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VENTURE CAPITAL STRUCTURE AND ORGANISATION

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ABSTRACT

This study is an opinion paper which examined the influence of Venture Capital Structure on the Organisation. One of the major constraints of startup, early-stage and emerging enterprises that have been deemed to have high growth potential or which have demonstrated high growth (in terms of number of employees, annual revenue and scale of operations), is startup fund. In the late 70s and early 80s, the United States of America government was permitted to invest pension funds on venture capital funds which eventually gave birth to venture capital firms that invest funds in these early-stage companies in exchange for equity. Apart from providing funding, venture capital structure also offers mentorship and investor alliance networking to help startups achieve their success. Venturing is a risky business with a high failure rate. Even with a low rate of success, venture investing model is still attractive for many capital venture structure because the higher risk at stake will give higher possibilities for gain to the company. As an opinion paper, the study adopted secondary data as source of data collection which entailed review of literature related to the study under investigation. The findings of the study revealed that venture capital structure influence organisational performance positively, as it provides financial support services which protect the business from any financial interruption or constraint hence, necessitate the adequate and effective performance of organisation. The study concluded by asserting that venture capital structure enhances organisational success as it provides the financial backup for organisational effectiveness. Venture capital structure is considered a pivotal and essential source of business funding and growth. It is a life wire for enterprises and the future of enterprises to an extent, depends on it.

Keywords: Venture Capital, Structure, Startup business, Organisational effectiveness, Equity

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INTRODUCTION

Venture capital structure was first established in 1946 after World War II by Karl Compton (MIT President, General Georges F. Doriot (Harvard Business School Professor) and a local business leader using organization named American Research and Development (ARD). ARD trades a close end fund which trade shares between investors on an exchange like an individual stock. In 1958, Draper, Gaither and Anderson formed the first venture capital limited partnership. This partnership was different from the previous close end funds and was exempt from security regulations, including the exacting disclosure requirements of the investment company act 1940.

During 1960 - 1970 most venture organizations raised money either through closed end fund or Small Business Investment Company (SBIC) and were sponsored by the Federal government to enhance the venture capital industry. In the late 1960s and 1970s most of SBICs collapsed because it was designed poorly by the US government; however, the venture industry increased dramatically in the late 1970 and early 1980 because The US government was permitted to invest the pension funds on venture capital funds followed by the '*prudent man'* rule.

The startups develop their products using financing from the third party with Venture Capital (VC) structure. Venture capital structure is becoming a trend in helping startups to grow. This happens because besides providing funding, venture capital structure also offers mentorship and investor networking to help startups achieve their success. There is a number of Venture capital structure in the world performing fund raising for investing on new startups; big corporates also participate in investing on startups using subsidiary companies that act as a venture capital structure vehicle to manage funds from the parent company. Since 2014, Venture capital structure has become the major leading investors on many venture transactions in the world with a big share of venture pie. In the future, venture capital structure will still play a critical role in shaping startup business in the world.

Venturing is a risky business with a high failure rate and big money involved. William Hambert, a legendary venture capitalist who made early investment in Apple, Genentech, and Google, said that the possibility of failure rate for venture investing is 90%; it means that there will be only 1success from each 10 startups invested. Venture capital players like "500 Startup" created more moderate calculations for failure rate possibility to around 50-60%. Even with a low rate of success, venture investing model is still attractive for many venture capital structures because the higher risk at stake will give higher possibilities for gain for the company.

LITERATURE REVIEW

CONCEPT OF VENTURE CAPITAL STRUCTURE

America Venture Capital Association defines Venture capital structure as a kind of equity capital that plunged into emerging, swift and competitive enterprises by professional financiers. Venture capital structure financing can be defined as equity investments in closely held private companies with no publicly traded stock intended for a limited period of time (Gompers, 2001). Venture capital structure is often called "patient capital" as it seeks a return not through immediate and regular payments of principal and interest, but through long-term capital appreciation (Gompers, 2001).

Venture capital investors not only provide capital but also offer value-added services to startup in the form of strategic advice (mentoring), introducing alliance networks and facilitating exit strategies.

Venture capital is equity financing, where an investment partner sits alongside the entrepreneur and assists in strategically *Managing Risk* associated with building high potential, fast growth and capital efficient companies (Napp, and Minshall, 2011).

CONCEPT OF ORGANISATION

"Organisation is defined as a corporate group. A corporate group is a social relation which is either closed or limits the admission of outsiders by rules… its order is enforced by the actions of specific individuals whose regular function this is."

According to Louis A. Allen: "Organisation can be defined as the process of identifying and grouping the work to be performed, defining and delegating responsibility and authority and establishing relationships for the purpose of enabling people to work most effectively together in accomplishing objectives."

According to Koontz and O' Donnel: "The establishment of authority relationships with provision for coordination between them, both vertically and horizontally in the enterprise structure, is the essence of organisation."

Features of Organisation

1. Composition of Interrelated Individuals:

Organisation is a composition or aggregation of interrelated individuals. The organisations are not merely a number of individuals collected at random but they are composed of individuals who are interrelated. The identifiable interrelated group of individuals determines the boundary of the organisation. It shows the organisation as a separate entity from the other elements in its environment.

2. Deliberate and Conscious Creation and Recreation:

Organisation is a social unit which is deliberately constructed or reconstructed. It is a system of consciously coordinated activities of two or more persons. This feature differentiates the organisation from the other social units. Unlike other social units, members enter in the organisation through a contract and can be shunted out also if their performance is not satisfactory. Thus, the relationship is purely of a contractual nature. Recreation of groups can be made by the organisation through promotions, demotions or transfers of people in the organisation.

3. Achievement of Common Objectives:

An organisation is a conscious and purposive creation. It is a means towards the achievement of common enterprise objectives. The objectives of various segments lead to the achievement of major business objectives. The organisational structure should build around common and clear cut objectives. This will help in the proper accomplishment of objectives.

4. Division of Work:

Organisation includes breaking up the entire work into different segments. Different segments of work are then assigned to different persons for their efficient accomplishment. This brings in division of labour. It is not that one person cannot carry out many functions but specialization in different activities is necessary to improve one's efficiency. Organisation helps in dividing the work into related activities so that they are assigned to different individuals.

5. Coordination:
Coordination of various activities is as essential as their division. It helps in integrating and harmonizing various activities. Coordination also avoids duplications and delays. In-fact, various functions in an organisation depend upon one another and the performance of one influences the other. Unless all of them are properly coordinated, the performance of all segments is adversely affected.

6. Co-operative Relationship:
An organisation creates co-operative relationship among various members of the group. An organisation cannot be constituted by one person. It requires at least two or more persons; organisation is a system which helps in creating meaningful relationships among people. The relationship should be both vertical and horizontal among members of various departments. The structure should be designed that it motivates people to perform their part of work together.

THREE TYPES OF VENTURE CAPITALISTS
According to Napp, and Minshall (2011), a good venture capitalist is a thoughtful, experienced ally, who sits alongside the entrepreneur as a partner and a mentor, knowing full well that their fate is intertwined. Most venture capitalists fall into the following three types — domain expert, operator or networker.

A domain expert is someone who's deep into a certain field and knows everything going on in this industry.

An operator, or a growth expert, is someone who has a track record of growing and scaling a company.

A networker is someone who can make important intros to domain experts, operators, or your next investor.

THE VENTURE FUND STRUCTURE
The image on the left is the structure of a private equity fund, but the idea is the same.

Venture Fund is the main investment vehicle used for venture investing. Each is structured as a limited partnership governed by partnership agreement covenants, of finite life (usually 7–10 years). It pays out profit sharing through carried interest (about 20% of the fund's returns).

Management Company is the business of the fund. The management company receives the management fee from the fund (about 2%) and uses it to pay the overhead related to operating the venture firm, such as rent, salaries of employees, etc. It makes carried interest only after the Limited Partners have been repaid.

Limited Partners (LPs) is someone who commits capital to the venture fund. LPs are mostly institutional investors, such as pension funds, insurance companies, endowments, foundations, family offices, and high net worth individuals.

General Partner (GP) is the venture capital partner of the management company. GPs raise and manage venture funds, set and make investment decisions, and help their portfolio companies exit, because they have a fiduciary responsibility to their Limited Partners.

Portfolio Companies (Startups) receive financing from the venture fund in exchange for shares of *preferred equity*. The fund can only realize gains if there is a liquidity event (such as mergers and acquisitions or IPOs) and these shares can be converted to cash.

THREE INVESTMENT FUNDS TYPES

According to Swanson, and Chermack, (2013) investment fund type are categorize into the following:

1. Focus on **Stage** (early, mid or late). Later stage means large capital requirement and decreasing risk and return. Most big funds have to go late stage because of their fund size.

2. Focus on **Geography**. Some dedicated regional funds focus on prevailing market dynamics, i.e. 500 Startups has the 500 Kimchi fund for South Korea.

3. Focus on **Sector**. Popular industry sectors include med-tech (Incube Ventures), biotech, IT, greentech (Nth Power, Tech Partners), etc.

HOW RETURNS ARE GENERATED

As we mentioned before, venture funds can only realize gains if there is a liquidity event (aka “exit”), which generally means one of the following three situations:

1. **Share Purchase**: A buyout of an investor’s position via a new investor looking to buy ownership or the company repurchasing stock.

2. **Acquisition (M&A)**: Strategic acquisition by an incumbent who is buying a differentiated technology, a large customer base, a rockstar team, or some other combinations. Google, Facebook, Yahoo, j2 Global and Microsoft are among the top buyers in the tech space.

3. **Initial Public Offerings (IPO)**: Large stand-alone businesses with stable customer base, product strategy and growth potential, i.e. True Car, Alibaba.

Dynamics of a Venture Fund

Most venture funds last over a period of 7–10 years but are only active in the first 3–4 years. At the end of Year 4, majority of the fund will already be invested. The rest of the fund enters a harvest period for follow-on investments in a few good performers. Many VC funds reserve about 50% to support existing portfolio companies. A smaller fund may not even do follow-on investments because they require a larger capital for a small incremental ownership. In other words, ownership gets more expensive and the economics does not always make sense. As an entrepreneur, you need to do your research and know a fund’s vintage (yes, just like wine), which refers to the year when the fund was raised. If a fund is over four years old, don’t even bother because most likely it won’t have much money left for new investments.

ROLES OF VENTURE CAPITAL STRUCTURES

According to Eisenhardt (1989), venture capital structure has the following roles:

Mentoring— Venture capital structure provide companies with strategic, operational and financial advice. They help startup to form the company as a legal entity, grow an idea to become a product, validate the product to customer and assist with other strategic direction during company operation.

Alliances— Venture capital structure can introduce the company to an extensive network of strategic partners, domestically and internationally. Venture capital structure also can help startup to obtain follow on funding from another partner to expand the business dimension.

Facilitate exit— Venture capital structure are experienced in the process of preparing a company for an initial public offering (IPO) and can also facilitate a trade sale.

VENTURE CAPITAL STRUCTURE AND ORGANIZATION

According to Avots, Strenga, and Paalzow (2013), venture capital structure influence organization in the following light:

Corporate Strategy Change

According to Zider (1998), corporate strategy is concerned with the overall purpose and scope of the organization to meet stakeholder expectations. This level is heavily influenced by investors and directors in the business and acts to guide strategic decision-making throughout the business. Corporate strategy is often stated explicitly in a “mission statement”. The changes of organizational behavior in the corporate strategy level when the corporate goes into venture business are in the following area:

1) ***Risk Level***; corporates usually have regulations to do a business with moderate or low risk exposure level, corporates always review the business plan and doing a detail due to diligence before deciding to make an investment in order to protect their investment. Venturing business has a nature as business with high-risk exposure level because venture investment at the early stage and at that time the product may not be ready and not commercialized yet. The customers as the target have also not yet validated it and the detail of the business plan is not available yet, so doing venturing business through CVC will shift the risk level that will be faced by the corporates from moderate to high-risk level business.

2**)** ***Decision Making*****;** corporate in making a decision should comply with the company regulation, sometimes the decision should follow staging approval up to the board of director and commissioners based on their authority and creates long duration time for decision making. In Venture capital structure, the decision-making should be decided very fast, because the business trend is changing very fast too and it cannot wait for longer decision. Corporate should adapt their decision making process in Venture capital structure to become leaner and faster.

3) ***Investment Duration*****;** corporate usually make an investment for business that gives return in a short duration for less than 5-year period. VC business by nature is a long duration investment that gives return for more than 5-year period. If corporate want to enter venturing business, they need to change their investment paradigm from a short term to a long-term investment duration.

B. Business Strategy Change

Business strategy is concerned more with how a business can compete successfully in a particular market, or how to beat the competition. It concerns strategic decisions about choosing products, meeting customer needs, gaining advantage over competitors, exploiting or creating new opportunities, and etc.

According to Schefczyk (2001), the changes of organizational behavior in business strategy level happened when corporates go into venture business in the following area:

1) *Investment Return*; corporates usually target revenue as a key performance indicator (KPI) for investing business units. It is different from venturing business that does not use revenue as KPI because in the initial stage, startup does not create much cash from their business. The KPI that is used for venturing business in the initial phase is a company valuation and it is measured based on the amount of the funding received by startups during their initial business.

2) *Investment Source*; corporates in doing investing use self-financing or loan from banking as their financing source and as a return the corporate provide solid business plans and assets for investment assurance. Startups cannot provide guarantee for loan prerequisite, so the investing source for CVC to finance startup uses fund raising and the majority is provided by CVC parent company.

3) *Product Management*; corporates when perform investing usually focus on a single product or a company that gives a high impact to the corporate business. Venturing business does not have any product with a high impact yet because all of the products are still in the development stage, so investing in VC should focus on managing the product portfolio that is projected to grow in the future (Eisenhardt, 1989).

C. Functional Strategy Change

Functional strategy is concerned with how each part of the business is organized to deliver the corporate and business-unit level on strategic direction. Operational strategy therefore focuses on issues of resources, processes, people and etc.

The changes of organizational behavior in the functional strategy level happened when corporates are going into venture business in following area:

1) *Human Interaction*; interaction between employees in big corporations use formal communication such as formal letter/email and formal meeting based on the employee's position; this is very different with the interaction in Venture capital structure that generally use non formal communication like social media chat without any rank barrier. This change should be implemented by corporates when they do venture capital structure business, because startups as Venture capital structure counterpart also uses non-formal interaction on their daily communication.

2) *HR Treatment*; corporates treat their employees based on the contract between the company and the employees and each party has their own right and obligation that should comply with the corporate regulation. Venture capital structure treat their employees as an entrepreneur so they should become creative people without many restrictions for the benefit of the company.

3) ***Organizational;*** organization in the corporate is well structured because it should represent all the roles within the company and it is very different from an organization in Venture capital structure that is very flexible and depends on the up-to-date situation.

METHODOLOGY

This study is an opinion paper as such reviewed relevant literatures related to the study under investigation, journal, articles and unpublished materials related to the study under investigation was review as such the study adopted a secondary data as a source of data collection. also in a bit to expatiate the course of study: venture capital structure and organization, the opinion of Dr. Deebii Nwiado was put into consideration as it provide adequate knowledge and guide that enhance this paper.

SUMMARY OF FINDINGS

According to Weick (1989), Venture capital structure influence organizational performance positively as venture capital structure provide financial services which protest the business from any finical interruption or constraint hence necessitate the adequate and effective performance of organization.

Venture capital structure is a form of private equity financing that is provided by venture capital firms or funds to startups, early-stage, and emerging companies that have been deemed to have high growth potential or which have demonstrated high growth (in terms of number of employees, annual revenue, scale of operations, etc.). Venture capital firms or funds invest in these early-stage companies in exchange for equity, or an ownership stake. Venture capitalists take on the risk of financing risky start-ups in the hopes that some of the firms they support will become successful. Because startups face high uncertainty (Weick, 1989).

The typical venture capital investment occurs after an initial "seed funding" round. The first round of institutional venture capital to fund growth is called the Series A round. Venture capitalists provide this financing in the interest of generating a return through an eventual "exit" event, such as the company selling shares to the public for the first time in an initial public offering (IPO), or disposal of shares happening via a merger, via a sale to another entity such as a financial buyer in the private equity secondary market or via a sale to a trading company such as a competitor (Avots, Strenga, & Paalzow, 2013).

CONCLUSION

In a nutshell, venture capital structure enhances organizational success as it provides the financial backup for organizational effectiveness. Big corporations which have a plan to enter venture business should be aware about the changing and shifting behavior of the organization and try to adapt the changes for the success of their business. Venture capital is unique in its commitment towards enhancing organizational growth, venture capitalist do not only provide money to start a business, they also offer, monitoring, aliening and technical services for firm in other to utilized the money, therefore venture creature structure is considered a pivotal and essential source of business funding and growth. It can be conclusively asserted that venture capital structure is a life wire and the future of enterprises to an extent depends on it.

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