



What is Venture Capital Financing?

Venture capital (VC) is a type of funding provided by investors to early-stage small businesses with long-term growth potential. However, capital does not always take the form of money; it can also take the form of managerial or technological skills as well. Venture capital funds have been around as saviours, providing much-needed assistance to cash-strapped promoters and creative individuals in exchange for securities, whereas traditional methods of financing, such as bank loans, government subsidies, etc may be expensive and onerous for new entrepreneurs and require assets to back the same. However, the process of fundraising from VC funds is replete with legal issues and considerations to be borne in mind.

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Benefits of Venture capital Financing

1. Kick-Off and Expansion Strategy

For someone wishing to build their company grounds-up, venture capital funding may be a good option because it provides the initial monetary boost to kick-off the business and allows entrepreneurs to capitalize on the

commercial and financial experience that is generally required for business growth. Members of the venture capital fund sitting on the board of the start-up can bring tremendous value to the way in which the company grows. The help of an able start-up lawyer at this stage would go a long way to set the story right for the company from the beginning and ensure that the foundation is set well for future growth.

## 2. Exposure and Resources

Venture capital funds can aid young businesses in a range of areas, including taxation, accounting, and staffing. Furthermore, this is especially important at the initial, but critical growth phase. Potential advantages include faster growth and higher achievement due to the learnings gleaned by such venture capital funds in other start-ups being passed on and utilized—essentially, the removal of need to reinvent the wheel. Seasoned experts from the venture capital fund sitting on the board of the start-ups can add tremendous value both from a micro and macro perspective.

In addition to the financial investment, a venture capital fund can contribute their wealth of experience, knowledge, and networking to overcome the challenges confronting such new and tiny enterprises and learn from the mistakes of other start-ups which were helped by the fund.

## 3. Ease of Networking

Most venture capital investors are well-connected in the corporate world and can be a huge asset to start-ups. They can connect the start-up to other portfolio companies where there may be synergies and also to companies outside their portfolio but connected with the seasoned partners of such funds. This could help the start-ups attract the interest of employees, clients, and even business partners due to the brand-value of the venture capital fund. By choosing venture capital financing, start-ups are able to easily plug into the vast network of the investor, which may assist in meeting upcoming capital requirements.

## 4. Protection of Personal Assets

A big draw for founders towards venture capital funds is the possibility of ring-fencing their personal assets and having a separate financial identity from the start-up. The fact that the personal assets of the founders are not pledged or put on the line in case of a default or liquidation makes fund raise from venture capital funds a lucrative alternative to founders.

Potential Drawbacks of VC Financing

### 1. Distraction & Cost

Typically, start-ups look to raise venture capital after exhausting other ways and means of funding and need further capital for growth and creating a runway. However, it is a known fact that the entire exercise of fundraising can take several months and could lead to the founders being distracted from managing and growing the business of the company. At the same time, in the view of many successful founders, the 'actual cost' of venture capital financing should not be ignored. While at an early stage larger dilution of stake for smaller funding round may be considered par, it is only at the time of an exit via IPO or strategic sale that the real cost of equity comes forth.

### 2. Ownership Stake & Long-Term Funding

Amongst the main perceived downside of venture funding is the fear that company founders will have to give up control and have their equity diluted. Any fund raise is usually accompanied with dilution of founders' stake and

having the investor sit on the board. While this may not be a issue at early stages, as the company grows with more investors becoming shareholders and potentially having board seats, chances of friction with the investors on variety of issues may arise due to differing views and objectives and in some cases the founders may have to cede control to the investors as well. This may not be good for the company or the founders, hence the quantum of dilution and the control and other rights being given to the investors via the Shareholders' Agreement should be well thought through at the inception itself and discussed in advance with the start-up lawyer to avoid such pitfalls and prevent complications in decision-making.

### 3. Formal Reporting Structure

Along with the in-flow of venture capital fund, comes the requirement to set up formal structures including board with rules and regulations which provide governance oversight to the investors and helps them diagnose any problems. However, for a start-up, these may seem like fetters, limiting the flexibility of the company, reducing the amount of control that the founders have and generally slow down the decision making process in a really fast-paced environment which start-ups today operate in.

#### 5 Tips for raising Investment for Startups

##### Tip 1: Networking

Building a network in an entrepreneur's business field is critical not only for the growth of the business but also for securing capital funding. In today's technology-driven world, it is essential to establish a broad network of helpful contacts that will lead to the introductions of the appropriate venture capital funds and others in the ecosystem to expand the business.

##### Tip 2: Calculation of Funding Needs

Before approaching venture capital funds, the entrepreneur must determine the quantum of funds required to meet the financial objectives. Being able to project the quantum of funds needed along with the potential equity dilution based on corporate and personal tax returns, bank records, a profit-and-loss statement, and revenue predictions gives the potential investor good comfort. .

##### Tip 3: Hiring a Good Startup Lawyer

Once the networking and funding criteria are finalized, the start-up should retain a good start-up lawyer to deal with the complexities of fund-raising procedure, putting the requisite documentation/contracts in place, obtain the business-critical licenses and registrations, ensure compliance with labour and employment laws and protect intellectual property. A good start-up lawyer literally acts in the capacity of chariot driver who maneuvers the entrepreneur towards his/her final goal through the chaotic battlefield.

##### Tip 4: Pitching for the VC Deal

When venture capital funds invest in a company, they get involved in its decision-making process and wield considerable weight on account of their shareholding and being present on the board. Hence it is critical to find a suitable VC investor whose principles, processes and ethos are aligned with those of the entrepreneur to avoid friction at the later stage, which would cause focus to be diverted from the core objective of growing the business.

##### Tip 5: Exercise Caution

In order to receive VC funding, an entrepreneur must also use discretion while revealing information about his idea/company. In the unfortunate event that the transaction is not completed, there could be a risk of the

entrepreneur's ideas and information spreading/being deployed by a usurper, which could be detrimental to the entrepreneur's/company's growth. Hence one should always be cautious about critical and sensitive information.

#### Conclusion

There is no 'one-size-fits-all' model of funding and each venture capital fund and start-up needs to find the right match. Several start-ups may require considerable sums of funding with larger dilution from investors to realize their concepts, while others may make do with a smaller amount with lower dilution in order to propel them ahead. Regardless of the conditions, it is advisable to analyze the investee company's potential funding possibilities and existing financial situation before making any decision. Even though venture capital funds have been active in the Indian market for some time, they have gained increased popularity as a result of the country's ongoing startup boom.

Both the venture capital fund and the start-up seeking the investment stand to benefit from venture capital funding. If a company in which a venture capital firm has invested is successfully acquired or goes public, the VC firm generates multiple 'X' return, which are then distributed to the fund's limited partners and increases the brand value and prospects to raise further funds. Similarly, the start-ups benefit from such funding by having access to money at the correct moment and for the right needs across all phases.

It could be said with certainty that today's venture capital funds have established themselves as one of the primary sources of funds for creative business entrepreneurs, and also helping propel the economy at the same time.

#### FAQs

What are some of the most common legal errors made by startups?

Some of the most common mistakes made by Startups can be:

1. Lacking vital documentation/agreements in place along with business-critical licenses and registrations to operate the company.
2. Not having a robust Founders' Agreement amongst the founders
3. Entering into a partnership with the aninvestor who may not be most suited and accepting onerous obligations in the investment documents.
4. Failing to understand Tax and Intellectual Property related issues early on before they become huge and costly mistakes.

What are some of the legal regulations and guidelines surrounding venture capital investments?

Some of the important legal regulations and guidelines surrounding the venture capital industry are:

1. The SEBI (Venture Capital Funds) Regulation, 1996 governs venture capital fund registration and activities in India.
2. Companies Act, 2013 governs all aspects of the start-up company, including incorporation, fund-raising, corporate governance, etc. and would govern investments by venture capital funds.
3. Income Tax Act, 1961 governs all the taxation aspects of the start-up company, including the taxation on the venture capital fund at the time of exit.
4. Registration under DPIITs StartupIndia Scheme providing tax related and other benefits to start-ups.
5. Compliance with Foreign Exchange Management Act regulations would be necessary in the event of foreign direct investment into the start-up.