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VENTURE CAPITAL - FUNDING NEW ALTERNATIVE

Alotaibi Mohamed Meteb
Associate Prof., Al Imam Mohammad Ibn Saud Islamic University,
College of Economic and Administrative Sciences, Department of Economic, Saudi Arabia
drmotaibi14@gmail.com

Abstract

The experience of venture capital in most of the developing countries is a new one and its recent results are very limited. Its contribution proportion to the financing of projects does not exceed 10%. It is specialized in financing some certain sectors and not others. Those are high-risk sectors. This paper aims to discuss the concept and forms of financing venture capital with an indication of the advantages and disadvantages of this new type of funding in light of reviewing some international experiences such as the American, United Kingdom, and French experiences applied in this regard. The paper handles the most important rules and policies necessary to support the success of this type of financing in the developing countries. The study has adopted the descriptive analysis method to diagnose this phenomenon and determine its application effects and the benefit from the developed countries experiences. In the end, the research paper proposes a set of conditions and policies needed to support the success of this type of financing in the developing countries.

Keywords: Venture Capital, Developing countries, investment projects, international experiences

INTRODUCTION

Several small and medium enterprises in the developed countries have overcome the problems of funding accessibility from several sources as a result of available financial services diversification and the use of modern technologies in the market financing. This helps control the risks and costs in contrast to their developing-countries counterparts where the funding problem still represents the main obstacle against its development and at the evolution and expansion stage. The projects dependence on their own funds as an internal funding source is often insufficient to cover the various needs through the stages of its various projects related to renewable and expanded investments. Therefore, it may have no choice but to resort to external financing (bank loans) conditioned by certain constraints such as (collateral required, the interest rate, the complex administrative procedures, trust) by the financial market represented in the specialized institutions and banks, as well as the lack of transparency and credibility of the information provided about the projects financial status and their ability to pay in the future. Thus, its funding is limited and weak, and does not encourage investment. In light of these difficulties, it was necessary to seek a new funding alternative funding for the dominant conventional financing system through developing the venture capital technology.

Research Importance

The attention that is given to the research topic is due to the importance of venture capital finance as a new source of funding for emerging and high-risk projects, along with the inability of traditional banks to finance emerging and high-risk projects that are based on innovation, creativity and invention, this is beside the scarcity of research and studies that are concerned about the subject of venture capital finance, particularly in developing countries.

Research Problem

The research problem lies in confronting many small and medium emerging projects in developing countries financing difficulties that may lead to lack of success, as the studies have shown the failure of 85% of the emerging projects because of problems that are related to funding from by traditional banks because of the high costs of obtaining loans and the required guarantees or banks rejection to finance as a result of the fear of the increasing risk of the new project and the project that is not studied well , which leads to the loss of growth opportunities and potential employment opportunities of the project. Thus, it was necessary to search for alternative funding sources for traditional funding sources and the most important one is venture capital finance. The fields of venture capital finance are limited to in the high-tech projects such as information technology and communications, as the most famous web sites like Google and Face book were funded by venture capital finance.

Research objectives

The aim of this paper is to discuss the concept and forms of financing venture capital with an indication of the advantages and disadvantages of this new funding type in light of the review of some international experiences applied in this regard, the most important rules and policies necessary to support the success of this type of financing in the developing countries.

Research hypothesis

There is a direct relation between the degree of risk in the financing decision and the expected profits from the project, as there is an inverse relationship between the degree of risk and financing decision.

THE CONCEPT OF VENTURE CAPITAL FINANCING

A method or technique to finance investment projects with high risk by companies called the venture capital companies (financing with private capital). This method is not based on cash-only, as is the case in the traditional banking financing, but is based on the participation, where the involved company funds the project without a guarantee of its capital or return (the source of risk). Thus risking their own money, unlike the traditional banking system, this refuses to give loans due to lack of collateral. In this case the risk-taking (the investor) bears the total or partial loss in the case of the project failure. The investor contributes in the institution management to ease the potential risks in all its various stages, both during the construction or renovation, expansion and growth to achieve its development and success. In other words, these funding companies are based on the profits and losses share through the (advanced technology - high risk - and promising profits) Therefore, these companies success requires them to be patient for a period of almost three years to ensure big profits (Finnerty, J ,2004) . The venture capital companies collect financial resources to demonstrate the shareholders ability and skills in raising the funds and attract investors, then look for projects requesting this type of financing, then the selection of the best projects suited to this funding. Finally, these companies resale the subscriptions to get out of the funded projects, and raise their subscription once again at the funding market (Gerald Joe, 2005). These companies have achieved remarkable success in the United States and Europe (England, the Netherlands) through the main objective of providing sufficient funds for new institutions or high risk. The venture capital emergence is dated back to the French-origin general "Doriot" who established in America in 1946, the first company specialized in the venture capital in the world "ARD". It was specialized in financing the new electronic companies and these companies growth had remained slow in the U.S. market until 1977. However in Europe, these companies are recent. The European association established the venture capital company in Brussels in 1983. Its profits ranged annually between 250%, 300%. The percentage of financing risk capital estimated 64% of the high-risk projects. All the developed countries have hastened to adopt this method, with varying results among them. Italy, Spain and Germany have failed in this experience (European Venture Capital Association).

FORMS OF VENTURE CAPITAL FUNDING

Funding varies according to the phase where the financing-required company exists. There are four financing stages, namely the phase of capital establishment, capital development, capital of ownership transfer, and capital of the correction. In the first phase, emerging and innovative high-risk institutions- which have great hope of growth and development- are funded. Capital is allocated to cover the expenses of research and experiments and the development of the new laboratory and commercial items. It also covers market commodity testing until the start-up phase and the beginning of production. It is a difficult financing due to the seriousness of the institution probable failure of the institution, which has no legal entity at this phase (Merton, R, 1993). The second phase of capital development is that one at which the project has reached the productivity stage of revenue generation. However, it faces financial pressures make it to resort to external financing sources to achieve the hopes of internal growth (an increase of productive and marketing capability); the external growth (project or branches acquisition, or markets diversification) and the expansion, whose average ranges annually between 10% - 5%. It venture capital includes as well, the two phases of project's development and maturity. Risks tend clearly to decrease, and self-financing plays a clear role at this phase. At the third phase, i.e. capital of ownership transfer, funding used funding whenever there is a change of the project owning majority into a new group of owners, or convert an already existing project into a holding financial company aims to purchase the existing projects (cases of death - accession). This phase includes also granting the company loans for new partners to ensure that there is no activity obstruction. After meeting all financial obligations, ownership is transferred to the investing partners in the subsidiary company. Finally the fourth phase which is capital correction is allocated to projects already existing, but facing special difficulties. They have the self- potentials to restore their ability and activity, but they need financial revival in order to be put in order, and anew resettle in the market and become able once again to achieve profits (Rwinh Abdel Samie, and Hijazi Ismail, 2006).

THE ADVANTAGES AND DISADVANTAGES OF VENTURE CAPITAL

The venture capital company is a partner to the institution original owners, and takes profits percentage ranged between 30% - 15%, in addition to 2.5% for annual administrative expenses. It also bears part of the losses when they occur. The practical, technical and financial support is beneficial to the company and helps ensure its success. It opens the way for long-term participation when the company is capable of growth and production. This is not available in the short-term debts. The venture capital company has the opportunity to choose a promising project. Many new projects are high risk and expected high profits as well as (Abdullah Ibrahim, 2006). One of venture capital funding characteristics is that it occurs in stages and not all at once. At the end of any stage, the beneficiary seeks anew the taxpayer, and this is a guarantee of the investment sincerity and the display of the work results. The taxpayer can distribute funding on several projects to compensate losses when they occur, along with the partner monitoring so as the project can avoid engaging in adventures of undesirable consequences. Moreover, this type of financing is able to fund high-risk projects which only owners of high financial capability can perform with compensating this risk with high returns. This type of financing also helps expand the ownership base, by attracting many investors, and financing other new projects through the higher capital revenue. In addition to its major role in financing small and medium enterprises, particularly during the establishment phase and when they do not possess the adequate funds and banks were reluctant to provide loans without collaterals (Marshall, J and V. Bansal, 2005). In contrast to the previous advantages, venture capital may represent a certain burden to the establishers by rights generated to the taxpayer because of participating in the project, such as participation in decision-making, and intervention in directing the course of the project. Furthermore, the project requires high amounts of the taxpayer to recover the shares, in the case of the project.

INTERNATIONAL EXPERIENCE IN THE FIELD OF VENTURE CAPITAL

The venture capital company is characterized in the American experience to be specialized in the promising and emergent companies' field. It selects distinguished sectors with high-growth opportunities like that of technology. In a study of 500 venture capital funded American institutions over four years and about 80% them are operating in the technology sector as compared to a similar number of self-funded institutions. The results as shown in Table (1), indicate clear supremacy for the venture capital funded companies over the self-funded ones in all aspects except in the case of creating a more efficient labor, where the two projects have equal proportion (Abdul Basit, Wafaa, 2006).

Table 1: A comparison between venture capital funded projects
and self-funded projects in the U.S.

Comparison	self-funded risk	projects funded venture capital
Create a more efficient labor (%)	**% 59-**	**% 59 +**
Employment per year (%)	**% 3 -**	**% 25+**
R & D expenditures per person (USD)	**8000**	**16000**
Annual investment rate (%)	**% 9+**	**% 35 +**
Annual productivity rate (%)	**% 5+**	**% 12+**

The experience of the United Kingdom that is the second in the world after the United States in terms of venture capital finance. The majority of its investments have been formed by pension funds and venture capital funds. The investments of governmental and public sector in these projects have reached, about 69% of venture capital investments. The global economic crisis and the decline in shares of information technology sector in 2008 have negative impact on the funding of venture capital system, where funding this system fell by 53% in 2009. It is not much different from the American experience, where the decline of funding was because of the same reason (Selim Elmasdy, 2008).

In the French experience, and according to the Bank of France report, a group of institutions was selected, of which 38% work in the technology sector, such as electronics, information, where 30% of these institutions established in 1990, and the rest established since 1980, employing between 100-500 workers. Part of these institutions is venture capital funded and the other part is not. The comparison results between venture capital funded and not, as shown in Table (2). It is clear from Table (2) that the projects financed by venture capital are much superior to those funded in other ways (Abdul Basit, Wafaa, 2006).

Table 2: Comparison of venture capital funded projects and self funded projects in France

Comparison	non-funded risk capital projects	projects funded with capital
Development turnover (%)	**% 5,3+**	**% 34 +**
Evolution of the volume of exports (%)	**% 12 +**	**% 67,8+**
Evolution of the volume of investment (%)	**% 4-**	**% 51,3+**
Evolution of the volume of employment (%)	**% 3,4-**	**% 19,9 +**
Development of middle-income rate (%)	**% 3,5-**	**% 5,4 +**

The most important criteria for evaluating ideas and projects that are funded by venture capital system are the following (Berbesh Elsayed, 2007):

- The idea must have added and implemental value and can achieve a reasonable growth rate.
- The expected rate of return on investment in the proposed project must be appropriate with the high degree of risk in funding.
- The project owner and the team must enjoy the skills and experiences with a high degree of efficiency.
- The financial and economic situation must be suitable to finance such ideas, inventions and innovations

THE CONDITIONS NECESSARY FOR THE SUCCESS OF THE VENTURE CAPITAL COMPANIES IN DEVELOPING COUNTRIES

The developing countries should provide favorable conditions for the success of venture capital institutions and for development of their activities to include these terms on the legislative, political, economic aspects. The higher the risk is, the more reluctant investors for investment are. In addition, it is necessary to encourage the establishment of venture capital companies, regardless of its founders' nationality. It is necessary as well to support partnership methods with the foreign venture capital institutions, particularly those possess high technology. Furthermore, it is necessary to establish centers for research and training to help finance emergent projects, provide consultations and follow-up their activity. It is necessary to provide an information base for investors in all aspects of economic activity (Liew Soon Bin, 2007). Finally, it is recommended to establish market securities which deliberate shares and securities for these companies. The developing countries should provide assistance and support to these institutions and encourage the private sector to create this kind of companies in order to overcome the various difficulties facing their activity. These difficulties include low income and high risk. The developing countries should support these institutions in various ways, whether directly or indirectly. The developing countries can particularly provide tax incentives and regulatory requirements governing the work of these institutions. The developing countries can ease the establishment procedures of such institution by including them in the commercial law of each country (Abdullah Beleidy, 2007). In addition, each country should create to common or public funds for risk capital as a form of support for these institutions, in line with those established in the United States of America in 1957, and Germany in 1995, Finland in 1994. Banks, financial institutions, independent investors, insurance companies, pension funds can play a vital role in the development and increase of the effectiveness of venture capital companies, to meet the financing needs, which the conventional finance is unable to meet as a result of the risk high degree surrounding it.

RESEARCH FINDINGS AND RECOMMENDATIONS

In the light of what has been early mentioned, the following results can be concluded:

- Difficulty in obtaining finance from traditional banks because of the high costs of obtaining loans and the guarantees that are required by the bank or the bank rejection for funding as a result of the fear of the increasing risk of the new project and the project that is not studied well.
- Traditional investment control over the majority of investors, which is limiting the ability to support and develop the venture capital companies in developing countries.

- The absence of legislative and commercial rules and regulations that are supporting venture capital companies in developing countries.
- The scarcity of venture capital companies in developing countries due to the absence of the culture of awareness of the importance of investment through venture capital companies and the rule of the idea of moving away from high-risk investment.
- Diversity segments of investors in venture capital companies and the contribution of these companies to reduce information asymmetry problems.

In the light of previous results, the research recommendations are as follows:

- Diversification of investments in venture capital companies to distribute risks and reduce them.
- The establishment of more venture capital companies in order to provide the required funding for the ideas, inventions and innovations in new different fields.
- The composition of specialized authority for venture capital companies in order to provide the necessary support and care to play its role better.
- The use of foreign experiences in the establishment of venture capital companies in developing countries.
- The development of curricula in schools and universities and adding entrepreneurship within the curriculum.
- Investment of scientific research and university studies, including innovations and inventions and ideas and their implementation on the ground through the provision of technical and financial support and funding them by venture capital.

CONCLUSION

The objective of this paper has been to explanation the concept and form of venture capital in most of the developing countries as is a new one and its recent results are very limited. Its contribution proportion to the financing of projects does not exceed 10%. It is specialized in financing some certain sectors and not others. Those are less-risk sectors. This is attributed to the weakness of professional competence, lack of effective techniques to control the high-risk, the growing forms of corruption, lack of confidence, as well as the lack of transparency and credibility in the information provided on the financial conditions of companies, and the weakness of financial markets, political and economic instability, absence of democracy, and non-observance of human rights in most of these countries. The capital venture implementation in underdeveloped countries has several problems. To overcome these difficulties, governments in less developed countries have to study and learn from advanced countries experiences.

Roles and regulations have to be flexible and easy. To guarantee success for these projects, policies have to be adopted given the financial resources available and setting priorities for projects that yield high income and employment.

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