Venture Capital – an indubitable source of finance for start-ups

Shamin A. Sookia of Perigeum Capital Ltd unfolds the evolution of venture capital over the years – explaining how, from being a source of finance for high-risk start-ups, it has now moved to funding lower-risk, management buy-outs – and then goes beyond to assess how it can withstand the current challenging environment to again come into its own.

While the Venture Capital (VC) world consists of funds made available for the financing of new business ventures, in practice a much wider range of activities than purely start-up situations have been financed by VC funds. Indeed, the expansion of existing businesses and the provision of finance for management buy-outs may be funded by VC funds. Different stages of risk, different stages of investee maturity and consequently a different degree of post-investment active involvement by the venture capitalist are characteristic of these various investments.

Ultimately, venture capital is a way in which investors support entrepreneurial talent with finance and business skills to exploit market opportunities and thus to obtain long-term capital gain. However, VC firms have been criticised to some extent for moving away from high-risk start-up finance towards much lower risk management buy-outs (MBOs).

The provision of risk capital for young, high growth companies at an early stage in their development has, traditionally, involved venture capital. Also, VC investment in the early stages of maturity of an investee company usually involves managerial support until the investee company is in a position to raise further finance from conventional funding sources. This aspect of "hands on" investment distinguishes venture capital from other, more passive forms of investment.

A bit of history – the UK perspective

The acceleration in the rate of expansion of venture capital in the last decades has given the industry a much higher profile. In the UK, during the 1980s, there was a growing awareness of the rapid emergence of funds in the US that were providing finance for early-stage investees. The rapid growth in high-tech businesses requiring risk capital backing resulted in the development of these funds.

Also, during the economic recovery of the early to mid-eighties there was an increasing number of start-ups and management buy-outs. The attraction of riskier, longer-term investment increased with the increase in demand along with the general optimism of the eighties and the belief that the bull market would be sustained. Further, in order to fuel economic recovery as well as make inroads into the unemployment figures, the UK wanted to promote new enterprises and small businesses. The developments in the capital markets were an important factor influencing growth of venture capital as well.

A new exit route by which venture capitalists could realise the capital gains on their investments was provided by the creation of the Unlisted Securities Market and the Over-the-Counter (OTC) Market in the UK.

Growth of the VC market and related characteristics

Venture capital (VC) investment has clearly enjoyed substantial growth over the last three decades. There has been a significant shift away from start-up / early-stage finance toward MBO opportunities, although some would argue that this does not represent true VC investment as the extent of technical and managerial input from the venture capitalist are minimal in most MBO investments. This trend has serious implications for the entrepreneur trying to raise finance for a new or immature venture. It seems that it has become increasingly difficult to attract venture capital backing for such enterprises. It is therefore important for the entrepreneur to be fully aware of the types of investment that each fund will consider, and the methods that are utilised in appraising investment proposals, if the probability of success in security venture funding is to be maximised.

The following factors have been seen to be crucial for a VC investment to be successful:

- Investees' managerial experience in the sector
- Marketing skills of the management team
- Projected growth turnover
- Size of the entrepreneur's investment in relation to means
- Financial skills of the management team
- Market sector experience

Critical measures of success versus failure

Historical data relating to businesses seeking VC backing is often perceived as having limited relevance as an indicator of potential future performance due to the state of change of a business at a time when seeking VC investment. However, projections which display trends that differ noticeably from any available historical trends may be treated skeptically by some funds unless there is adequate explanation of the change.

> VC investment has clearly enjoyed substantial growth over the last three decades

Studies conducted on VCs have revealed that in the view of the investor the major contributory factor to failure is the inability to achieve the predicted turnover. Other factors include failure to control costs, lack of marketing skills and, often, the investees' underestimation of the time required to achieve targets.

So, in the overall evaluation, venture capitalists consider sector-specific experience amongst the investee management team to be very important. However, lack of sector-specific managerial skills is

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not widely thought to be a contributory factor to failure, thus indicating that sector-specific skill of the investee infers potential upside gain, rather than potential downside risk. In evaluating the risk involved, most venture capitalists evaluate the risk of an individual project in isolation, rather than in terms of its effect on the total risk of the funds' portfolio of investments, but many funds attempt to reduce the risk through diversification.

Whilst demanding a seat on the board of the investee company is seen to be the most important form of monitoring of and involvement in investments, monthly or quarterly accounts are other ways of monitoring investments. Few venture capital investors provide continuing managerial assistance to the investee companies. The most important factor governing the decision-making process of the venture capitalist is the experience and track record of the investee management. The venture capitalist sees such management expertise reducing the risk of failure and boosting potential returns. It can thus be argued that an entrepreneur seeking venture capital will be unlikely to gain financial backing if there is a lack of management experience in the specific sector.

Current situation of VC market – back to the dot-com bubble era

The situation that we are currently witnessing may imply a return to what has been observed in the past with the building of the VC industry on the back of the software sector in the context of the rise of digitalisation. Just as the dot-com bubble reset the sector in the year 2000, we have been seeing a similar reset from the bonanza of deals in 2021 and 2022. Software deal value dropped 71.8% year-on-year in Q2 2023, more than any other sector. In fact, software went from representing 40.2% of deal value in 2022 to 29.3% in 2023. Despite this trend, startups within the software segment that are linked to Artificial Intelligence (AI) may see significantly more dealmaking in future quarters, given the recent investment boom in that space.

As a matter of fact, European VC dealmaking dropped significantly in the first half of 2023 as the macroeconomic headwinds caught up with the VC ecosystem. Deal value in the first half of 2023 is down 60.8% compared with the same corresponding period in 2022 and 34.2% lower than in the second half of 2022. In fact, VC deal activity peaked in Q1 2022 and has been on a steady quarterly decline since.

All this may be attributed to the slow and steady decline to a shift in the macro environment as higher interest rates, high inflation, a closed IPO exit window, and tough fundraising conditions have all been significant decelerators to growth and dealmaking in the VC market. Public markets have started recovering in 2023, especially in the US where the Federal Reserve has hinted a movement towards an end in monetary tightening. The European monetary tightening cycle may continue for longer given that inflation has been persistently high in the UK and in the eurozone. This is in addition to the ongoing war between Russia and Ukraine, which continues to have inflationary consequences.

The way forward: Challenging headwinds force VCs to focus on cost reduction

The first half of year 2023 has witnessed investors accepting that VC dealmaking has decelerated, fundraising has become more challenging, and exiting unprofitable businesses through an IPO is no longer that popular. Instead, we have seen VCs work with their startups to restructure their operations in-house and extend runways as far down the line as they can, given the current situation and especially the dearth in funding. This has shifted company strategies from focusing solely on growth to cost reduction strategies, that is, prioritising cost management, leading to layoffs and hire freezes across the entire startup ecosystem, with the tech sector having the lion's share of layoffs.

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Given the subdued dealmaking environment, in contrast with the not-too-far era of abundant capital and low interest rates, the data collected on the ground seems to indicate a trend towards larger deals. It can be reasonably expected that due to the stagnant exit environment coupled with rising interest rates, non-traditional investors will continue to reduce their participation in the VC ecosystem, and that venture capital funds will need to weather this challenging environment with a continuing focus on cost reduction strategies in the foreseeable future.