The Blackstone Group: the firm's initial public offering and the birthday celebration of its CEO. The Wall Street Journal observing Blackstone Group's Steve Schwarzman's 60th birthday celebration in February 2007 described the event as follows:

The Armory's entrance hung with banners painted to replicate Mr. Schwarzman's sprawling Park Avenue apartment. A brass band and children clad in military uniforms ushered in guests. A huge portrait of Mr. Schwarzman, which usually hangs in his living room, was shipped in for the occasion. The affair was emceed by comedian Martin Short. Rod Stewart performed. Composer Marvin Hamlisch did a number from "A Chorus Line." Singer Patti LaBelle led the Abyssinian Baptist Church choir in a tune about Mr. Schwarzman. Attendees included Colin Powell and New York Mayor Michael Bloomberg. The menu included lobster, baked Alaska and a 2004 Louis Jadot Chassagne Montrachet, among other fine wines.

Schwarzman received a severe backlash from both critics of the private equity industry and fellow investors in private equity. The lavish event which reminded many of the excesses of notorious executives including Bernie Ebbers (WorldCom) and Dennis Kozlowski (Tyco International). David Bonderman, the founder of TPG remarked, "We have all wanted to be private – at least until now. When Steve Schwarzman's biography

with all the dollar signs is posted on the web site none of us will like the furor that results – and that's even if you like Rod Stewart."

Rubinstein's fears would be confirmed when in 2007, the Service Employees International Union launched a campaign against private equity firms, specifically the largest buyout firms through public events, protests as well as leafleting and web campaigns. A number of leading private equity executives were targeted by the union members however the SEIU's campaign was non nearly as effective at slowing the buyout boom as the credit crunch of 2007 and 2008 would ultimately prove to be.

In 2008, the SEIU would shift part of its focus from attacking private equity firms directly toward the highlighting the role of sovereign wealth funds in private equity. The SEIU pushed legislation in California that would disallow investments by state agencies (particularly CalPERS and CalSTRS) in firms with ties to certain sovereign wealth funds. Additionally, the SEIU has attempted to criticize the treatment of taxation of carried interest. The SEIU, and other critics, point out that many wealthy private equity investors pay taxes at lower rates (because the majority of their income is derived from carried interest, payments received from the profits on a private equity fund's investments) than many of the rank and file employees of a private equity firm's portfolio companies.

Private equity - venture capital

Considering the growth stage of companies and their financing reasons, the financial partnership investments can be made at different stages, like seed financing, start-up financing, early stage financing, expansion financing, mezzanine financing, LBO and MBO. These stages sometimes mark the distinction between venture capital and private equity investments. Although the differences between venture capital and private equity investments are not apparent in many cases, seed, start-up or early stage companies with a business or product development plan are generally financed by venture capital funds whereas private equity funds prefer investments to ongoing businesses at later stages of growth via mezzanine or expansion financing. Private equity funds seek companies, which have reached a certain size (revenues exceeding \$10m in Turkey), enjoy high operating profit, realise rapid growth, hold considerable market share, and create significant entry barriers in their sectors.

Companies, that cannot realise profitable investment opportunities because of lack of funding and those are financially distressed but operationally viable, are attractive candidates for financial investments. The value created can be shared between the investor and investee.

As you might have noticed that both private equity and venture capital are mostly used simultaneously, yet there is a difference between them.

What is the difference between Venture Capital and Private Equity?

The text book answer that would be given by most B-School professors is that venture capital is a subset of a larger private equity asset class which includes venture capital, LBO's, MBO's, MBI's, bridge and mezzanine investments. Historically venture capital investors have provided high risk equity capital to start-up and early stage companies whereas private equity firms have provided secondary tranches of equity and mezzanine

investments to companies that are more mature in their corporate lifecycle. Again, traditionally speaking, venture capital firms have higher hurdle rate expectations, will be more mercenary with their valuations and will be more onerous in their constraints on management than will private equity firms.

While the above descriptions are technically correct and have largely held true to form from a historical perspective, the lines between venture capital and private equity investments have been blurred by increased competition in the capital markets over the last 18 – 24 months. With the robust, if not frothy state of the capital markets today there is far too much capital chasing too few quality deals. The increased pressure on the part of money managers, investment advisors, fund managers and capital providers to place funds is at an all time high. This excess money supply has created more competition between investors, driving valuations up for entrepreneurs and yields down for investors.

This increased competition among investors has forced both venture capital and private equity firms to expand their respective horizons in order to continue to capture new opportunities. Over the last 12 months I have seen an increase in private equity firms willing to consider earlier stage companies and venture capital firms lowering yield requirements to be more competitive in securing later stage opportunities.

The moral of this story is that if you are an entrepreneur seeking investment capital your timing is good. While the traditional rules of thumb first explained above can be used as a basic guideline for determining investor suitability, don't let traditional guidelines keep you from exploring all types of capital providers. While some of the ground rules may be changing your capital formation goals should remain the same: entertain proposals from venture capital investors, private equity firms, hedge funds, and angel investors while attempting to work throughout the entire capital structure to seek the highest possible valuation at the lowest blended cost of capital while maintaining the most control possible

A reader of the financial press will come across the phrases 'private equity' (PE) and 'venture capital' (VC), often used interchangeably such that it can be assumed they both

describe the same thing. And on one level that is true: both are used to describe the investment of cash for equity (eg, shares) in companies by specialist investors seeking an increase in value in the investee company and then to realise a return on their investment. However, within that universal description hide a number of key differences between the two forms of investment. Below are three of those key differences:

Type of investee company

First, and most fundamentally, the type of potential investee company that will attract the attention of PE investors will often be very different to that which VC investors will seek out. A key part of the PE investor's business model will be to leverage their investment by supplementing the equity investment with debt. The intention is for the debt to be repaid over time, using the cashflow generated by the investee company, thus leaving the PE investor with its shares in a debt-free investee company which should then be much more valuable than at the point of acquisition. So, while the projected growth of the potential investee company's business is clearly a factor in the decision as to whether to invest and on what terms, a key characteristic of a company that will attract PE investors is strong and reliable cashflow in its business, to provide the means to pay down the debt. And, as the debt is typically provided by banks which will look for security for the loan, the investee company also needs to have sufficient tangible assets (eg, freehold properties and stock) to provide that security.

By contrast, a VC investor does not typically look for leverage. Instead they look to invest in companies with the potential for rapid and exponential growth in the underlying business. Such growth is unlikely to be found in mature businesses selling into established markets. Instead, the VC investor will be focusing on companies looking to either (i) provide a radical new approach to an existing market or, perhaps, (ii) create a brand new market. Typically, these businesses are involved in the development of technology and, at the point they need working capital to aid that development, they may have only a rough idea of how (or even if) the technology will work or ultimately what market it will address. Such companies are therefore not generating many sales and often

have only some intellectual property by way of assets, thus making it impossible to attract the bank debt which the PE investor needs to obtain the leverage described above. VC deals then are typically 'all equity'.

Use of proceeds

Second, the proceeds raised from the investor tend to be used for different purposes in the two types of investment. In a PE deal, there is typically the purchase of all or some of the existing shares in the investee company. As a consequence, some of the money invested by a PE investor will actually be paid to the existing owners of the company, thus providing them with a reward for the value of the investee company at the point of investment. This is because companies attracting PE investment tend to be more mature for the reasons described above and so have a demonstrable current value. In a VC deal, the value is typically in the future – if the business works, it may deliver very good returns. However, the risk of non-performance is relatively high. Also, a typical VC investee company needs working capital as it is not yet generating significant cash from its business, so any money that is invested is needed for the business itself. Consequently, it is unusual for any cash invested in a VC deal to be paid out to current owners of the company.

Type of risk

Finally, the risks that the PE investor faces can be different to those confronting his or her counterpart in a VC deal. While both will want to investigate and understand the current and potential liabilities of the business they are considering investing in (a process known as due diligence), and will want to ensure that they are provided with regular financial information and that key decisions concerning the business cannot be taken without their consent, the VC investor will also be concerned with trying to mitigate the effect of the many uncertainties facing the business of the company as it develops its products and markets. Critically, they will be concerned with what happens if the business needs more working capital after their investment (this is very common in VC investee companies, which might have three or more financing rounds before reaching break even, which will

dilute the interests of existing shareholders in the business as more shares are issued each time) and/or the development of the underlying business is less exciting than originally hoped for. So a VC investor will often seek to invest in a 'preferred' share as opposed to an 'ordinary' share. The preferred share may provide the VC investor with an enhanced share of the proceeds at the point of sale of the company (known as a liquidity preference) and/or the right to get extra shares at nominal value if the company subsequently needs more working capital and the valuation of the business at that time has actually gone down (known as an anti-dilution right).

The PE investor will of course also be concerned about future performance of the investee company, but by contrast will be more focused on identifying exactly when the terms of the bank debt will allow the bank to call in the loan prematurely, thus potentially making the business insolvent and so destroying the value in the PE investor's equity.

Venture capital firms and funds

Structure of venture capital firms

Venture capital firms are typically structured as partnerships, the general partners of which serve as the managers of the firm and will serve as investment advisors to the venture capital funds raised. Venture capital firms in the United States may also be structured as limited liability companies, in which case the firm's managers are known as managing members. Investors in venture capital funds are known as limited partners. This constituency comprises both high net worth individuals and institutions with large amounts of available capital, such as state and private pension funds, university financial endowments, foundations, insurance companies, and pooled investment vehicles, called fund of funds or mutual funds.

Roles within venture capital firms

Within the venture capital industry, the general partners and other investment professionals of the venture capital firm are often referred to as "venture capitalists" or

"VCs". Typical career backgrounds vary, but broadly speaking venture capitalists come from either an operational or a finance background. Venture capitalists with an operational background tend to be former founders or executives of companies similar to those which the partnership finances or will have served as management consultants. Venture capitalists with finance backgrounds tend to have investment banking or other corporate finance experience.

Although the titles are not entirely uniform from firm to firm, other positions at venture capital firms include:

- **Venture partners** - Venture partners are expected to source potential investment opportunities ("bring in deals") and typically are compensated only for those deals with which they are involved.
- **Entrepreneur-in-residence (EIR)** - EIRs are experts in a particular domain and perform due diligence on potential deals. EIRs are engaged by venture capital firms temporarily (six to 18 months) and are expected to develop and pitch startup ideas to their host firm (although neither party is bound to work with each other). Some EIR's move on to executive positions within a portfolio company.
- **Principal** - This is a mid-level investment professional position, and often considered a "partner-track" position. Principals will have been promoted from a senior associate position or who have commensurate experience in another field such as investment banking or management consulting.
- **Associate** - This is typically the most junior apprentice position within a venture capital firm. After a few successful years, an associate may move up to the "senior associate" position and potentially principal and beyond. Associates will often have worked for 1-2 years in another field such as investment banking or management consulting.

Structure of the funds

Most venture capital funds have a fixed life of 10 years, with the possibility of a few years of extensions to allow for private companies still seeking liquidity. The investing cycle for most funds is generally three to five years, after which the focus is managing and making follow-on investments in an existing portfolio. This model was pioneered by successful funds in Silicon Valley through the 1980s to invest in technological trends broadly but only during their period of ascendance, and to cut exposure to management and marketing risks of any individual firm or its product.

In such a fund, the investors have a fixed commitment to the fund that is initially unfunded and subsequently "called down" by the venture capital fund over time as the fund makes its investments. There are substantial penalties for a Limited Partner (or investor) that fails to participate in a capital call.

It can take anywhere from a month or so to several years for venture capitalists to raise money from limited partners for their fund. At the time when all of the money has been raised, the fund is said to be closed and the 10 year lifetime begins. Some funds have partial closes when one half (or some other amount) of the fund has been raised. "Vintage year" generally refers to the year in which the fund was closed and may serve as a means to stratify VC funds for comparison.

Compensation

Venture capitalists are compensated through a combination of management fees and carried interest (often referred to as a "two and 20" arrangement:

- **Management fees** – an annual payment made by the investors in the fund to the fund's manager to pay for the private equity firm's investment operations. In a typical venture capital fund, the general partners receive an annual management fee equal to up to 2% of the committed capital.

- **Carried interest** - a share of the profits of the fund (typically 20%), paid to the private equity fund's management company as a performance incentive. The remaining 80% of the profits are paid to the fund's investors. Strong Limited Partner interest in top-tier venture firms has led to a general trend toward terms more favorable to the venture partnership, and certain groups are able to command carried interest of 25-30% on their funds.

Because a fund may run out of capital prior to the end of its life, larger venture capital firms usually have several overlapping funds at the same time; this lets the larger firm keep specialists in all stages of the development of firms almost constantly engaged. Smaller firms tend to thrive or fail with their initial industry contacts; by the time the fund cashes out, an entirely-new generation of technologies and people is ascending, whom the general partners may not know well, and so it is prudent to reassess and shift industries or personnel rather than attempt to simply invest more in the industry or people the partners already know.

Venture capital funding

Venture capitalists are typically very selective in deciding what to invest in; as a rule of thumb, a fund may invest in one in four hundred opportunities presented to it. Funds are most interested in ventures with exceptionally high growth potential, as only such opportunities are likely capable of providing the financial returns and successful exit event within the required timeframe (typically 3-7 years) that venture capitalists expect.

Because investments are illiquid and require 3-7 years to harvest, venture capitalists are expected to carry out detailed due diligence prior to investment. Venture capitalists also are expected to nurture the companies in which they invest, in order to increase the likelihood of reaching a IPO stage when valuations are favourable. Venture capitalists typically assist at four stages in the company's development

-
- Idea generation;
 - Start-up;
 - Ramp up; and
 - Exit

There are typically six stages of financing offered in Venture Capital, that roughly correspond to these stages of a companies development

- Seed Money: Low level financing needed to prove a new idea (Often provided by "angel investors")
- Start-up: Early stage firms that need funding for expenses associated with marketing and product development
- First-Round: Early sales and manufacturing funds
- Second-Round: Working capital for early stage companies that are selling product, but not yet turning a profit
- Third-Round: Also called Mezzanine financing, this is expansion money for a newly profitable company
- Fourth-Round: Also called bridge financing, 4th round is intended to finance the going public process

Because there are no public exchanges listing their securities, private companies meet venture capital firms and other private equity investors in several ways, including warm referrals from the investors' trusted sources and other business contacts; investor conferences and symposia; and summits where companies pitch directly to investor groups in face-to-face meetings, including a variant know as "Speed Venturing", which is akin to speed-dating for capital, where the investor decides within 10 minutes whether s/he wants a follow-up meeting.

This need for high returns makes venture funding an expensive capital source for companies, and most suitable for businesses having large up-front capital requirements which cannot be financed by cheaper alternatives such as debt. That is most commonly the case for intangible assets such as software, and other intellectual property, whose

value is unproven. In turn this explains why venture capital is most prevalent in the fast-growing technology and life sciences or biotechnology fields.

If a company does have the qualities venture capitalists seek including a solid business plan, a good management team, investment and passion from the founders, a good potential to exit the investment before the end of their funding cycle, and target minimum returns in excess of 40% per year, it will find it easier to raise venture capital.

Main alternatives to venture capital

Because of the strict requirements venture capitalists have for potential investments, many entrepreneurs seek initial funding from angel investors¹, who may be more willing to invest in highly speculative opportunities, or may have a prior relationship with the entrepreneur.

Furthermore, many venture capital firms will only seriously evaluate an investment in a start-up otherwise unknown to them if the company can prove at least some of its claims about the technology and/or market potential for its product or services. To achieve this, or even just to avoid the dilutive effects of receiving funding before such claims are proven, many start-ups seek to self-finance until they reach a point where they can credibly approach outside capital providers such as venture capitalists or angel investors. This practice is called "bootstrapping".

There has been some debate since the dot com boom that a "funding gap" has developed between the friends and family investments typically in the \$0 to \$250,000 range and the amounts that most Venture Capital Funds prefer to invest between \$1 to \$2M. This funding gap may be accentuated by the fact that some successful Venture Capital funds have been drawn to raise ever-larger funds, requiring them to search for correspondingly larger investment opportunities. This 'gap' is often filled by angel investors as well as

¹ An **angel investor** or **angel** (known as a **business angel** or **informal investor** in Europe) is an affluent individual who provides capital for a business start-up, usually in exchange for convertible debt or ownership equity. A small but increasing number of angel investors organize themselves into **angel groups** or **angel networks** to share research and pool their investment capital.

equity investment companies who specialize in investments in startups from the range of \$250,000 to \$1M. The National Venture Capital association estimates that the latter now invest more than \$30 billion a year in the USA in contrast to the \$20 billion a year invested by organized Venture Capital funds.

In industries where assets can be securitized effectively because they reliably generate future revenue streams or have a good potential for resale in case of foreclosure, businesses may more cheaply be able to raise debt to finance their growth. Good examples would include asset-intensive extractive industries such as mining, or manufacturing industries. Offshore funding is provided via specialist venture capital trusts which seek to utilise securitization in structuring hybrid multi market transactions via an SPV (special purpose vehicle): a corporate entity that is designed solely for the purpose of the financing.

In addition to traditional venture capital and angel networks, groups have emerged which allow groups of small investors or entrepreneurs themselves to compete in a privatized business plan competition where the group itself serves as the investor through a democratic process.

Unlike public companies, information regarding an entrepreneur's business is typically confidential and proprietary. As part of the due diligence process, most venture capitalists will require significant detail with respect to a company's business plan. Entrepreneurs must remain vigilant about sharing information with venture capitalists that are investors in their competitors. Most venture capitalists treat information confidentially, however, as a matter of business practice, do not typically enter into Non Disclosure Agreements because of the potential liability issues those agreements entail. Entrepreneurs are typically well-advised to protect truly proprietary intellectual property.

Limited partners of venture capital firms typically have access only to limited amounts of information with respect to the individual portfolio companies in which they are invested and are typically bound by confidentiality provisions in the fund's limited partnership agreement.

Confidential information

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Methods of Venture Financing

Venture capital is typically available in three forms in India, they are:

Equity: All VCFs in India provide equity but generally their contribution does not exceed 49 percent of the total equity capital. Thus, the effective control and majority ownership of the firm remains with the entrepreneur. They buy shares of an enterprise with an intention to ultimately sell them off to make capital gains.

Conditional Loan: It is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India, VCFs charge royalty ranging between 2 to 15 percent; actual rate depends on other factors of the venture such as gestation period, cost-flow patterns, riskiness and other factors of the enterprise.

Income Note: It is a hybrid security, which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales, but at substantially low rates.

Other Financing Methods: A few venture capitalists, particularly in the private sector, have started introducing innovative financial securities like participating debentures, introduced by TCFC is an example.

OBJECTIVES

1. To provide the determined entrepreneur with information about the steps for obtaining venture capital financing.
2. To understand the application of Venture capital financing as a source of capital
3. To have an insight about the process of venture capital financing
4. To know the various terms and conditions while raising capital through venture capital
5. To understand the capital growth venture in India
6. To identify the current attitudes of venture capitalists and private equity investors around the world regarding international investing.
7. To understand the legal aspects of Venture capital and private equity Investment in India

DATA ANALYSIS

&

DATA INTERPRETATION

VENTURE CAPITAL ANALYSIS

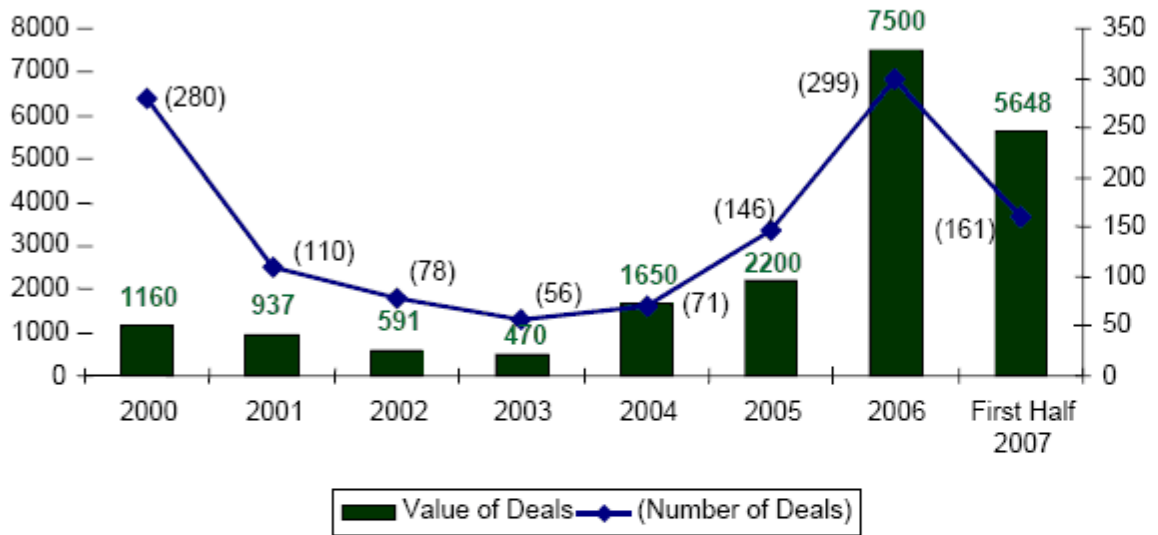
Setting the Stage - Venture Capital in India

1. Phase I - Formation of TDICI in the 80's and regional funds as GVFL & APIDC in the early 90s.
2. Phase II - Entry of Foreign Venture Capital funds (VCF) between 1995-1999
3. Phase III - (2000 onwards). Emergence of successful India-centric VC firms
4. Phase IV – (current) Global VCs and PE firms actively investing in India
5. 150 Funds active in the last 3 years (Government, Overseas, Corporate, Domestic)

The Opportunity

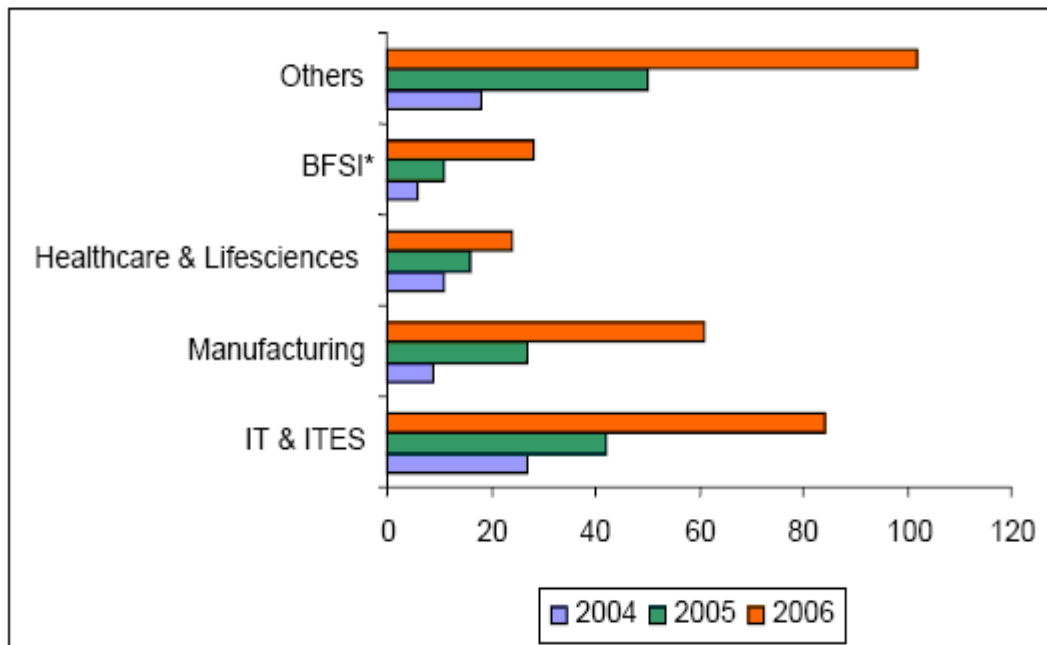
-
1. High Growth in Technology and Knowledge based Industries (KBI)
 2. KBI growing fast and mostly global, less affected by domestic issues.
 3. Several emerging centers of innovation – biotech, wireless, IT, semiconductor, pharmaceutical.
 4. Ability to build market leading companies in India that serve both global and domestic markets.
 5. India moving beyond supplier of low-cost services to higher-value products.
 6. Quality of entrepreneurship on ascending curve.

**Growth of Private Equity/Venture Capital in India
2000-1H2007 (US\$ millions)**



Investments by Sector

Number of Deals



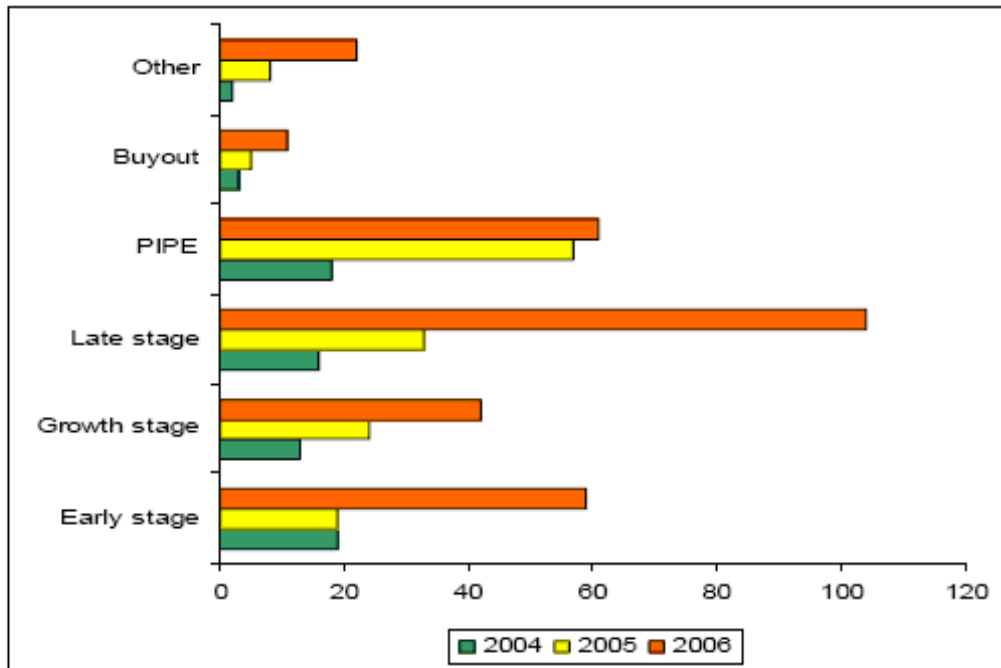
2006: Others

Textiles, garments, Media & Entertainment, Retail
Eng/Construction, Food & Beverage, Real Estate

*Banking, financial services & insurance

Investments by Stage

Number of Deals



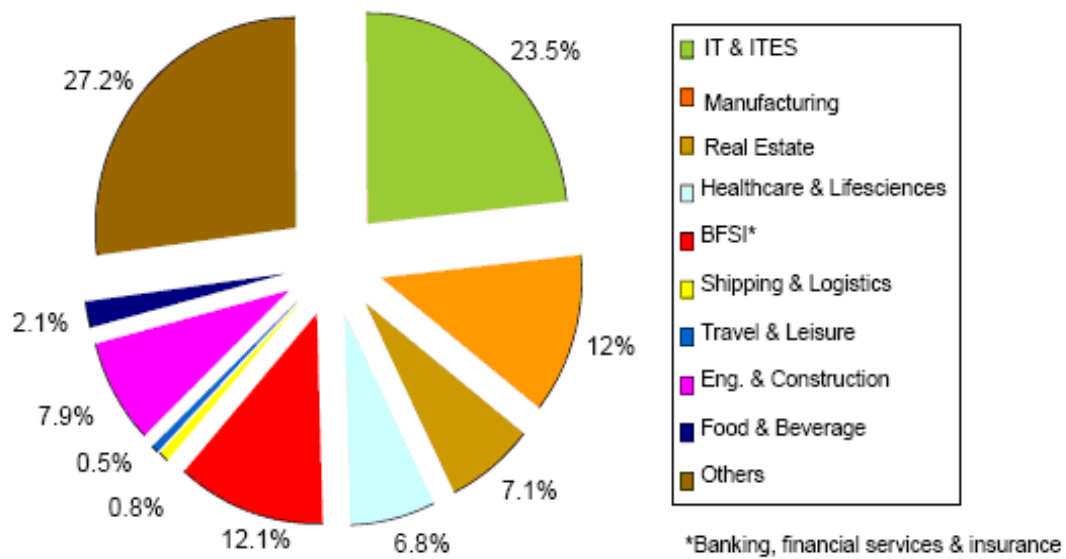
PIPE – Private investment in public equity

2006 Private Equity/Venture Capital Trends

1. US\$7.5bn invested in 2006 across 299 deals.
2. IT & ITES retained its status as the favorite industry among PE investors, followed by manufacturing and real estate.
3. Largest PE deal was \$900M LBO of Flextronics by Kohlberg Kravis Roberts (KKR).
4. M&A and IPO activity continued to remain strong.

2006 PE/VC investments by industry

Total US\$ 7.5Bn



Private Equity Investments by Stage: 2006

Stage of Company	No. of Deals	Amount (US\$M)
Early Stage	59	236
Growth Stage	42	393
Late Stage	104	3663
PIPE	61	1314
Buyout	11	1125
Others	22	769

- Late stage and PIPE deals accounted for ~70% of overall value of PE transactions (PIPE: banking, pharma, auto components)

Selected ES IT/ITES Investments 2006

Others: Animation services: Rich Crest, remote IT infrastructure management Microland; chip design firm InSilica

Company	Investors	Amount (US\$-M)	Sector
24x7 Learning	KITVEN, Individuals	10	Online education services
Travelguru	WestBridge (Sequoia)	10	Online travel services
People Infocom (Mauj)	WestBridge, Sequoia, Intel	10	Mobile Content
Secova	Barings PE	8	HR BPO
BillDesk	Clearstone, SIDBI, SBI	8	Online Services
Indium Software	Iris Capital	1	Software Testing
PharmARC	Baring PE	11	Marketing Analytics
AppLabs	Sequoia Capital	10	Software Testing
Bubble Motion	Sequoia Capital	10	Mobile VAS
Seventymm	Matrix Partners	7	Online movie rentals

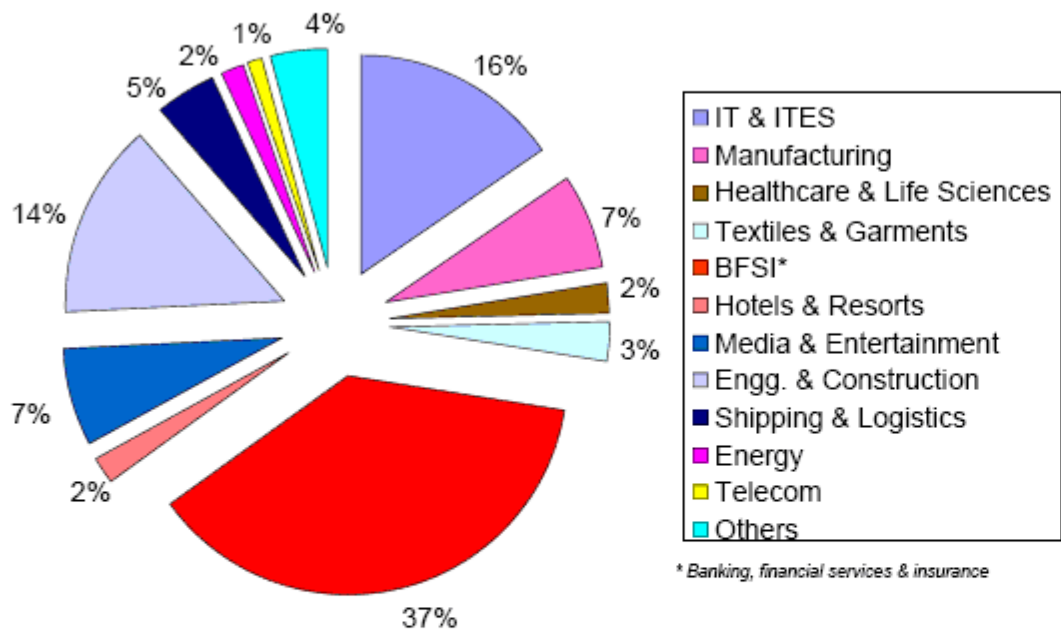
Selected IT/ITES Exits 2006

Company	Investors	Amount (US\$-M)	Acquirer	Sector
Mphasis	Baring PE	380 (for 52%)	EDS	BPO
Progeon	Citigroup	115	Infosys Tech	BPO
R Systems	Intel Capital, GE Capital	25	IPO	IT Services
OfficeTiger	RR Donnelly	250	RR Donnelly	BPO
CSS Group	SAIF	21	SAIF	IT Services
Allcargo	New Vernon, Volarado	32	IPO	Logistics

Top Cities Attracting Private Equity Investments (2006)

City	No. of Deals	Value(US\$M)
Mumbai	69	1,780
Delhi/NCR*	41	395
Bangalore	40	1,525
Chennai	22	354
Hyderabad	17	492
Pune	10	1,114

* National Capital Region

Private Equity/Venture Capital Investments by Industry**Total US\$ 5.6 Bn (First Half of 2007)**

Private Equity Investments by Stage: 2007**(First Half)**

Stage of Company	No. of Deals	Amount (US\$M)
Early Stage	24	154
Growth Stage	25	1082
Late Stage	67	2162
PIPE	34	1714
Buyout	6	440
Others	6	47

- Total number of deals: 162 with total amount invested at ~ US\$5.6B

Private Equity Investments by Stage: 2007

	No. of Deals	Value US \$M	% Share
IT & ITES	48	876	15.51%
Manufacturing	14	389	6.89%
Healthcare & Life Sciences	13	126	2.23%
Textiles & Garments	6	160	2.83%
BFSI*	26	2121	37.55%
Hotels & Resorts	3	104	1.84%
Media & Entertainment	9	413	7.31%
Engg. & Construction	13	812	14.38%
Shipping & Logistics	9	257	4.55%
Energy	3	98	1.74%
Telecom	2	50	0.89%
Others	16	242	4.28%

* Banking, financial services & insurance

162	5,648
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DATA INTERPRETATION

How does the Venture Capital Industry Work?

Venture capital firms typically source the majority of their funding from large investment institutions such as fund of funds, financial institutions, endowments, pension funds and banks. These institutions typically invest in a venture capital fund for a period of up to ten years.

To compensate for the long term commitment and lack of both security and liquidity, investment institutions expect to receive very high returns on their investment. Therefore venture capitalists invest in either companies with high growth potential where they are able to exit through either an IPO or a merger/acquisition. Although the venture capitalist may receive some return through dividends, their primary return on investment comes from capital gains when they eventually sell their shares in the company, typically between three to five years after the investment.

Venture capitalists are therefore in the business of promoting growth in the companies they invest in and managing the associated risk to protect and enhance their investors' capital.

Selecting the Venture Capital Investor

The members of the Indian Venture Capital Association comprise a number of venture capital firms in India. The IVCA Directory of Members provides basic information about each member's investment preferences and is available from the Association.

Prior to selecting a venture capitalist, the entrepreneur should study the particular

investment preferences set down by the venture capital firm. Often venture capitalists have preferences for particular stages of investment, amount of investment, industry sectors, and geographical location.

An investment in an private, unlisted company has a long-term horizon, typically 4-6 years. It is important to select venture capitalists with whom it is possible to have a good working relationship. Often businesses do not meet their cash-flow forecasts and require additional funds, so an investor's ability to invest in additional financing rounds if required is also important.

Finally, when choosing a venture capitalist, the entrepreneur should consider not just the amount and terms of investments, but also the additional value that the venture capitalist can bring to the company. These skills may include industry knowledge, fund raising, financial and strategic planning, recruitment of key personnel, mergers and acquisitions, and access to international markets and technology. Entrepreneurs should not hesitate to ask for references from investors.

What do VC's Look For?

Venture capitalists are higher risk investors and, in accepting these risks, they desire a higher return on their investment. The venture capitalist manages the risk/reward ratio by only investing in businesses which fit their investment criteria and after having completed extensive due diligence.

Venture capitalists have differing operating approaches. These differences may relate to location of the business, the size of the investment, the stage of the company, industry specialization, structure of the investment and involvement of the venture capitalists in the companies activities.

The entrepreneur should not be discouraged if one venture capitalist does not wish to

proceed with an investment in the company. The rejection may not be a reflection of the quality of the business, but rather a matter of the business not fitting with the venture capitalist's particular investment criteria. Often entrepreneurs may want to ask the venture capitalist for other firms that might be interested in the investment opportunity.

Venture capital is not suitable for all businesses, as a venture capitalist typically seeks :

Superior Businesses

Venture capitalists look for companies with superior products or services targeted at large, fast growing or untapped markets with a defensible strategic position such as intellectual property or patents.

Quality and Depth of Management

Venture capitalists must be confident that the firm has the quality and depth in the management team to achieve its aspirations. Venture capitalists seldom seek managerial control, rather they want to add value to the investment where they have particular skills including fund raising, mergers and acquisitions, international marketing, product development, and networks.

Appropriate Investment Structure

As well as the requirement of being an attractive business opportunity, the venture capitalist will also seek to structure a deal to produce the anticipated financial returns to investors. This includes making an investment at a reasonable price per share (valuation).

Exit Opportunity

Lastly, venture capitalists look for the clear exit opportunity for their investment such as public listing or a third party acquisition of the investee company.

Once a short list of appropriate venture capitalists has been selected, the entrepreneur can proceed to identify which investors match their funding requirements. At this point, the

entrepreneur should contact the venture capital firm and identify an investment manager as an initial contact point. The venture capital firm will ask prospective investee companies for information concerning the product or service, the market analysis, how the company operates, the investment required and how it is to be used, financial projections, and importantly questions about the management team.

In reality, all of the above questions should be answered in the Business Plan. Assuming the venture capitalist expresses interest in the investment opportunity, a good business plan is a pre-requisite.

The Business Plan

The Entrepreneur has to prepare a business plan for the Venture Capitalist to fund.

Venture capitalists view hundreds of business plans every year. The business plan must therefore convince the venture capitalist that the company and the management team have the ability to achieve the goals of the company within the specified time.

The business plan should explain the nature of the company's business, what it wants to achieve and how it is going to do it. The company's management should prepare the plan and they should set challenging but achievable goals.

The length of the business plan depends on the particular circumstances but, as a general rule, it should be no longer than 25-30 pages. It is important to use plain English, especially if you are explaining technical details. Aim the business plan at non-specialists, emphasising its financial viability.

Avoid jargon and general position statements.

Essential areas to cover in your business plan

Executive Summary

This is the most important section and is often best written last. It summarises your business plan and is placed at the front of the document. It is vital to give this summary significant thought and time, as it may well determine the amount of consideration the venture capital investor will give to your detailed proposal.

It should be clearly written and powerfully persuasive, yet balance "sales talk" with realism in order to be convincing. It should be limited to no more than two pages and include the key elements of the business plan.

1. Background on the company

Provide a summary of the fundamental nature of the company and its activities, a brief history of the company and an outline of the company's objectives.

2. The product or service

Explain the company's product or service. This is especially important if the product or service is technically orientated. A non-specialist must be able to understand the plan.

- Emphasise the product or service's competitive edge or unique selling point.
- Describe the stage of development of the product or service (seed, early stage, expansion). Is there an opportunity to develop a second-generation product in due course? Is the product or service vulnerable to technological redundancy?
- If relevant, explain what legal protection you have on the product, such as patents attained, pending or required. Assess the impact of legal protection on the marketability of the product.

3. Market analysis

The entrepreneur needs to convince the venture capital firm that there is a real commercial opportunity for the business and its products and services. Provide the reader

a combination of clear description and analysis, including a realistic "SWOT" (strengths, weaknesses, opportunities and threats) analysis.

- Define your market and explain in what industry sector your company operates. What is the size of the whole market? What are the prospects for this market? How developed is the market as a whole, i.e. developing, growing, mature, declining?
- How does your company fit within this market? Who are your competitors? For what proportion of the market do they account? What is their strategic positioning? What are their strengths and weaknesses? What are the barriers to new entrants?
- Describe the distribution channels. Who are your customers? How many are there? What is their value to the company now? Comment on the price sensitivity of the market.
- Explain the historic problems faced by the business and its products or services in the market. Have these problems been overcome, and if so, how? Address the current issues, concerns and risks affecting your business and the industry in which it operates. What are your projections for the company and the market? Assess future potential problems and how they will be tackled, minimised or avoided.

4. Marketing

Having defined the relevant market and its opportunities, it is necessary to address how the prospective business will exploit these opportunities.

- Outline your sales and distribution strategy. What is your planned sales force? What are your strategies for different markets? What distribution channels are you planning to use and how do these compare with your competitors? Identify overseas market access issues and how these will be resolved.
- What is your pricing strategy? How does this compare with your competitors?
- What are your advertising, public relations and promotion plans?

5. The management team

Demonstrate that the company has the quality of management to be able to turn the business plan into reality.

- The senior management team ideally should be experienced in complementary areas, such as management strategy, finance and marketing, and their roles should be specified. The special abilities each member brings to the venture should be explained. A concise curriculum vitae should be included for each team member, highlighting the individual's previous track record in running, or being involved with, successful businesses.
- Identify the current and potential skills gaps and explain how you aim to fill them. Venture capital firms will sometimes assist in locating experienced managers where an important post is unfilled - provided they are convinced about the other aspects of your plan.
- List your advisers and board members.
- Include an organisation chart.

6. Financial projections

The following should be considered in the financial aspect to your business plan:

- Realistically assess sales, costs (both fixed and variable), cash flow and working capital. Produce a profit and loss statement and balance sheet. Ensure these are easy to update and adjust. Assess your present and prospective future margins in detail, bearing in mind the potential impact of competition.
- Explain the research undertaken to support these assumptions.
- Demonstrate the company's growth prospects over, for example, a three to five year period. • What are the costs associated with the business? What are the sale prices or fee charging structures?
- What are your budgets for each area of your company's activities?

- Present different scenarios for the financial projections of sales, costs and cash flow for both the short and long term. Ask "what if?" questions to ensure that key factors and their impact on the financings required are carefully and realistically assessed. For example, what if sales decline by 20%, or supplier costs increase by 30%, or both? How does this impact on the profit and cash flow projections?
- If it is envisioned that more than one round of financing will be required (often the case with technology based businesses in particular), identify the likely timing and any associated progress "milestones" or goals which need to be achieved.
- Keep the plan feasible. Avoid being overly optimistic. Highlight challenges and show how they will be met.

Relevant historical financial performance should also be presented. The company's historical achievements can help give meaning, context and credibility to future projections.

7. Amount and use of finance required and exit opportunities State how much finance is required by your business and from what sources (i.e. management, venture capital, banks and others) and explain the purpose for which it will be applied.

Consider how the venture capital investors will exit the investment and make a return. Possible exit strategies for the investors may include floating the company on a stock exchange or selling the company to a trade buyer.

The Investment Process

The investment process begins with the venture capitalist conducting an initial review of the proposal to determine if it fits with the firm's investment criteria. If so, a meeting will be arranged with the entrepreneur/management team to discuss the business plan.

Preliminary Screening

The initial meeting provides an opportunity for the venture capitalist to meet with the entrepreneur and key members of the management team to review the business plan and conduct initial due diligence on the project. It is an important time for the management team to demonstrate their understanding of their business and ability to achieve the strategies outlined in the plan. The venture capitalist will look carefully at the team's functional skills and backgrounds.

Negotiating Investment

This involves an agreement between the venture capitalist and management of the terms of the term sheet, often called memorandum of understanding (MoU). The venture capitalist will then proceed to study the viability of the market to estimate its potential. Often they use market forecasts which have been independently prepared by industry experts who specialise in estimating the size and growth rates of markets and market segments.

The venture capitalist also studies the industry carefully to obtain information about competitors, entry barriers, potential to exploit substantial niches, product life cycles, and distribution channels. The due diligence may continue with reports from other consultants.

Approvals and Investment Completed

The process involves due diligence and disclosure of all relevant business information. Final terms can then be negotiated and an investment proposal is typically submitted to the venture capital fund's board of directors. If approved, legal documents are prepared.

The investment process can take up to two months, and sometimes longer. It is important therefore not to expect a speedy response. It is advisable to plan the business financial needs early on to allow appropriate time to secure the required funding.

Risk and return

A widespread misconception concerning financial partnerships is that they provide cheap capital. On the contrary, the financial funds evaluate these investments as more risky compared with an investment into a quoted firm or a firm with financing capabilities and request a higher return to compensate for their investments. From the view of the investee company, the financing risk is less than debt financing. The banks have strict payment terms, whereas the financial funds share the upside potential of investee companies, are more flexible and do not put companies under rigorous obligations. The ultimate goal of the financial fund is to successfully capitalise its investment after an investment period of two to five years and accomplish a profitable exit through an IPO or a strategic sale. In rare occasions, assuming that the invested company has generated a significant cash flow, the sale of the shares to the shareholders might also be an exit strategy.

Structure of financial funds

Similar to the intermediary role of banks in the transmission of deposits and other resources to the industry in the form of credits, financial funds act as the intermediary between the investors and investee companies.

The relationship between the investor and the fund is established in accordance with the structure and terms of the fund. The most common form of these funds emerges as limited partnerships. For instance, to form a financial fund of \$50m, the management company invests a capital of \$1m as the major shareholder while the pension funds, insurance companies, and other fund management companies provide the remaining \$49m as the limited partners. The management company receives two per cent of the fund as the annual management fee and is entitled to a success fee (carried interest) of around 20 per cent for a return exceeding a specific level of around ten per cent. If the \$50m fund grows into \$120m in four years after the payment of the management fee, the management company will receive a total management fee of \$4m ($\$1m \times 4$), and a success fee of $(120 - 50 (1.1)^4) \times 0.2 = \$9.3m$. The management company will furthermore

earn \$2.2m in return for its investment of \$1m. As a result, the management company will make a total return of \$14.5m with an investment of \$1m. The investors will earn a return of 220 per cent over an investment period of four years.

The limited partnership is the most ideal financial fund management structure avoiding possible conflicts of interest between the fund managers and limited partners, and aligning the incentives of the parties with each other. The fund managers will devote their best efforts to earn a satisfying return on their own investments and receive the highest success but more important than that, to appeal more investors for their subsequent funds. Apart from the widely approved limited partnership structure, there are also various financial funds managed by large conglomerates and/or open to the public.

Methods of Venture Financing

Venture capital is typically available in three forms in India, they are:

Equity : All VCFs in India provide equity but generally their contribution does not exceed 49 percent of the total equity capital. Thus, the effective control and majority ownership of the firm remains with the entrepreneur. They buy shares of an enterprise with an intention to ultimately sell them off to make capital gains.

Conditional Loan: It is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India, VCFs charge royalty ranging between 2 to 15 percent; actual rate depends on other factors of the venture such as gestation period, cost-flow patterns, riskiness and other factors of the enterprise.

Income Note : It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales, but at substantially low rates.

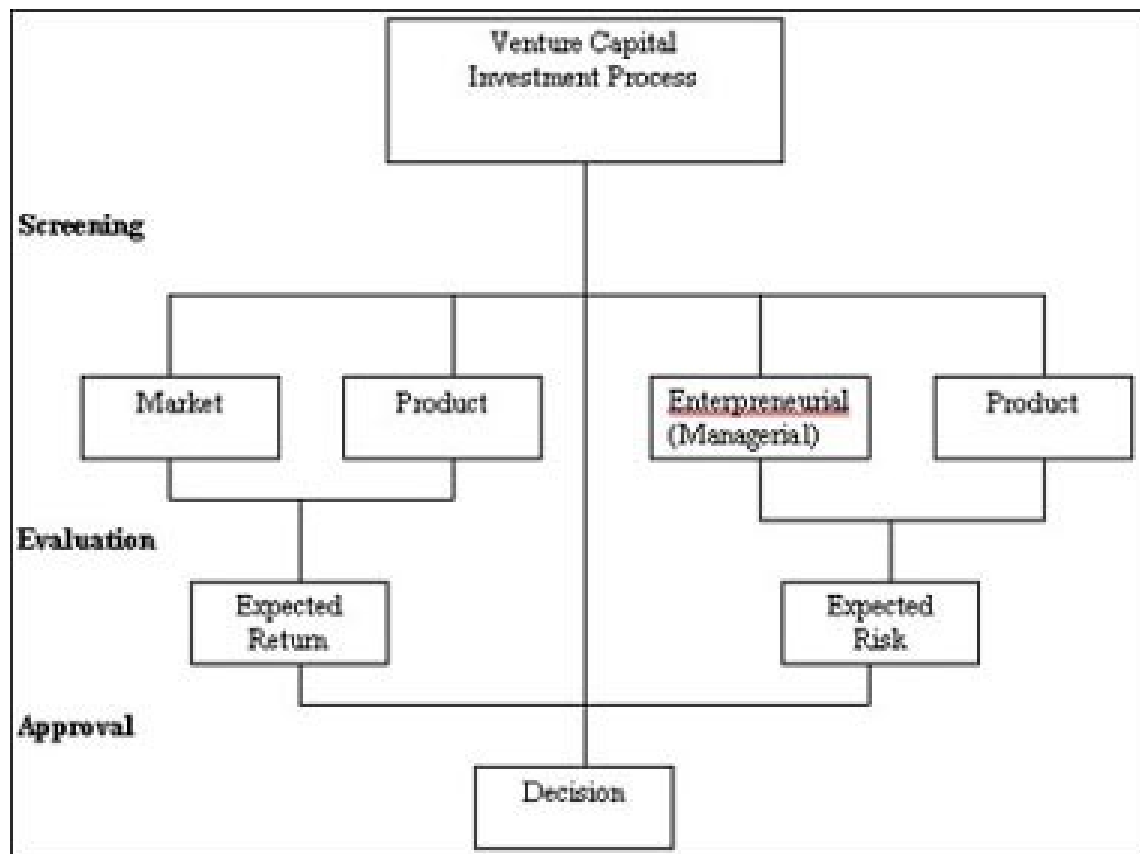
Other Financing Methods: A few venture capitalists, particularly in the private sector, have started introducing innovative financial securities like participating debentures, introduced by TCFC is an example.

Investment

Process

Financial funds keep the following route in the investment process:

- Project search
- Project pre-elimination
- Project evaluation
- Negotiations, pricing
- Deal structuring
- Due diligence
- Closing
- Audit, managerial support
- Exit



Deal origination:

In generating a deal flow, the VC investor creates a pipeline of deals or investment opportunities that he would consider for investing in. Deal may originate in various ways. referral system, active search system, and intermediaries. Referral system is an important source of deals. Deals may be referred to VCFs by their parent organisations, trade partners, industry associations, friends etc. Another deal flow is active search through networks, trade fairs, conferences, seminars, foreign visits etc. Intermediaries is used by venture capitalists in developed countries like USA, is certain intermediaries who match VCFs and the potential entrepreneurs.

Screening:

VCFs, before going for an in-depth analysis, carry out initial screening of all projects on the basis of some broad criteria. For example, the screening process may limit projects to

areas in which the venture capitalist is familiar in terms of technology, or product, or market scope. The size of investment, geographical location and stage of financing could also be used as the broad screening criteria.

Due Diligence:

Due diligence is the industry jargon for all the activities that are associated with evaluating an investment proposal. The venture capitalists evaluate the quality of entrepreneur before appraising the characteristics of the product, market or technology. Most venture capitalists ask for a business plan to make an assessment of the possible risk and return on the venture. Business plan contains detailed information about the proposed venture. The evaluation of ventures by VCFs in India includes;

Preliminary evaluation: The applicant required to provide a brief profile of the proposed venture to establish prima facie eligibility.

Detailed evaluation: Once the preliminary evaluation is over, the proposal is evaluated in greater detail. VCFs in India expect the entrepreneur to have:- Integrity, long-term vision, urge to grow, managerial skills, commercial orientation.

VCFs in India also make the risk analysis of the proposed projects which includes: Product risk, Market risk, Technological risk and Entrepreneurial risk. The final decision is taken in terms of the expected risk-return trade-off as shown in Figure.

Deal Structuring:

In this process, the venture capitalist and the venture company negotiate the terms of the deals, that is, the amount, form and price of the investment. This process is termed as deal structuring. The agreement also include the venture capitalist's right to control the venture company and to change its management if needed, buyback arrangements, acquisition, making initial public offerings (IPOs), etc. Earned out arrangements specify the entrepreneur's equity share and the objectives to be achieved.

Post Investment Activities:

Once the deal has been structured and agreement finalised, the venture capitalist generally assumes the role of a partner and collaborator. He also gets involved in shaping of the direction of the venture. The degree of the venture capitalist's involvement depends on his policy. It may not, however, be desirable for a venture capitalist to get involved in the day-to-day operation of the venture. If a financial or managerial crisis occurs, the venture capitalist may intervene, and even install a new management team.

Exit:

Venture capitalists generally want to cash-out their gains in five to ten years after the initial investment. They play a positive role in directing the company towards particular exit routes. A venture may exit in one of the following ways:

1. Initial Public Offerings (IPOs)
2. Acquisition by another company
3. Purchase of the venture capitalist's shares by the promoter, or
4. Purchase of the venture capitalist's share by an outsider.

The financial funds would evaluate the firms, which they identify or approached by the firm directly. However they usually prefer firms presented by respected intermediaries and financial consultants, which have pre-evaluated the opportunity, prepare the company for the process and present the deal in a well-structured format. The financial consultants provide assistance to the companies in the preparation of the business plan and related selling documents, computation of the firm value on which the negotiations will be based and in all the other stages until closing. The financial consultancy services in Turkey are offered by corporate finance departments of several commercial and investment banks, accounting firms, and consultancy firms.

A financial fund reviews roughly 100 projects in a year; around ten projects proceed to the negotiation stage while only one to two of them are finalised. Therefore, it's rational to approach several funds simultaneously while seeking capital for a firm/project to increase the possibility of success.

The financial funds have varying expectations, investment criteria, and concentration areas. Some funds look for IT and telecom firms, some search for companies manufacturing to the end-users, and some are concentrated in the service business.

It is of significant prominence to present the company/the project to the financial fund in a thorough and well-conceived format since there will barely be a second chance considering the large number of projects presented. The preparation stage might take some weeks or extend to a couple years in some cases. The preparations for the final presentation of the firm will take a couple of weeks assuming that the company is already structured for the process. The companies would rather establish an effective MIS system and keep their records properly since there is always a possibility that the company might need the support of a financial fund in the future.

The arrangement of a company profile analysing the sector, company's operations, facilities, production, products, suppliers, customers, financials, and projections is a crucial step in the presentation of the firm to the financial fund. The history and current status of the company should be emphasised no less than the future of the company in the selling documents, company profile, info memo, and financial analysis. Concerning a newly established firm, the company profile will be much like a business plan stressing the prospects. It should also be noted that financial funds assign more emphasis on a proficient management than a bright idea or a promising sector.

The companies, which could stand out in the pre-evaluation phase will follow through a long due-diligence and negotiation process. This stage might continue for months and will be a tough period for the company. The company should be aware that it has to commit considerable management time and some of its resources for the project.

The company valuation is executed via discounted cash flow and comparative analysis with market indicators. In some cases, the funds base their pricing on the exit projections. To exemplify, if the net profit of a company at the end of the third year is forecasted as \$5m and a P/E ratio of ten is a reasonable estimate for a public offering, a fund with an investment of \$10m and an annual return expectation of 30 per cent will have 43.9 per cent of the company (The expected value of investment after three years/ The expected value of the company after three years = $10 \times 1.33 / 5 \times 10$).

After the parties have agreed on the price, legal, financial and technical due-diligences are performed. In the closing stage, obligatory approvals, like anti-competition, foreign investment should be received. In the meantime, share purchase and shareholder agreements are drafted and finalised, articles of association are revised, and related employment, non-competition and confidentiality agreements are signed with the management. The cash transfers and deal structuring should be made in a way that minimises the risks and tax obligations. The contracts and deal structure are as important as the price in many deals.

In this tough process, the companies should cooperate with prominent financial and legal consultants to negotiate the rigorous terms proposed by some funds. For example, the risk profile of the project will totally change if the fund will have the right to sell back its shares after a certain period at a pre-determined return or will have the right to sell its shares to another investor without restrictions.

Although the contracts are the major guides in the resolution of disputes, funds and companies establish partnerships based on mutual trust. It's important to stress that both parties will share the same interest and prospects after the establishment of a partnership.

Pursuant to the closing and injection of the funds into the company, the relationship between the fund and the company will enter a new period. The fund will continue to monitor the company closely to protect its rights and contribute to the performance of the company. The fund will keep representatives in the board of directors, the company will regularly inform the fund regarding the operations, and consult for specific decisions. The

funds are usually not involved in the daily operations of the company but focus on long-term performance.

The major distinction between private equity, venture capital funds and other financing alternatives is the assistance provided by funds in management, recruitment, institutionalisation, strategic planning, and the establishment of contacts with customers, suppliers, bankers, and lawyers. Incubators also offer office, equipment, legal and financial support to project owners and cooperate with them to present their projects to venture capital funds. Some incubators function as venture capital funds.

A profitable exit constitutes the final step of the investment process. The main exit mechanisms are IPO and strategic sale. The heightened interests of foreign investors to Turkey, advancement of capital markets, increasing market capitalisation, and favourable IPO prospects will facilitate the exit procedure and enhance returns. Therefore, the interest of funds to the Turkish market is closely related with the politic and macroeconomic developments.

Benefits for the company

The financial partnership will enable the company to strengthen its capital structure, get rid of risky and high cost loans, satisfy working capital requirements, undertake the deferred investments, and to act more flexible and aggressive in M&A activities. The conventional argument that the funds, after a thorough analysis, invest into reliable and promising companies will promote the image of the company in the eyes of the banks, customers, and suppliers and release positive signals to the market. The pace of institutionalisation will accelerate; establishment of effective financial and operational reporting systems together with improving transparency will make the company more attractive for other investors in the future. The managerial support and contacts provided by funds will speed up this process.

Need for economies of scale and scope, increased global competition are putting a pressure on smaller firms to grow, to make international and local partnerships. The

companies isolated from capital markets and financial funds will encounter a stiff competition, their market positions will be ruined and long-term survival will be jeopardised. The prominent companies will be selected by the financial funds, as well as capital markets, while the others will gradually vanish. Thus funds will help the consolidation process either via roll-ups merging a number of small firms with each other or by strengthening the selected ones relative to others.

Global private equity and venture capital activities

As previously mentioned, financial funds expand at a groundbreaking rate. The resources channelled to the venture capital funds increased from \$3bn in 1990 to \$10bn in 1996, and boosted to \$55bn in 1999. The swift fund accumulation is primarily attributable to the spectacular returns of venture capital funds. The average venture capital investment returns in the period between 1994 and 1999 are 44 per cent, 34 per cent, 28 per cent, 18 per cent, and 147 per cent. These returns are extremely high in comparison to other investment alternatives. The underlying reason behind the high returns is the rally of hi-tech firms in the stock exchanges and appetite of investors for technology IPOs in NASDAQ, especially the IPO of firms with no bottom-line performance but great expectations. In 1990, 80 per cent of the firms offered to the public were profitable in the previous year before the IPO, whereas this ratio steadily declined to 59 per cent in 1998 and 20 per cent in 1999. From another point of view, the abundance of venture capital funds allowed these companies to realise public offerings.

Until recent years, the growth of private equity funds outperformed that of venture capital funds. The total size of private equity funds was less than the total size of venture capital funds in 1980 but private equity funds doubled venture capital funds in 1994. A review of the European and emerging markets reveal that the venture capital investments fall behind private equity investments. The funds have a material size and prefer companies with a track record.

The major reasons mentioned for the rapid growth of private equity funds and particularly outside the US are the risk averse nature of investors, fund managers with finance backgrounds, who lack entrepreneurship, the lower level of managerial support, less manager time committed in private equity projects, and the higher efficiency ratio due to the larger size projects. Furthermore, the weakness of a legislative framework, inadequate protection of minority rights, and lack of entrepreneurship and technological development hamper early stage venture capital investments. This trend reverted in the recent years with the boom in technology and the rise of technology focused venture capital funds is followed in US and other markets.

INDIAN SCENARIO

Venture Capital in India

In India the Venture Capital plays a vital role in the development and growth of innovative entrepreneurships. Venture Capital activity in the past was possibly done by the developmental financial institutions like IDBI, ICICI and State Financial Corporations. These institutions promoted entities in the private sector with debt as an instrument of funding. For a long time funds raised from public were used as a source of Venture Capital. This source however depended a lot on the market vagaries. And with the minimum paid up capital requirements being raised for listing at the stock exchanges, it became difficult for smaller firms with viable projects to raise funds from public. In India, the need for Venture Capital was recognised in the 7th five year plan and long term fiscal policy of GOI. In 1973 a committee on Development of small and medium enterprises highlighted the need to faster VC as a source of funding new entrepreneurs and technology. VC financing really started in India in 1988 with the formation of

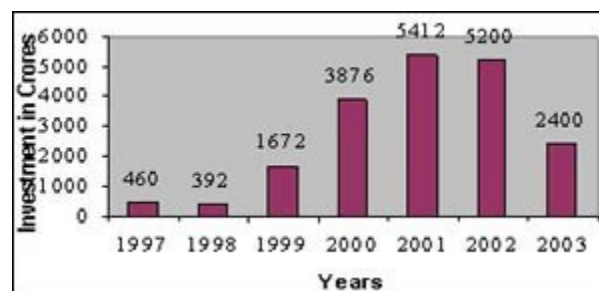
Technology Development and Information Company of India Ltd. (TDICI) - promoted by ICICI and UTI. The first private VC fund was sponsored by Credit Capital Finance Corporation (CFC) and promoted by Bank of India, Asian Development Bank and the Commonwealth Development Corporation viz. Credit Capital Venture Fund. At the same time Gujarat Venture Finance Ltd. and APIDC Venture Capital Ltd. were started by state level financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high net-worth individuals. The venture capital funds in India are listed in Annexure I.

Venture Capital Investments in India

The venture capital investment in India till the year 2001 was continuously increased and thereby drastically reduced. Chart I shows that there was a tremendous growth by almost 327 percent in 1998-99, 132 percent in 1999-00, and 40 percent in 2000-01 there after venture capital investors slow down their investment. Surprisingly, there was a negative growth of 4 percent in 2001-02 it was continued and a 54 percent drastic reduction was recorded in the year 2002-2003.

Chart I

Venture Capital Investments



Source: The Economic Times

SEBI Venture Capital Funds (VCFs) Regulations, 1996

A Venture Capital Fund means a fund established in the form of a trust/company; including a body corporate, and registered with SEBI which (i) has a dedicated pool of capital raised in a manner specified in the regulations and (ii) invests in venture capital undertakings (VCUs) in accordance with these regulations.

A Venture Capital Undertaking means a domestic company (i) whose shares are not listed on a recognised stock exchange in India and (ii) which is engaged in the business of providing services/production/manufacture of articles/things but does not include such activities/sectors as are specified in the negative list by SEBI with government approval- namely, real estate, non-banking financial companies (NBFCs), gold financing, activities not permitted under the industrial policy of the Government and any other activity which may be specified by SEBI in consultation with the Government from time to time.

SEBI (Venture capital funds) Regulations 1996

The venture capital fund regulations by the Securities and Exchange Board of India are a comprehensive set of laws to be followed by the venture capital funds in India. From the registration of venture capital funds to the action to be taken in case of default, the regulation has been divided in VI chapters.

Registration Of Venture Capital Funds

A Venture capital fund can either be a fund established as a trust under the Indian trust act or a company as defined under companies act 1956.

The regulations provided for the registration of a company or a trust which either was functioning as a venture capital fund before the commencement of this act or proposed to do so after the commencement of this act.

A company or trust (which functioned as a venture capital fund before the commencement of these regulations) shall cease to function as a venture capital fund if it

does not apply to SEBI for registration within 3 months from the commencement of the regulations.

i) An application for grant of certificate to be made to SEBI in Form A along with a fee of Rs.25,000. The fee shall be paid through a draft.

ii) There are certain conditions which must be fulfilled before the certificate of registration is granted by SEBI:

a) In case of a company, the MOA of the company shall have the business of venture capital fund as its main object, and invitation to public shall be expressly barred by the MOA and AOA, in addition to this, any officer of the company shall be involved in any litigation connected to the security market or should not have been convicted of an economic offence.

b) In case of a trust, the trust is in form of a deed and has been duly registered under the Indian registration act. Carrying the business of venture capital fund is its primary objective. Any trustee of the trust is not involved in a litigation connected to security market and has not been convicted of any economic offence.

c) In case of a body corporate, it should be formed under the laws of central or state legislature and it is permitted to venture in the field of venture capital funds.

iii) The application for registration shall be complete in all respect. If SEBI discovers any thing in the application that renders it incomplete, it shall give the applicant a time of thirty days to remove the loophole, failing which the application can be rejected by the board.

iv) SEBI after finding the applicant to be eligible, shall inform the applicant about it, after receiving the information the applicant shall tender to SEBI the registration fee which is Rs.5 lacs, after receiving which SEBI shall issue the Certificate of registration.

Conditions and Restrictions On Investments

The regulation has applied a lot of condition and restriction to the amount of investment to be made in and by the venture capital fund in India.

An investment in the venture capital fund can be made by any person whether Indian, Foreigner or NRI, but no investment which is less than Rs.5 lacs can be allowed in the venture capital fund this however does not apply to investment made by the employees, directors or the principal officers of the company or by the trustee where the venture capital fund is a trust.

The investment strategy at the time of registration shall be disclosed by the venture capital fund. The venture capital fund shall also disclose the duration of its life cycle. Not more than 25% of the fund shall be invested in a single venture capital undertaking. Investment to be made in the following manner:

- i) At least 66.67% of the fund to be invested shall be invested in unlisted equity shares or other instruments linked to equity shares of the venture capital undertaking.
- ii) Not more than 33.33% of the investible fund shall be invested by the way of IPO of a venture capital undertaking whose shares are proposed to be listed, the debt instrument of the venture capital undertaking in which the venture capital fund has already invested, preferential allotment of equity shares of a listed company, equity shares or equity linked instrument of a financially weak company and SPV's which have been created by the venture capital fund..

No venture capital fund shall get its units listed on any recognized stock exchange till the expiry of three years from the date when they were issued to the investors by the venture capital fund. The venture capital funds shall also not invite any member of the public by way of advertisement to subscribe to its units. The venture capital fund may receive investments only through private placements of its units.

Placement Memorandum or Subscription Agreement

Every venture capital fund shall issue a placement memorandum which contains all the terms and conditions' relating to the scheme through which money is proposed to be raised from the investors. The venture capital fund may also enter into a subscription agreement with the investors which would specify the terms and conditions of the scheme through which money is proposed to be raised. The venture capital fund shall submit a copy of such placement memorandum or subscription agreement with SEBI along with the report of the money actually raised through such agreement or memorandum. The placement memorandum or the subscription agreement shall have the follow

It shall contain the details of the trustee and the trust as well as the details of the directors and the principal officers of the venture capital fund. It shall also state the minimum amount of money to be raised to start the venture capital fund and the minimum share to be invested in every scheme of the venture capital funds. Tax implications which would be applied to the investors shall also be stated. The manner of subscription to the units of the fund, the period of maturity of the fund if any and the manner in which the fund would be wound up shall also be stated.

Every venture capital fund shall maintain a book of record for a period of eight years which would generate the true picture of the venture capital fund. SEBI at any time can call for information regarding the working of the venture capital fund, the information shall be submitted to SEBI in the specified time period.

Investigation

SEBI on receiving a complaint from the investors appoint one or more person as investigating officer, who would undertake investigation in relation to the maintenance of the account books of the venture capital fund, compliance of the regulation and the affairs of venture capital funds. A notice of at least ten days shall be given before the investigation is carried on though if SEBI deems it to be in interest of the investors it may not serve a notice at all. It shall be the duty of every officer of the venture capital fund to cooperate with the investigation officers, they shall be provided with all the documents,

books etc which are in the custody of the officers of the venture capital fund. The investigation officer shall also be furnished with any statement he demands for. After the completion of investigation the investigation officer shall submit his report to SEBI. The board after considering the investigation and giving the venture capital fund to be heard may direct the venture capital fund not to launch new schemes or prohibiting the concerned person from disposing off the property of the venture capital fund or to refund to any investor any amount of money or asset.

Action In Case Of Default

Any venture capital fund that fails to act in accordance with the regulations, or fails to furnish reports of the affairs of the venture capital fund to SEBI or furnishes report that is not true, does not cooperate in any enquiry instituted by SEBI or fails to act on the complaints made by the investors or does not give a satisfactory reply in this regard to SEBI, shall be dealt with in manner provided in SEBI (procedures for holding enquiry by enquiry officers and imposing penalty) regulations, 2002

Recommendations of SEBI (Chandrasekhar) Committee, 2000 SEBI appointed the Chandrasekhar Committee to identify the impediments in the growth of venture capital industry in the country and suggest suitable measures for its rapid growth. Its report was submitted in January, 2000. The recommendations pertain to

1. Harmonisation of multiplicity of regulations
2. VCF structures
3. Resource raising
4. Investments
5. Exit
6. SEBI regulations
7. Company law related issues and
8. Other related issues.

Types of Venture Capital Funds

Generally there are three types of organised or institutional venture capital funds: venture capital funds set up by angel investors, that is, high net worth individual investors; venture capital subsidiaries of corporations and private venture capital firms/ funds. Venture capital subsidiaries are established by major corporations, commercial bank holding companies and other financial institutions. Venture funds in India can be classified on the basis of the type of promoters.

- 1 . VCFs promoted by the Central govt. controlled development financial institutions such as TDICI, by ICICI, Risk capital and Technology Finance Corporation Limited (RCTFC) by the Industrial Finance Corporation of India (IFCI) and Risk Capital Fund by IDBI.
2. VCFs promoted by the state government-controlled development finance institutions such as Andhra Pradesh Venture Capital Limited (APVCL) by Andhra Pradesh State Finance Corporation (APSFC) and Gujarat Venture Finance Company Limited (GVCFL) by Gujarat Industrial Investment Corporation (GIIC)
3. VCFs promoted by Public Sector banks such as Canfina by Canara Bank and SBI-Cap by State Bank of India.
4. VCFs promoted by the foreign banks or private sector companies and financial institutions such as Indus Venture Fund, Credit Capital Venture Fund and Grindlay's India Development Fund.

It is popularly believed that venture capitalists fund only established players and proven products. There is a lot of cynicism amongst many about all the hype that private equity and venture capital is getting in India of late.

However, the truth is that, in recent times in India, the VCs have actually provided capital to relatively new, start-up companies that have a reasonable, though not certain, prospects

to develop into highly profitable ventures. Travelguru.com is a case in point, funded by Sequoia Capital and Battery Ventures.

The advent of firms like Helion Ventures with a \$140 million corpus is helping the VC scenario to improve in the country. The three key people behind Helion Ventures, Ashish Gupta, Sanjeev Aggarwal and Kanwaljit Singh, all carry with them a successful track record across various companies in the international arena.

What is interesting is that for first time in India, venture capital will be backed by successful entrepreneurs who themselves have a hands-on experience in handling and developing businesses.

Innovation is the key driver of competitiveness within organisations as well as within countries. It has been well said: "Nothing is more powerful than an idea whose time has come." However, innovative ideas need more than research and knowledge to succeed.

They need not only financial, but also, managerial (technical, marketing and HR), support to achieve success. This support is lent in many forms by private funding and incubation organisations such as venture capitalists.

Akhil Gupta, JMD & CFO of Bharti Airtel, once remarked, "While we could have raised funding from other sources, Warburg Pincus' involvement helped us in scaling up significantly." Almost identical has been the findings of a research conducted recently by Venture Intelligence (founded by Arun Natarajan, a leading provider of information and networking services to the private equity and venture capital ecosystem in India) with the guidance of Prof. Amit Bubna of Indian School of Business, Hyderabad, to study the economic impact of PE and VCs on the Indian businesses.

The following are some of the interesting observations of this study:

- The study shows that the PE and VC backed companies grew faster compared to the non-PE backed peers and even better than the benchmark indices like the NSE

Nifty. They found that the sales of listed PE-backed companies grew at 22.9% as compared to 10% for non-PE-backed listed firms.

- PE backed firms added more jobs to the economy and even the wages at listed PE financed firms grew at around 32% as compared to 6% for non-PE-backed firms.
- An astonishing finding was that almost 96% of the top executives felt that without the support and the backing of private equity these companies would not have existed or would have grown at a slower rate, while only about 4% felt that they would have developed the same way even without PE funding.
- The study also shows that the biggest support of the PE investors were provided in the area of strategic direction followed by the financial advice and then recruitment and the marketing activities.

Thus venture capital has become an important source of finance for innovative ideas that are risky and have a potential for high returns over a long-term horizon. Venture capitalist investment is driven by the expectation that the start-ups invested in could give them a higher rate of return than other firms.

In the process venture capitalists have created some of the best known companies in the world. Without VCs we might not have seen companies such as Apple, Compaq, Sun Microsystems, and Intel to name a few.

Some of the unique features of a VC firm are:

- **Investment in high-risk, high-returns ventures:** As VCs invest in untested, innovative ideas the investments entail high risks. In return, they expect a much higher return than usual. (Internal Rate of return expected is generally in the range of 25 per cent to 40 per cent).
- **Participation in management:** Besides providing finance, venture capitalists may also provide technical, marketing and strategic support. To safeguard their investment, they may also at times expect participation in management.
- **Expertise in managing funds:** VCs generally invest in particular type of industries or some of them invest in particular type of businesses and hence have

a prior experience and contacts in the specific industry which gives them an expertise in better management of the funds deployed.

- **Raises funds from several sources:** A misconception among people is that venture capitalists are rich individuals who come together in a partnership. In fact, VCs are not necessarily rich and almost always deal with funds raised mainly from others. The various sources of funds are rich individuals, other investment funds, pension funds, endowment funds, et cetera, in addition to their own funds, if any.
- **Diversification of the portfolio:** VCs reduce the risk of venture investing by developing a portfolio of companies and the norm followed by them is same as the portfolio managers, that is, not to put all the eggs in the same basket.
- **Exit after specified time:** VCs are generally interested in exiting from a business after a pre-specified period. This period may usually range from 3 to 7 years.

Buyouts and second-stage financing are the most popular stages of venture capital financing. Globally, according to a report by PricewaterhouseCoopers, around 80 per cent of the total private equity investment is done at these stages.

A Case on Technology Development & Information Company Of India Ltd.

TDICI was incorporated in January 1988 with the support of the ICICI and the UTI. The country's first venture fund managed by the TDICI called VECAUS (Venture Capital Units Scheme) was started with an initial corpus of Rs.20 crore and was completely committed to 37 small and medium enterprises. The first project of the TDICI was loan and equity to a computer software company called Kale Consultants.

Present Status: At present the TDICI is administering two UTI –mobilised funds under VECAUS-I and II, totaling Rs.120 crore. the Rs.20 crore invested under the first fund, VECAUS-I, has already yielded returns totaling Rs. 16 crore to its investors.

Some of the projects financed by the TDICI are discussed below.

MASTEK , a Mumbai based software firm, in which the TDICI invested Rs.42 lakh in equity in 1989, went public just three years later, in November 1992. It showed an annual growth of 70-80 percent in the turnover.

TEMPTATION FOODS, located in PUNE, which exports frozen vegetables and fruits, went public in November 1992. The TDICI invested Rs.50 lakh in its equity.

RISHABH INSTRUMENTS of Nasik got Rs.40 lakh from the TDICI. It manufactures a range of meters used in power stations in collaboration with the ABB Metra Watt of Germany. After making cash losses totaling Rs.25 lakh in two bad years, it turned around in 1989 and showed an increase of over 70 percent in the turnover.

SYNERGY ART FOUNDATION, which runs art galleries in Mumbai and Chennai and plans to set up in Pune and Delhi too, had received Rs.25 lakh from the TDICI as convertible loans which were converted into equity on march 31, 1994. Most of this money has been used for the company's innovative art library scheme at least paintings to corporate clients.

However, in spite of the venture capital scenario improving, several specific VC funds are setting up shop in India, with the year 2006 having been a landmark year for VC funding in India.

Sumir Chadha, MD of Sequoia Capital India, feels that a slowdown could be on the cards for the year 2007 as the companies and investors may try to give some time and test the investment decisions made by them over the last year.

The first quarter of the calendar year 2007 is already over. There is no sign of the VC story slowing down. This is a good sign for all the entrepreneurs out there with an idea! If you have an idea, this is the time to tell it. You never know, someone might be listening round the corner.

HYPOTHESIS

1. Venture capital is closely associated with technology and innovation.
2. Venture capital firms only invests in high profit making ideas
3. The terms and conditions of venture capital financing are very stringent
4. Venture capital financing is one of the easy source of financing for new business ideas

CONCLUSION

1. Venture capital is available to entrepreneurs with an innovative idea and a solid business model
2. Venture capital is definitely one of the important sources of capital formation for new and emerging business ideas
3. Venture capital and private equity industry in India supports entrepreneurial activity and innovation.
4. To act as catalyst in enlarging entrepreneurial base by funding/facilitating funding to ventures involving innovative product/process/technology with entry barriers and aiming to maximize wealth of stakeholders.
5. Venture capital is a unique form of finance capital with special implications for high-technology economic development.
6. Venture capitalists are proficient in locating high-technology investment opportunities where they exist and that, as such, capital gaps are a reflection of underlying structural weaknesses in an area's technology base. Policymakers should turn their attention away from finance capital programs and return to the basics of building a strong technological infrastructure and integrated industrial base.
7. Through this understanding, and armed with a comprehensive and thorough business plan, an entrepreneur will have realistic expectations and can concentrate on targeting the financing search for the most promising investment sources.

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