

## Venture Capital and Private Equity – Concept and Evolution

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### ABSTRACT

Entrepreneurs with innovative ideas, products or services representing knowledge based industries, and intending to start a new business, often face challenges in raising capital for running the business. Venture capital and private equity emerged as an alternative source of finance to fill the gaps of conventional financing mechanism and promote innovative entrepreneurship. Venture Capital originally evolved in USA and developed enormously across the other parts of the world during the second half of the seventies. Venture capital which involves early stage financing was an important feature of the US venture capital industry whereas Europe had an established financial speciality in private equity financing which involves late stage financing. Other than the developed countries of USA, Europe and UK venture capital financing grew gradually across many developing countries. The contribution of venture capital financing to fill the gaps in the conventional financial system by providing funding to new entrepreneurs and helping them to commercialise new technologies over a period of time led to the growth of the small and medium enterprises in the various sectors of the economy across the world. The current article explores the evolution of venture capital and private equity globally and analyses the venture capital investment practices across USA, Europe and Asia.

**Key Words:** *Venture Capital, Private Equity, evolution, investment practices, industry concentration*

### INTRODUCTION

Entrepreneurs with innovative ideas, products or services representing knowledge based industries, and intending to start a new business, often face challenges in raising capital for running the business. These businesses are generally characterized by intangible assets and more risk associated with their returns and future prospects (Povaly, 2007). Hence, due to the non-availability of collaterals/tangible assets, a convincing financial position and profitability status, raising debt from conventional sources of financing like banks and financial institutions becomes difficult for them.

Thus, venture capital and private equity emerged as an alternative source of finance to fill the gaps of conventional financing mechanism and promote innovative entrepreneurship. It evolved as a source of funding available for investment in small and medium enterprises for new entrepreneurs setting up ventures, which are typically technology based and

risky in nature but have the potential to develop into major economic contributors of the country (Reddy, 2009). Also known as 'risky capital', venture capital developed as a source of funding available for early stage financing of new and young enterprises which have attractive growth prospects (Pandey, 1992).

## CONCEPT OF VENTURE CAPITAL AND PRIVATE EQUITY

Jane Koloski Morris, editor of the well-known industry publication; *Venture Economics*, defined venture capital as providing seed, start up and first stage financing and also funding the expansion of companies that have already demonstrated their business potential but do not yet have access to the public securities market or to credit oriented institutional funding sources (Bhatia, 2008). It represents a financial investment, in the form of equity, quasi-equity and sometimes debt-straight or conditional (i.e. interest and principal payable when the venture starts generating sales), made in new untried technology, or high-risk venture, promoted by a technically or professionally qualified entrepreneur, where the venture capitalist expects the enterprise to have a high growth rate, provides management and business skills to the enterprise, expects medium to long-term capital gains, and does not expect any collateral to cover the capital provided (Pandey, 1996). The financial investment made may also take the form of a derivative instrument (Verma, 1997).

Venture capital and private equity was a source of money for start-up companies. This was typically raised by venture capital firms who invest in young rapidly growing private companies that need capital to develop and market their products and have the potential to develop into significant economic contributors. In return for this investment, the venture capitalists generally receive significant ownership of the company and seats on the board. As per National Venture Capital Association (NVCA), professionally managed venture capital firms are generally private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and venture capitalists.

But as per the European Private Equity and Venture Capital Association (EVCA), 2007, venture capital is actually a subset of private equity and refers to equity investments made for launch, early development, or expansion of a business. It has a particular emphasis on entrepreneurial undertakings rather than mature businesses. Private Equity covers not only the financing required to create a business, but also includes financing in the subsequent development stages of its life cycle. A difference was observed between US (NVCA) and Europe (EVCA), wherein venture capital firms in US invest in seed, start-up, and expansion stages and excludes buyouts which come under the purview of private equity firms, but in Europe venture capital firms provide finance in all stages including from start-up to buyouts. But there is a similar view across both markets that private equity investments can range from start up to buyouts. This made it clear that venture capital is a subset of private equity (Naqi & Hettihawa, 2009). The Asian markets were found to follow the concept as given by EVCA where in venture capital would include investments in start-ups as well as matured companies.

## GLOBAL EVOLUTION OF VENTURE CAPITAL AND PRIVATE EQUITY

Venture Capital originally evolved in USA and developed enormously across the other parts of the world during the second half of the seventies. The VCPE industry developed almost simultaneously in the continents of USA and Europe, but the pace of development was observed to be different. UK also showed developments with respect to the success of adoption of venture capital financing after the Governments Business Expansion Scheme which provided tax pass through to the venture capitalists who invested in entrepreneurial ventures (Rao, 2010). Other than the developed countries of USA, Europe and UK venture capital financing grew gradually across many developing countries.

The following section will focus on the evolution of venture capital and private equity globally and analyse the venture capital investment practices across USA, Europe and Asia.

### EMERGENCE OF VENTURE CAPITAL AND PRIVATE EQUITY IN USA

Venture capital as a mode of finance, which evolved after the World War II by a few wealthy American families has played a very important role in the development and growth of the economy in USA. The modern organizational form of venture capital however began with the formation of American Research and Development (ARD) founded by George Doriot, a Harvard Business School professor, in 1946. ARD was the first venture capital firm which raised funds to invest in new businesses based on university technology from institutions like Massachusetts Institute of Technology (MIT). Its first investment of US\$ 70,000 in Digital Equipment Corporation grew more than US\$500 mn. ARD financed about 100 companies over a period of 11 years and gained 35 times its initial investments (Verma, 1997). This marked the growth of venture capital financing in USA post 1950.

Another important event post General Dorioit's innovation was the enactment of the Small Business Enactment Act in 1958. Under this Act the Small Business Investment Companies (SBIC) were licensed to invest in early stage businesses and benefitted by giving them tax incentives and government loans. SBICs still exist today and share many characteristics of modern venture capital firms; however, regulatory restrictions affiliated with SBICs keep it from becoming the dominant institutional form. An important milestone for the venture capital industry came in the 1960s with the development of the limited partnerships structure for venture capital investments. Limited partnerships are by far the most common form of organization in the venture capital industry.

There was a phenomenal growth in the number of venture capital firms from 1965-72 with capital commitment of almost US\$500 mn (Jain & Manna, 2009). The investment activity in 1960's to 1970 was concentrated in early stage and expansion stage companies majorly in the electronic, medical, data processing and computer services industries thus making venture capital finance synonymous to technology finance. With the introduction of SBIC's and limited partnerships structure accelerating the growth of venture capital, the industry also witnessed the emergence of independent venture capital firms like Sequoia Capital in 1972 which were ready to finance semi-conductor, micro- electronics, biotechnology and computer companies which provided impetus to consumer and industrial products also. Thus, the scope of venture capital financing was increased to

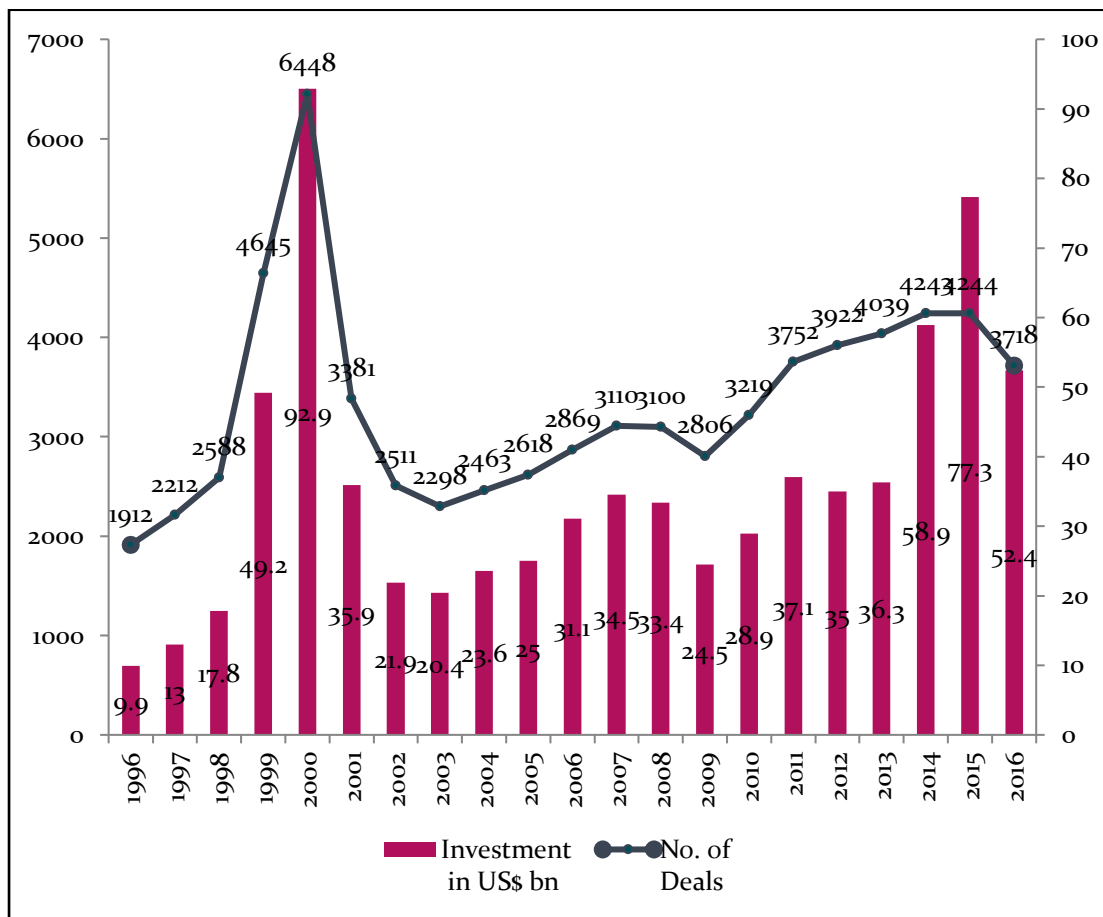
other industries of the economy also which was earlier concentrated in only technology based industries.

Later in 1973, the National Venture Capital Association (NVCA) was formed to serve the growing number of venture capital firms in USA. The year 1974, saw a turning point due to the stock market crash which made the investors risk averse. The growth levels once again took great pace after 1978 when the capital gain rates went down from 49% to 29% which ensured more returns to the investors (Panwar, 2009). The next big change for VC industry came in 1979, when the relaxation of investment rules for U.S. pension funds allowing them to invest in venture capital firms led to historically large inflows from these investors to the asset class. The success of the venture capital firms in the 1980's led to the increase in the number of firms from just a few dozen at the beginning of the decade to 650 firms at the end of the decade and the capital managed by these firms increased from \$3 billion to \$31bn.

The rising graph of the venture capital investments in the 1980's however saw a downturn when the returns to the venture capital firms started declining due to factors like competition amongst the firms, the IPO market collapsing due to another stock market crash in 1987 and inexperience of the many venture capital fund managers (Gompers & Lerner, 2001). In the early 1990s, the amount of money raised by VC funds each year was moderate and this is when the venture capital firms started improving operations at their portfolio companies rather than continuously making new investments. The late 1990's however, was considered as the boom time for the venture capital industry and hence the previous 15 years period 1980-1995 was rightly termed as the pre-boom period by Professor Andrew Metrick from Yale School of Management.

As seen in Figure 1 in the late 1990's US saw favorable economic climate along with the internet boom which opened up attractive opportunities for the venture capital firms to invest and earn good returns. The investments were at its peak in 2000. The rise once again saw a downfall during 2001 when the NASDAQ crashed which adversely affected the valuations of these start-up technology firms and consequently the venture capital firms started pulling off their investments leading to a decline in the industry growth. This period of 2001-2003 when the Dot-Com bubble busted, had its negative impact on the venture capital investments too. Venture capital investments were steady at 2003 levels through the second quarter of 2005. As a percentage of GDP, venture investments were 0.058% in 1994, peaked at 1.087% (nearly 19 times the 1994 level) in 2000 and ranged from 0.164% to 0.182% in 2003 and 2004. The revival of an Internet-driven environment in 2004 through 2007 helped to revive the venture capital environment which kept its increasing pace till 2014.

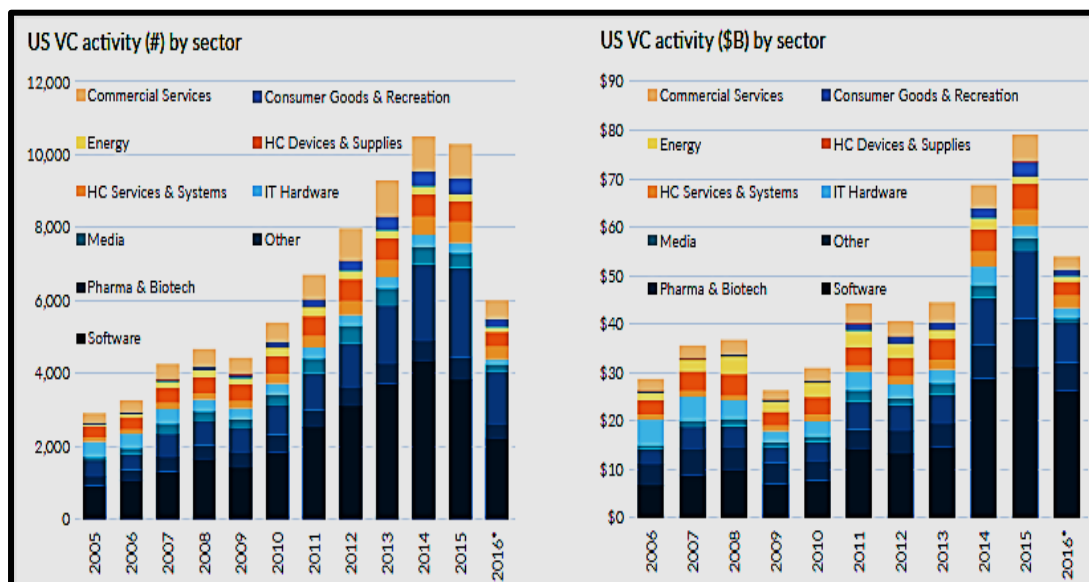
**Figure 1: Venture Capital Investments in USA from 1996 to 2016**



Source: Dow Jones, Venture Source

The investment levels again picked up post 2013 till 2015 showing a healthy consistency due to improvement in economic picture and rapid changes in IPO exit environment thereby encouraging more investments (E&Y Report, 2014). Following record levels of financing activity and proceeds in 2014 and 2015, the venture capital market cooled in 2016, with a decrease in the number of financings and a sharp contraction in valuations. Despite the decline in deal flow, however, the \$52.4 billion invested in the US venture capital ecosystem still represented the third-highest annual total since 2000 (Wilmer Halle Report, 2017). The number of deals declined by 12% from 4244 in 2015 to 3718 in 2016. Total reported venture capital investments contracted by almost one-third, from \$77.3 billion in 2015 to \$52.4 billion in 2016. Despite falling short of the total annual proceeds in 2014 and 2015, the 2016 figure is 52% higher than the annual average of \$34.5 billion that prevailed for the three-year period preceding 2014.

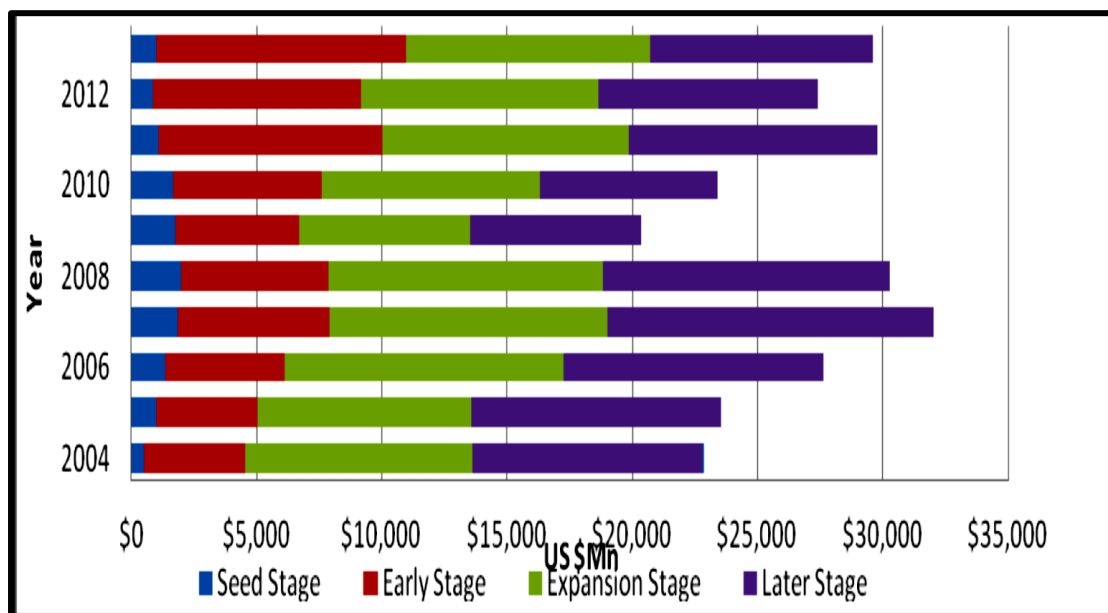
**Figure 2: Venture Capital Investments in USA by sector from 2005 to 2016**



Source: PitchBook, 2016

Figure 2 above showed the distribution of venture capital investments in USA across various sectors in value (US\$ bn) and in volume (No. of deals) from 2006 to 2016. It was observed that a distinct concentration of financing happening in the IT sector (comprising Software, Bio Tech, and Hardware) was followed by Media, Healthcare and Consumer Goods & Services (Venture Monitor, Pitch Book Report, 2016). The trend has almost been similar both in terms of value as well as volume. Thus, the IT sector has consistently dominated across the decade and has been receiving the highest share of venture capital investments.

**Figure 3: Venture Capital Investments in USA by stages from 2004 to 2013**



Source: Price Waterhouse Coopers, Money Tree Reports



Figure 3 shows the distribution of venture capital investments in USA across various stages in value (US\$ Mn) and in volume (No. of deals) from 2004 to 2013 (PWC, Money Tree Report, 2008). It was observed that there has been substantial venture capital funding in the expansion and late stages as against the seed and start up stages which actually are pure venture capital investments. More investments in late and expansion stages reflected the risk averseness of the venture capitalists to invest in risky early stages. Thus the pull of venture capital investments in USA was evidenced towards growth and late stages of the investee companies.

Venture capital industry in USA evolved as a robust ecosystem and stimulated the growth of this industry across the world. Various factors which contributed to the growth of USA VCPE industry included innovation in technology requiring funding, development of entrepreneurial climate, changes in legal framework favoring the growth of venture capital investments and existence of efficient stock markets providing liquidity to the investments. Many events like Internet boom, Dot com bubble, stock market crash, global financial crisis also impacted the growth of venture capital industry in USA. Venture capital investments in Expansion stage of development and Software sector though have maintained their dominance; the venture capital industry has seen to spread across various sectors of the economy.

### **EMERGENCE OF VENTURE CAPITAL AND PRIVATE EQUITY IN EUROPE**

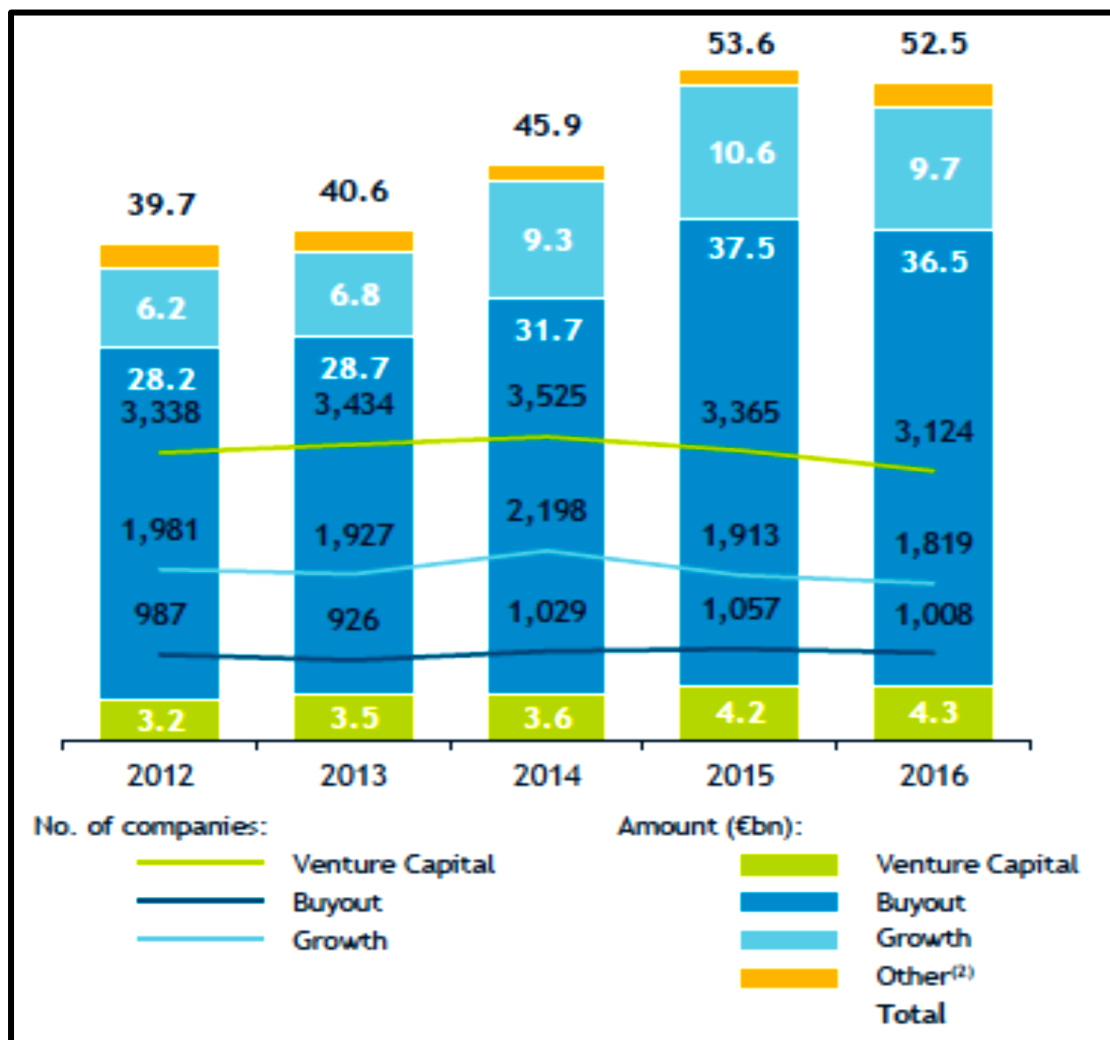
Europe being the birthplace of both industrial revolution and modern capitalism started its venture capital activities by providing growth capital to private businesses in the 1980's. The European Venture Capital Association (EVCA) was formed in 1983 to support the venture capital firms in Europe, wherein 75% of the venture capital activity is concentrated in three countries, namely United Kingdom, France and Netherlands (Panwar, 2009). In the initial years, the growth of venture capital was very slow in Europe because financial institutions, equity markets and company law all of which directly have an impact on the venture capital industry, evolved differently as compared to USA thus leading to scarce development in Europe (OECD, 1986). In the late 1980's fast growth in venture capital was visible in Europe due to many public policy changes, economic conditions and creation of the secondary stock exchanges. The venture capital pool increased from US\$8.95 bn in 1986 to US\$29 bn in 1990 (Panwar, 2009). The venture capital and private equity fund-raising in Europe compared quite well with that in the United States until 1997 and showed far less annual variability. Like USA, limited partnerships remain an important vehicle through which venture capital investing was done in Europe as well (Jenkinson, 2008). The major source of venture capital funding in Europe came from pension funds, banks and insurance companies, government agencies, and corporate investors.

Venture capital activity picked up in Europe during the mid-1990. As per EVCA, the total investment grew from a stable level of about €5 billion per year during the 1989- 1996 period to €25 billion in 1999 and €34.9 billion (invested in some 10,440 companies) in 2000. Disbursements dropped to €24.3 billion during 2001 but then rebounded over the subsequent three years, hitting €30.6 billion in 2004. Fund-raising grew even more dramatically over the past seven years, rising from about €5 billion during 1995 to nearly €48 billion in 2000, before falling to €27.5 billion during 2002 and remaining near that

level during 2003 and 2004. Since the early 1980s, a cumulative total of some €200 billion has been raised for investment in European private equity.

Originally, the sector penetration of venture capital firms in Europe has been in variety of industries. But with growing emphasis on development of technology, European venture capital firms focused on computers and electronics, communications, consumer goods and services and bio technology businesses. Another important aspect of European venture capital firms is that they also remain geographically concentrated wherein half of the venture capital investments are happening in United Kingdom followed by France, Netherlands and Germany (Panwar, 2009). It has also been observed that European venture capital firms have focused less on early-stage investments. Buyouts accounted for over 40 percent of European private equity investment during 1997 and 2000 and then surged to around 70 percent of total investment during 2003 and 2004. After spiking upward during the 1997–2001 period, early-stage companies now attract less than 7 % of total investment.

**Figure 4: Venture Capital & Private Equity Investments in Europe from 2012 to 2016**



Source: Invest Europe, European Private Equity Activity, 2016





Figure 4 showed the venture capital and private equity investments in Europe in the recent five years from 2012 to 2016. The investments showed a rising trend from 2012(€39.7 bn) till 2015(€53.6 bn). The total amount of equity invested in European companies in 2016 however remained stable at €52.5bn compared with 2015. The total number of companies receiving venture capital and private equity financing had decreased from 6306 (2012) to 5951(2016) showing a 6% decrease thereby indicating larger deals in value over the recent years.

Comparing the investments across the years on the basis of the stage of investments it was observed that venture capital investments (which were around 8% of the total investments) had been increasing by 35% from €3.2 billion in 2012 to €4.3 billion in 2016 over approximately 3000 companies. Buyout investments (which were around 70% of the total investments) had increased by 29% from €28.2 billion in 2012 to €36.5 billion in 2016 over approximately 1000 companies. Growth stage investments (which were around 20% of the total investments) had increased by 56% from €6.2 billion in 2012 to €9.7 billion in 2016 over approximately 1900 companies. Thus it was observed that venture capital (8%) and growth stage (20%) investments have shown significant increase though having lower share in the total investments indicating flow of capital to start up level and growing companies. Whereas buyout investments (70%) have continued to be dominant in the European markets as was the scenario a decade back.

Venture capital investments were found to be made in ICT (communications, computer and electronics) which was the largest sector at 44% of the total venture capital investment by amount, followed by biotech and healthcare (27%) and consumer goods and services (9%). Buyout investment concentrated in consumer goods and services sector (32%), business products and services (22%), ICT (16%), and biotech and healthcare (10%). Growth investment concentrated in ICT (27%), business products and services (20%), consumer goods and services (20%), and energy and environment (13%) (Invest Europe, European Private Equity Activity, 2016). Here, it was observed that investments majorly concentrated in ICT, consumer and business goods and services and healthcare which were quite similar to investment trends in USA.

To sum up, European venture capital and private equity industry has come a long way and is regulated on a national basis across all European member states and believes in high professional standards to facilitate a long term relationship with institutional investors and regulators.

## **EMERGENCE OF VENTURE CAPITAL AND PRIVATE EQUITY IN ASIA**

The concept of venture capital in Asia was established as a start-up capital for establishing new businesses and financing later stage developments by friends and families (Panwar, 2009). The modern venture capital concept however started in Asia in 1952 in Japan. This was followed by Hongkong in 1959 and India 1964. The other countries like Singapore, South Korea, Taiwan and China also started venture capital activities in the beginning of 1980's (Subhash, 2006). Like USA, many countries in Asia also defined venture capital as technology financing. But, most of the Asian countries follow a uniform approach to venture capital by providing funds to new, high risk, not necessarily high tech ventures and also provide management, marketing and financing skills to the investee firms (Pandey, 1996). During the 1970's venture capital development in Asia depended mainly



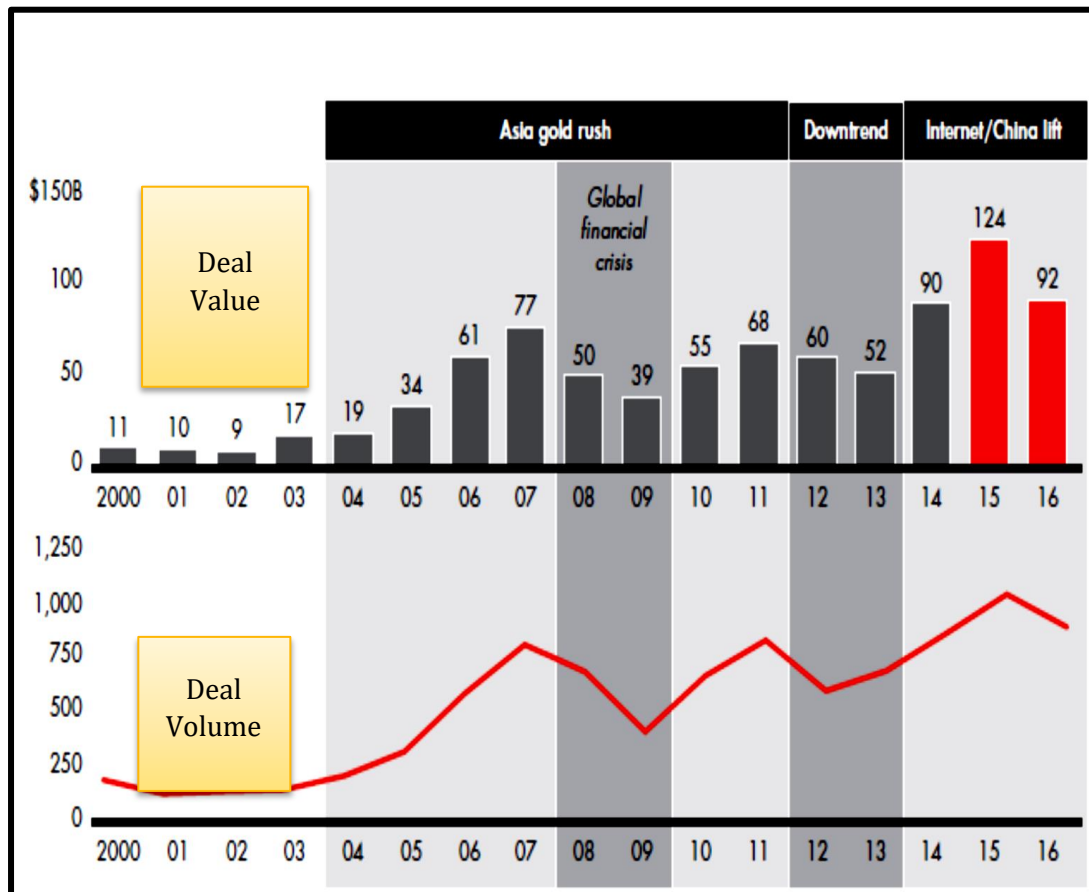
on overcoming cultural barriers and getting local venture capitalists to get involved in investment activity. In 1980's institutionalized venture capital activity gained momentum in Japan (Naqi & Hettihawa, 2007). In Japan most of the firms involved were commercial or investment bank subsidiaries that make very few truly entrepreneurial investments. By the end of 1980's there was very little evidence of venture capital adoption and adaptation in Asia. However, Asian venture capital fund raising and investing grew significantly during the 1990's reporting an average annual growth rate of 15% over the last 15 years ending 2004 as compared to 6% in Europe and 4% in US (Subhash , 2006). During the early 1990s, the Asian Dragons (Hongkong, Taiwan, South Korea, and Singapore) experienced tremendous economic growth (Naqi & Hettihawa, 2007). There was a shift from labour intensive and manufacturing environment to technology oriented industries in these countries, thereby increasing the scope of venture capital. The respective Governments played a proactive role in encouraging venture capital financing in Asia. On the basis of the Asia Pacific Venture Capital Pool for 2004, Japan was leading with 27% share followed by Hongkong 26.8%, Singapore 10.8%, Korea 8.3%, China 7.2% and India with only 3.2% of the total venture capital pool (Subhash, 2006). This showed the growth spread of venture capital activity in the Asian continent. Gradually over the years it was observed that with the boom in the venture capital and private equity activity around the world, many venture capitalists in USA started looking for cross border opportunities outside the national domains (Aylward,1998). This is when VCPE activity in Asia started gaining more momentum.

The following section looks at the potential of the Asian private equity and venture capital industry which has seen tremendous expansion in the recent years through continued economic growth, favorable demographics, a burgeoning middle class and maturing industry delivering positive returns to its investors thereby targeting long term growth.

### **Investment Momentum in Asian VCPE Market**

The figure 5 below showed the investment momentum of the VCPE deals in Asia from 2000 to 2016. A clear linear trend both in value of deals as well as the volume of deals was observed. The pickup in the investment activity post 2004 reached a peak in 2007 showing a 300% rise, just before the Global Financial Crisis. 2008 and 2009 saw the much expected downfall as the world felt the effect of the crisis and investors became risk averse. The activity once again picked up in 2010 and 2011 showing the revival post the crisis reaching the pre-crisis levels at US\$68 bn in 2011. The years 2012 and 2013 once again saw the slump before jumping up to another peak at US\$ 90 mn in 2014. The stellar rise in 2015 and a minor downfall in 2016 are explained in the next section.

**Figure 5: VCPE Deal Value and Deal Volume in Asia from 2000 to 2016**



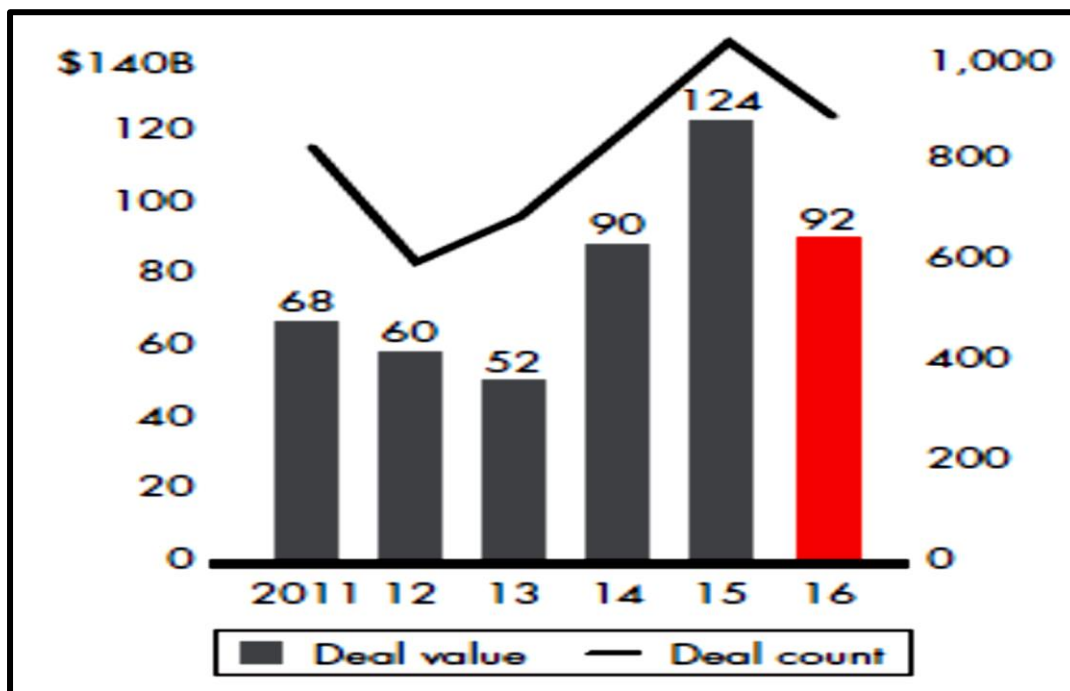
Source: Asia Specific Private Equity Report, Bain, 2017

### Vital Signs of Venture Capital and Private Equity in Asia in Recent Years

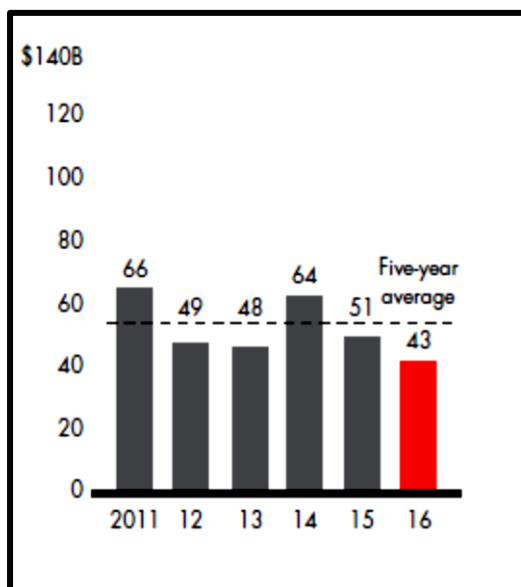
Figure 6 showed the glimpses of Asian VCPE investment market, fund raising and exit market respectively in the recent six years.

**Figure 6: Asian VCPE Investment Market, Fundraising and Exit Market**

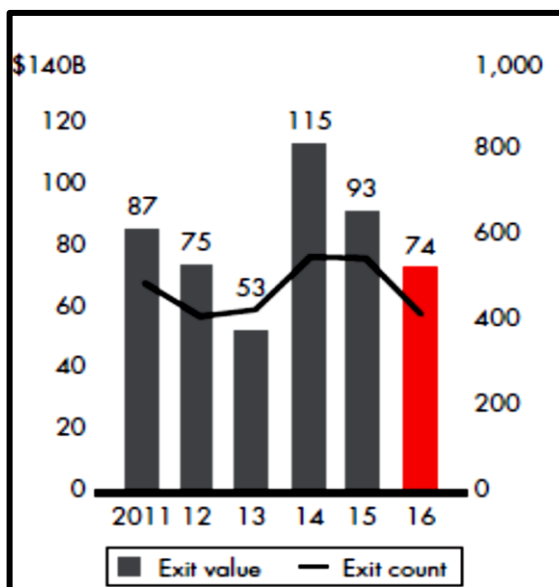
**Asian VCPE Investment Market**



**Asian VCPE Fund Raising**



**Asian VCPE Exit Market**



Source: Asia Specific Private Equity Report, Bain, 2017

The Asian VCPE market saw a slump in 2012 and 2013 after the boom in 2011 as is visible in the figure explaining the investment trends. But the investor performance was soon rewarded and 2014 saw the best performance till date (Bain, Asia Specific Private Equity Report, 2015).

The rise in the deal value to US\$90 billion and exits to US\$115 billion clearly shows the positive sentiment of the VCPE market. Much of 2014's rebound in both deals and exits stemmed from a return of massive transactions involving the biggest and strongest PE firms. The year 2015 followed the growth chart despite perplexing global economic landscape, low oil prices, currency fluctuations and the downfall of the Chinese economy. In spite of the all the turbulence, 2015 saw the highest ever deal value of US\$ 124 Billion. Exit activity remained robust at US\$ 92 billion despite the extreme volatility in the equity markets (Bain, Asia Specific Private Equity Report, 2016). Fundraising was almost at par with the historical average till 2015. The virtuous cycle of capital invested and capital returned at its peak showed the maturity of the Asian VCPE industry and this has been significantly improving in the past six years. The year 2016 was a package of many escalating concerns like Chinese debt levels, Brexit vote, political scandal in South Korea, demonetization in India and the US Presidential elections. But all this affected the VCPE market in Asia not much, as the deal value though reduced from US\$ 124 billion to US\$ 92 billion and is still the second highest so far, exit activity of US\$ 74 billion was moderate and average returns continued to outperform other asset classes. Fund raising went little below the five year average, which may probably because of the huge amounts being poured in these markets in past few years (Bain, Asia Specific Private Equity Report, 2017).

The Asian VCPE industry has matured significantly over the recent years with the Limited Partners being cash positive and the General Partners finding ways to return capital to its investors. The industry has grown and performed across all global crosswinds, with all its ups and downs based on its own fundamental strengths and weaknesses. The venture capital firms have diligently made its investments in the prospective sectors of the economy avoiding putting the stock of dry powder in lesser prospective sectors. This has helped them keep the returns growing and keeping the investors cash-positive, indicating that the VCPE investment cycle is solidly self-sustaining.

## CONCLUSION

The review of the evolution of venture capital and private equity in the US, Europe and developing countries of Asia shows that the VCPE industry of these continents have developed significantly in the past three decades. The pioneering venture capital industry in USA has been found to be the most successful due to the contribution of many factors including the presence of entrepreneurial culture, favorable legal framework and strong capital markets.

European VCPE industry also kept up its pace with the growing VC industry in USA, but was characterized with more focus on buyout deals as compared to venture capital deals. In spite of the initial local, cultural and regulatory barriers, the Asian VCPE industry have managed to create its space in the global VCPE industry due to the rapid economic growth of the developing countries in Asia.

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