VENTURE CAPITAL AS A POSSIBILITY OF FINANCING INNOVATIONS

Abstract

Innovative business venture by its nature is a risky area to allocate capital in. For many subjects interested in implementing innovations it is hardly possible to be provided with money from typical sources. Receiving capital from the stock exchange is possible only for big companies that are firmly grounded in the market. They are able to overcome the stock exchange entry barriers. Banks are embedded with means of precaution which make it more difficult to receive bank loans for projects of high or inestimable risk.

It is not a rule, however, innovations are a domain of small and medium enterprises. They are not completely hopeless in the financial market. Innovative products directed towards these market participants whose needs are not fulfilled by traditional financial instruments also appear. Forfaiting, factoring, leasing, franchising venture capital are only some of possibilities which are accessible for innovative business ventures in the capital market.

Venture capital funds are close-ended funds, they were developed mainly in the United States as a non-standard source of financing risky business ventures operating most frequently in the area of high technologies. Beneficiaries of such a capital are entrepreneurs who have an innovative product, method of production or a service. Benefiting from venture capital is connected to investments in, above all, new developmental enterprises. When we take under consideration the fact that venture capital is also connected with support in the area of management it also can be called „financial-advisory capital”.

There are both advantages and disadvantages of benefiting from venture capital. In the reference books this form of financing is frequently presented as a great secure form of receiving capital. Entrepreneurs are encouraged to take advantage of the offer provided by venture capital funds. Doubtlessly it can be good and sometimes the only solution when we have an idea but no money. However, we should remember that investors who provide us with financial resources in the form of venture capital - these business angels - are also business people aiming to receive profit. Resources received from the funds work mainly for the funds not for the entrepreneur. What is more, it is short-term or middle term capital which is usually withdrawn in the peak of the growth of the company’s value.


Keywords: venture capital, innovations, technology, financing, risk, management.

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Introduction

Innovation is every change which improves something, leads to a new quality or just means creation of a new product or a service. According to J. Koch and T. Koch innovation means to introduce new products, new means of production, to open a new market, obtaining a new source of materials or, last but not least, to introduce a new form of organisation of economic processes (J. Koch and T. Koch 2000 p. 9-17). This definition of innovation Schumpeter focuses on new combinations of factors of production.

P. F. Drucker (1992) defines innovation in a slightly different way. „Innovation is the specific tool of entrepreneurs, the means by which they exploit change as an opportunity for a different business or service....Innovation does not have to be technical, does not indeed have to be a „thing“ altogether.”

Neither patent application nor prototype, particular idea, policies – from economic point of view – cannot be defined as innovation. Using innovation in economic activities allows to verify their usefulness and also it allows to measure their efficiency. Hence innovations should be related with finance on every stage of production. It is necessary to calculate the risk of failure of implementing innovations and also overinvesting risk connected with overinnovation. When not taking into consideration all above, innovation is only the idea not investment.

From the definition of innovation the fact that the whole implementation process is usually complicated and that it requires a lot of specific knowledge, a lot of material and financial resources can be derived. Due to the fact that risk connected with innovative project is hard to be measured, it is difficult to obtain financial resources. Traditional sources of gaining capital, such as banks or stock exchange, frequently turn out to be inaccessible. Banks do not accept high risk or they demand high emoluments in the form of interest on a bank loan. However, these interests are too high for an entrepreneur. For small and medium enterprises an inaccessible place to search for financial resources is the stock exchange. Only big companies grounded firmly in the market are able to overcome the stock exchange entry barriers.

In the most developed countries in the world - the USA, Germany, Japan – the level of expenses on education has been relatively high for years. What is important, social and economic systems in these countries are not the same. There is free market system in the USA and less free market system in Germany and mixed in Japan. When we have the same level of expenses on R&D, quite important seem to be the structure of these expensases. In the developed countries, most of R&D expenses is financed by business (in OECD 59,1 %, and in EU 52,7 %). When we compare Poland to developed countries, there is quite different structure of these expenses. It means relatively lower share of expensases financed by business(34,8 %) and higher by budget (61,3 % it is average for 1995-2005). In European Union Programme for economic growth and employment research and innovations main priorities.
Some governments create special supportive programmes by which innovative projects are provided with money. Expenditures on research and development (R&D) which are foreseen in their budgets can satisfy the need for financial resources for introducing innovations only of a part of the entrepreneurs. For many investors it can be not sufficient enough. Solutions are alternative sources of capital. One of such financial sources is venture capital.

**Financing by venture capital**

The first enterprise which was offering financial capital along with support in realisation of a business venture was American Research and Development established in 1946 in the USA. In 1958 The United States Congress approved a legislation act called The Small Business Investment Act. Its goal was to subsidize venture capital with public resources by preferential loans whose size was dependant on the own capital of a business venture. In Europe roots of the venture capital go back to the year 1925. Development of the market falls on 1980s. (Grzywacz and Okońska, 2008, p. 48-50).

Venture capital funds are closed-ended funds. Their activity consists on the fact that a group of investors allocate their money in investments of a particular type – ones that can be uncertain but also can earn high rates of return. This type of financing investments concerns most frequently non-publicly traded companies. The venture capitalist is not allowed to exit such a company overnight, but he needs to wait until the enterprise develops fully. In Poland the domain of venture capital funds are usually enterprises which have a good product or have already been successful in the market what resulted from their rapid growth over the several past years, however, they fall short for capital for faster development and for increasing production capacities as well as for conquering another market niche or for developing their trade network.

According to American models venture capital funds are described in a slightly different way. An investment financed by them is directed towards new venture businesses based on advanced technologies which are characterised with hope of high profit but where significant investment risk is involved. Therefore it is frequently the main source of financing innovation.

The main goal of venture capital funds is to increase the market value of an enterprise. New capital serves financing a specific, precisely prepared investment programme. Frequently it concerns purchasing new technological lines or machines, development of a trade network or purchasing modern tools for production and steering and management. Most often this capital serves financial restructuring of an enterprise of increasing its current assets. Profits earned by the enterprise are usually entirely directed to its further development. Funds of the already presented type are created by public investors that are governmental agencies or local authorities or...
by private investors - such as: banks, corporations, insurance associations, pension funds, individual entities or higher education facilities. Funds examine in details chances of investment projects. They verify thoroughly information about a partner and his/her enterprise; they meet recipients of the product in order to get to know if sale would increase. They run a market analysis in case of a start-up businesses (Tamowicz and Rot, 2002, p. 6-7). Nevertheless, the most frequently, they want to meet people who run or will run the enterprise: check whether are they convinced about success, are they competent, what do they know about competition and modern management.

Venture capital funds have developed mainly in the United States as a non-standard source of financing risky business ventures operating most frequently in the area of high technologies. Their blossom to a large degree resulted from stagnation on the credit market and it was an answer to low commercial banks’ eagerness to loan funds for such business ventures, since commercial banks watch for sources of long-term profits in financing operations that are innovative projects which are characterised with limited risk level. Therefore they naturally pay their attention to and focus on business organisations which have long tradition of many years and are well grounded in the market. Venture capital funds - which are high risk capital funds, apply a completely different strategy. They search for investments of very high possible profitability accepting increased risk. The essence of venture capital business ventures, especially start-up businesses, consists of following issues:

- The fund allocates financial resources for taking possession of shares or stock shares. In comparison to a bank loan there is neither surety nor guarantee. A venture capital fund becomes a partner to the degree proportional to the capital it has invested, moreover, it takes the risk connected with a given business venture.
- A venture capital fund is usually not involved in current running of the enterprise, however, it tries to influence establishing the company’s development strategy and strictly controls its fulfilment. For that purpose the fund includes its representatives either in the enterprise’s board of directors or in the supervisory board. The fund transmits to the enterprise’s management priceless knowledge and experience through the hired high-performance experts.
- Time of financial involvement of venture capital is limited in advance and it ranges the most frequently several years. The profit is earned not as much on dividend as on the increase of the enterprise’s value. Usually profits are earned by introducing shares to a stock exchange, and by selling the shares to other partners and managers or to a foreign investor.

The key to the success of the discussed funds is an ability to find business ventures which are highly attractive from the perspective of initiators of new businesses. The most significant criteria of selection are:

- High rate of return on investment to the amount of 50% a year, which is possible to be obtained in several years.
• Strong management.
• Competitive product, technological superiority.
• Enterprises which operate in dynamic sectors or branches and are characterised by growth dynamics higher than mean dynamics within the branch (Cieślik, 2006, p. 138-139).

Beneficiaries of discussed investments are entrepreneurs who have an innovative product, method of production or service. Due to the fact that the discussed form of financing is connected with investments in, above all, new, developmental enterprises, venture capital may be called „developmental capital”. When we take under consideration the fact that venture capital is also connected with support in the area of management it also can be called „financial-advisory capital” (Szelągowska ed., 2007, p. 428).

**Venture capital as an element of private equity**

Terms „private equity” and „venture capital” are not equivalent, however, in Europe they are treated as synonyms. In Polish terminology there is no proper equivalent for the term „venture capital”, therefore English term is commonly utilised. However, in order to describe this form of financing, following terms are also frequently utilised: high risk capital, speculative capital, capital involved in risky transactions, high-risk funds (Bielawska, 2009, p. 188-189).

„Venture capital” means to to provide money for the initial capital of private non-publicly traded enterprises which are at the initial stages of their development. These funds are included in more significant investments, that are private equity investments, and most frequently are highly risky. The highest number of unsuccessful transactions occurs amongst venture capital investments. Minimal expected annual average rate of return is within bounds from 30% till 50%. „Private equity” - means to invest through private equity funds in non-publicly traded companies which are at different stages of their development, whose aim is to increase their value and obtain over-average capital profits. Annual average expected rate of return on total private equity investment is 25-30% minimum; expectations on rates of return depend on the level of risk. Venture capital investors - and wider private equity investors - contribute to a company also managerial capital which is a significant generator of the growth of the company’s value. In the category of „private equity” are included:

• Capital provided to an enterprise in order to avoid its going bankrupt (recovery, rescue capital, turnaround), for example when the enterprise’s current difficult financial situation results from the board’s of directors mistakes or is a consequence of not receiving financial resources from a big client or a key-client.
• Capital granted for financing undertakings which consist of taking over a company from its hitherto owners by its CEOs or external managers (MBO, management buy-outs, MBI, management buy-in).
• Capital devoted to privatization of enterprises owned by the government, e.g. purchasing Stomil Sanok, Polfa Kutno by funds managed by Enterprise Investors.
• Capital directed to withdrawing an enterprise's shares from public circulation (delisting) - transactions of this type become more and more popular, for example in Great Britain.
• Capital assigned to bridge financing - for example financing such companies as Sfinks, Eldorado by funds managed by Enterprise Investors.
• Capital for merges or takeovers (M&A mergers & acquisitions) and branch consolidations (buy & build strategy).
• Mezzanine – financing with hybrid securities - for example Solaria Bus & Coach or Lux-Med financed by Accession Mezzanine Poland (Szablewski, Pniewski and Bartoszewicz, 2008, p. 292-293).

Forms of venture capital investments

Venture capital investments can be made either directly by investors - direct investments means purchasing shares or stock shares of a company by which the investor acquires his right to dividend, right to collect newly issued shares or right to voice at the general meeting of shareholders - or by proxy of special financial agencies created for this purpose and called venture capital funds - indirect investments, when the investor acquires only right to the fund’s profit-share benefits. The choice of the form of investment depends on many factors: the stage of an enterprise’s development, size of the investment, a capital provider’s and a beneficent’s preferences of capital engaging, a willingness to take risks or a capital provider’s expectancies, fiscal consequences of an investment (Grzywacz and Okońska, 2008, p.52-52).

Direct investments

Direct investments create a so called non-formal market of private capital, which is not accurately regulated. There can be found investments undertaken by individuals or groups of individuals in the form of purchasing shares or stock shares of enterprises with high growth potential that are highly risky at the same time. Usually such investors are relatives and friends of the entrepreneur who searches for capital; these investors have emotional connections with the entrepreneur. Another group of investors are people who have access to big funds and have enormous experience in business. Subjects who supply capitals in the non-formal market are called informal investors or business angels (Pruchnicka-Grabias, 2008, p.63). They are private investors who were usually successful as private entrepreneurs or as managers in corpora-
tions. They would invest their own experience in business and financial resources as a support for new interesting business ventures in hope to achieve reasonable rate on return. They are attractive due to their great flexibility and pragmatic attitude (Cieślak, 2006, p. 142). A business angel can be won at every stage of development of an enterprise, however, they are mainly interested in so called start-ups. Business angels’ investments are directed towards seed stage and the first stage, that is start-up. These stages involve the business angel’s great engagement because there is a significant risk of losing financial resources. Amongst disadvantages of business angels can be indicated: quite high cost of capital received (a business angel obtains company’s shares and takes advantage of profit-share benefits) and intervention into the company’s work, what is, especially in Poland, hard to be accepted by stakeholders. Advantages of cooperation with business angels are as follows:

- a chance to receive capital for high-risk business ventures,
- the business angel’s experience, high competences and know-how,
- being interested in commencing to collaborate with other formal investors,
- increase of credibility of an enterprise,
- the business angel’s contacts and agreements with the enterprise’s potential partners and customers (experts, suppliers, financial institutions),
- increase of the enterprise’s equities (business angels’ investments are not long-term ones) (Bielawska, 2009, p. 194-196).

The institution of a business angel in Poland is only just formulating and evolving. Indigenous business angels are usually active entrepreneurs, not necessarily very rich ones, however, they are interested in developmental branches such as IT, biotechnology, telecommunication or advanced services. In Poland operate following networks of business angels:

- Lewiatan Business Angels (LBA)
- Polska Sieć Aniołów Biznesu PolBAN (PolBAN – Business Angels Club)
- Silesian Business Angels Network (SiLBAN)
- Lubelska Fundacja Rozwoju (Lublin Development Fundation) – at the stage of organising (Pruchnicka-Grabias, 2008, p. 64).

**Indirect investments**

Indirect investments consist in acquisition of participation entitlements of venture capital funds, similarly to traditional investments. An investor is not engaged directly into investment process, for this purpose he takes advantage of an intermediary, that is a special financial institution - the fund. The intermediary allocates collected resources on his behalf but for the benefit of investors. These institutions have high-qualified personnel and they work at: searching for interesting enterprises by analysing their chance of success, supporting the enterprise in management and divesting resources. Investing by proxy of such an institution is less risky than direct
investment, since the funds invest in several projects at the same time. A structure of a venture capital fund is usually based on the scheme which consists of four elements: total capital, investors, a managing subject and an object of investment. Total capital consists of resources allocated by the investors in the fund. Amongst the investors can be indicated: insurance companies, banks, pension funds, big companies, individuals and public institutions. Resources collected from them are managed by a managing subject whose main goal is to accrue the mandated total capital by allocating it in selected enterprises, which are objects of investment, on the condition that the objects of investment fulfil specific investment criteria. According to the way of accumulating capital and the level of variability of the participants the venture capital funds can be divided into close-ended funds and open-ended funds, which are also called trustee funds. In a closed-ended fund capital results from selling shares to the investors. Number of issued shares is at the stable level, which means that there is no permanent resources inflow. On the other hand, open-ended funds gain capital by issue of share units number of which changes together with the change of demand for them and this results in constant variability of the fund's capitals (Pruchnicka-Grabias, 2008, p.68).

Terms and strategies of obtaining a chance capital

Venture capital funds are ready to invest into companies of different branches or regions being at different stages of development, yet, in every case it needs to be an enterprise that has solid perspectives for dynamic growth. That is why venture capital investors search for entrepreneurs that (MGiP, 2005, p. 12),:

- Have a good management,
- Have a better service/product offer than the competition or have the technological advantage,
- They work on a raising market,
- They have a significant share of the market,
- They develop faster than their branch.

Venture capital funds investment process stages are to be listed as follows:

Stage I: Development of the fund’s idea

1. Choosing the organisational and legal form.
2. Establishing the investment strategy (business sector profile, geographical range, investments’ types).
3. Gaining the main investment partners (managers). Such people usually derive from the investment banking or either enterprises of the domain of production or service.
4. Obtaining capital from the investors (insurance funds, pension funds, enterprises, banks, business angels).
5. Obtaining attractive portfolio companies in a defined business sector range (Szablewski and Pniewski and Bartoszewicz, 2008, p. 298).

The beginning of the process that would end with obtaining venture capital starts with a clear and precise definition of the enterprise’s potential, its market terms and needs for capital. Propositions for a venture capital investor should be prepared properly. A basis for negotiations with a possible venture capital investor is a description of a company and of an undertaking. Usually venture capital funds expect a business plan, although some of them are ready to take into consideration a simpler document. On the other hand, others require additional financial projections or a business model, etc. No matter which of these situations it is, the material presented should introduce the company – its history products, owners, competition, position in the market, developmental strategy, but also its business results and prognoses as well as needs for capital and professional experience of the main shareholders and members of the board of directors. Venture capital investors read the business plans very thoroughly. A significant part of the non-realised projects is being thrown away at that very stage. When preparing a business plan one might benefit from a consultant’s assistance, however, the members of the board of directors should be involved in preparing the business plan (Szablewski and Pniewski and Bartoszewicz, 2008, p. 298).

**Stage II: Selection of business plans/portfolio companies**

1. Detailed analysis of the chosen projects (due diligence).
2. Negotiations and projects of investment stages.
3. Capital investment.

If the project passes through the initial stage of the analysis the most frequently the venture capital investor submits further questions and asks for additional information. Subsequently this is a moment for meeting of the board of directors of the company with the representatives of the fund - the project is initially approved and both sides start to make it more precise. The investor runs a deepened analysis of the enterprise including business analysis, financial audit, legal audit, organisational analysis, sometimes also analysis of technology or environmental protection, what requires a lot of detailed information and its confidentiality is guaranteed by the fund. If the fund realised that the enterprise is suitable for investment and an agreement on developmental plans of the enterprise were accepted, then next stage would start, these are: negotiations, i.e. the point when the management of the company and the investor establish conditions of the investment. Particularly the thing is to define for both sides: shares, responsibilities, rights, representatives in the supervisory board or the rules of managerial options etc. and - what seems to be the most difficult part of the negotiations - to establish the price of the investor’s acquiring the particular share in the created company. These negotiations are usually conducted parallel to due diligence. In fact, the draft of the most important conditions and ex-
expected price of the transaction are included in the agreement between sides involved at the early stage of due diligence negotiations.

**Stage III: Managing the value of the portfolio companies**

1. Participation in the supervisory board.
2. Constant verification of the investment’s results.
3. Recruiting the key-management.
4. Strategic advisory.
5. Support in searching for additional financial resources.

When the negotiations and due diligence finish successfully then comes the time to approve the agreement. Investment funds usually have a special organ, so called investment committee. It is the committee who makes the final decision on investment. This is the basis for signing the agreement and transferring capital to the enterprise.

Presented process of investment usually lasts several months. After signing the agreement the venture capital fund invests the money, nevertheless, it does not stop providing the enterprise with support. Decision of capital involvement into the company is considered by the fund as the beginning of a long-term cooperation which should be based on mutual trust and respect for the partners’ interest. Usually the fund is represented within the company by their representative or by representatives in the supervisory board. The fund observes current work of the company, achieved effects and supports the board of directors in strategic issues by providing them with the fund’s knowledge and experience or hiring experts in finance, marketing, strategic management or personnel management.

**Stage IV: Exiting the investment**

1. Exiting the investment (managerial buyout, first public offer, liquidation, merger, selling the company).
2. Gaining financial profit.
3. Closing the fund.

After few years, when a company develops according to expectations, a fund approaches the stage of exiting the company, i.e. to the stage of the disinvestment. According to the fund’s policy, company’s character, business sector and situation in the market – it happens usually after 3-7 years, although there are sometimes cases of longer or shorter investments. The exit strategy is to be agreed during the initial negotiations and might range from stock issue at a public market or obtaining a business sector investor or another financial institution. It might also be realised through repurchasing the stocks by the company’s management board, other shareholders etc. Exiting the investment might be realised in subsequent stages or as a one-time event. Venture capital fund leaves the company and realises the profit.
Ending the cooperation with venture capital

There are a few possibilities of ending the cooperation with a venture capital fund:

1. **Selling shares to a sector investor**

   This method of ending the cooperation with a venture capital fund happens through the sales of a defined block of shares or all the company’s shares to an investor who is within the business sector. An entrepreneur needs to take into account the investor’s motives do buy, i.e.:
   - Intending to increase the participation in the market – in such a situation a sector investor the most willingly would take control over a customer of the highest market share who offers a product range the closest to the one he/she is offering.
   - Willing to broaden the offer, a business sector investor searches for an enterprise that would have a complimentary offer,
   - Diversification of activities by entering a new market; in such a situation a company that is being overtaken should make sure that a new investor knows and understands differences between the markets of the companies. It is necessary if the relation with a potential investor is to be profitable.

   This method of exiting the investment is one of the most profitable and one of the most often realised strategies. It usually ensures the highest return on investment, since a business sector investor is more willing to pay a bonus to the public market valuation. The basic advantage of this strategy of investment is a stock liquidity since the business sector investor gives a possibility to sell off the whole block of shares that is owned by the fund and the entrepreneur paying a given, quite often relatively high, price. Business sector investor is usually interested in taking over the whole company or at least the controlling block of shares. Te benefits that the entrepreneurs tend to see in such an exit mechanism are:
   - Possibility to realise the profits through the resale of the part or of all of one’s shares,
   - A chance to gain access to the assets of a business sector investor – research and development of new products,
   - Technology, suppliers, distribution channels and the market for the company’s products,
   - Access to know-how (strategic management or marketing strategy).

2. **Making a portfolio company open-traded**

   A fund introduces a portfolio company to the stock-exchange or to a regulated OTC in order to sale its shares. This process includes open-trading the block of shares in public offering and gradual sale of the remaining shares at the stock market. Many entrepreneurs consider this method to be the best since it allows to keep control over the company and gives a possibility to realise personal profit through selling part of the shares. The public market provides a company with prestige and
trustworthiness; it also facilitates access to capital when a company needs assets for further development. A basic flaw of this method of ending the investment is a low stock liquidity. Both the entrepreneurs and the owners of a fund possess significant block of shares; it means that they usually cannot sell everything in a public offering since the main goal of appearing on the public market is acquiring capital for additional shares by the company through issue of new shares. If the shares already existing were a too big part of the offer, the company would not benefit from the stock market investors significant interest. That is because the investor’s money would not reach the company and would not work on increasing its value.

3. Resale of shares to a finance investor
Finishing the cooperation through sales to a financial investor makes sense when it comes to companies of a high growth potential who are not yet mature enough to enter the stock market or to sale to a strategic investor. Keeping the stocks too long significantly decreases the investment’s return rate. At that point sales to a finance investor (usually a different fund) is profitable. Thanks to such a transaction a fund is able to give the assets back to its investors and the entrepreneur and the board of directors are able to keep building the company’s value. In our country such transactions do not happen often, however, in Western Europe, it is a more and more popular way of exiting an investment.

4. Resale of shares to the board of directors or to other owners
There are situations when entrepreneurs who gain financing from a venture capital fund wish to regain total control over the company when the fund exits the investment. Then they would aim at repurchasing the company’s shares from the fund. It happens in a similar way when the shares are bought by the team of managers who manage the company, yet, who were not the owners of any of the company’s shares before. In both of these cases the source for financing the transactions is another capital fund or a bank who gives loans to such transactions.

5. Redemption of the fund’s shares
Redemption makes it possible for the initial founders to regain control of the business. It is not an easy solution. Main difficulty is the necessity to earn by the company reasonable profits (resources) that would finance the redemption. The fund may also be unwilling to end the cooperation this way. In such a situation it is possible to cash, that is bonus for control. Then there is also no tender between buyers. Despite these weaknesses the redemption seems to be a better solution than selling shares to the founders (Tomanowicz, 2004, p. 53).
6. Liquidation

Liquidation is caused by bankruptcy of a portfolio company or by proceedings for an arrangement with creditors. This way of exiting the investment ends the fund's engagement in the enterprise but the most frequently it also does not give any outcomes, since the sum received from the liquidation of assets is usually devoted to paying the financial obligations.

Characteristic features of venture capital funds

Particular utility of venture capital funds for the innovative enterprises results from certain specific features of this particular form of financing. Amongst them can be listed as follows:

- Long-term investment character that results from connecting the investor’s profits with a company’s long-term value. It gives the relations fund-company a partnership character and limits a risk of capital withdrawal when facing financial problems of difficulties with realisation of innovative projects;
- Equipping a company with its own capital realised by shares. It reconstructs a balance sheet of the enterprise, increases its credibility and decreases financial risk of operations controlled by the company;
- Providing a company with know-how on management and strategic planning as well as with a business contacts network that might allow to obtain efficient managers, brilliant scientists and to build own market relations in a cheaper, faster and more efficient way;
- Catalysing a company’s development through facilitating access to market research and increasing budget on company’s own scientific and developmental activities that fasten the course of adaptation processes in the company and make it more flexible when it comes to market changes.
- Giving a company an image of an innovative, pioneer subject that would shape a technological and technical progress, picturing it as trustworthy what has a particular significance when it comes to an enterprise that would introduce a new service or a new product in the market (Świderska, 2008, p. 43).

One of the venture capital investment features is a possibility to adjust it completely both when it comes to a kind or value of financial instruments applied and when it is about the period of time during which this investment tool would be applied to the enterprise. Venture capital fund investments are treated as the company’s liabilities, as a capital and not as an obligation. It is caused by the funds’ risk since no collateral neither in possessions nor a personal one is required, as it happens when gaining capital from a bank. Therefore a division of risk concerning investments between the enterprise and the venture capital is important. Additionally, the fund, in order to decrease the risk, becomes engaged in management in a direct way. In practice it means that a beneficent is obliged to present the investor periodical finan-
cial reports, information on realisation of plans, on sales and on investments. Usually a fund also requires to be informed immediately when important changes of financial or market satiation appear. A characteristic feature of financing undertakings by venture capital funds is the funds’ consulting activities. It is supposed to be seen through the increase of company’s value. Venture capital funds’ consulting might range to different areas of the enterprise that is shared. An investor might help through: personal advising, financial, technical, legal consulting, through intermediating during contacts with foreign customers, through market research. It is to be underlined that funds’ consulting activity has also negative consequences. These are the high costs of hiring experts and weakening the enterprises’ initiative. The fact of existence and active functioning of the venture capital market has a significant meaning for stimulating the entrepreneurship in the economy (Szelągowska red., 2007, p. 429).

Every entrepreneur who thinks about the possibility of financing his/her business with the assets coming from venture capital funds should also take into account all the arguments in favour or against such a solution. He/she should also consider those demerits and advantages from the point of view of his/her possibilities, expectations and needs. However, usually the benefits from venture capital fund investments are bigger than the limits that result from that fact and they influence in a positive way the competitiveness of the companies enforced by this form of capital (Grzywacz and Okońska, 2008, p.159).

Advantages of venture capital

When discussing the advantages of venture capital funds one needs to point out few categories of the positives (Grzywacz and Okońska, 2008, p. 154).
1. The main advantage of venture capital is the possibility to finance even very risky and innovative projects which could not be realised in any other way (it concerns the early stages of the company’s development).
2. Venture capital type funds are active investors, i.e. they take active part in working out and realisation of the strategy and management of the finances. Their existence is connected with monitoring of the enterprise's activity, especially when it comes to the financial results. The investors become the company’s associates. The basic formal levels of cooperation between a venture capital fund and a company are the supervisory board and the board of directors. The new shareholders also participate in the investment risks together with the other co-owners of the enterprise. Their goals are identical with the goals of the other co-owners and the company's management: the development of the company and a significant increase of its value. This type of funds is of a patient and experienced investor. He tries to help the company when it gets into trouble. The main areas of cooperation with the company and the help provided by the fund are:
   - help with creating the company’s strategy, business plans and financial plans;
   - counselling in preparing investment plans;
– capital restructuring, support in transformation of organizational structures;
– help with the choice of staff;
– support in contacts with financial institutions;
– help in the expansion abroad (the funds often have experience in the international financial markets);
– sectoral expertise;
– participation in searching for investors and support in negotiations with potential investors, help with gaining additional financing sources (part of the venture capital funds are the companies belonging to the banks);
– creating a marketing strategy;
– counselling when making the company go public;
– help with developing relations and gathering important data concerning the market;
– access to business information possessed by the fund, the profits might also come from a particular shape of the investment portfolio that could include the companies that provide/produce commodities that would be complimentary or might be providers/receivers of other controlled companies;
– enforcing and strengthening the company’s market position;
– when a need appears – proposing sector specialists that would cooperate with the enterprise’s managerial staff in order to exploit the company’s potential;
– serving with a friendly advice and a trusted person.
3. The fund as an investor influences also the amelioration of the enterprise’s image; it goes this way because the investments show the external subjects that:
– a significant investor believes in a company and the technologies it applies or concepts it realises;
– managers of an enterprise are properly motivated to manage the company in a good way;
– a significant investor will control, to the proper extent, the activities of the company’s managerial staff;
4. Venture capital investment influences the amelioration of the relation of debt to the enterprise’s own capital and increases its credit capacity and benefiting from the fund is not charged with paying the interests.

Disadvantages of venture capital

Financing an enterprise through venture capital funds has also certain disadvantages that can be gathered around few negative issues:
1. Venture capital funds are one of the most expensive financing forms available in the market. At the beginning it might seem that it is a cheap source of finances since no interests need to be paid. However, when such an operation becomes successful, often an afterthought appears stating that a fund had bought shares in a great enterprise too cheaply and that if a bank loan would had been taken instead of benefiting
from venture capital, neither the company nor the profits would be shared. Yet, it remains to be through that the capital cost will be high only when successful. An entrepreneur should think it through whether he/she prefers to have a small enterprise only to himself/herself or whether he/she would prefer e.g. 60% of a big company.

2. Necessity to share the worked out profit and power causes the most unwillingness of the owners of the small and medium enterprises who tend to be strongly connected to the company they owe. That is way, not taking into account the judgement on the entrepreneurs’ concerns rationality; the presented issues are to be concerned as disadvantages, no matter all the positive operation that can be assigned to cooperation with an investor.

Since the fund does not really have a possibility to withdraw the assets invested in an enterprise during the period of few years, instead, it expects not only information but also the possibility to influence the course of events in the enterprise. The CEO who supports and advises (also at an informal basis) is a partner of the company’s management. Additionally the fund frequently stipulates a right to influence the company’s important decisions, e.g. those concerning signing contracts of a significant value, judgement of the process of realisation of plans, accepting annual budgets, selling company’s assets, choosing the auditor, plans of a merge with other subjects, being overtaken by a different company. The company needs to be ready to accept a presence of the fund’s representative and losing some control that results from the amount of shares of the company. Fear is deepened by the fact that inviting the venture capital investor, even when selling just a minority shareholding, frequently ends with a mutual sale of the enterprise both by the entrepreneur and the investor after a period of few years. Venture capital is not the best idea to gain a capital for those companies that are owned by one family for generations.

3. The temporary character of the capital engaged by a venture capital fund is frequently regarded as a flaw. It does not matter much to the entrepreneur if he/she works out the exit terms with a fund in advance. A negative quality, when it comes to the capital’s rate of return, is the fact that the assets invested work rather on behalf of the fund and not the entrepreneur.

4. An additional flaw, when a fund exits an investment through the stock market, is the valuation of shares that is lower than the one made during the public offering.

**Conclusions**

Venture capital is a high risk capital. These funds are defined as one of the institutions of the capital market that finances new business undertakings or provides undertakings of a significant growth potential and low level of economical maturity with financial assets. The core of venture capital funds’ functioning is to support management, to create a founding base and the growth phases of new innovative undertakings – all that through providing them with financial resources and possible
management consulting. Economic sense of venture capital is expressed by providing a company, that is in a phase that precedes introducing a product in the market, with capital that would be free of interests and with improving the structure of the company’s passives. Indirectly it has a positive influence on a chance of obtaining an additional bank loan. Venture capital company excludes risks by a proper structure of the shares portfolio and by compensating losses in certain undertakings with high profits coming from the other projects. Presence of three factors at the same time is a distinguishing feature of this financing method:

- Venture capital company equips a company in an innovative way with own capital that comes in a shape of shares, it does not require commonly used guarantees or interests,
- Venture capital company is obliged to help with managing the company,
- In a medium and long time horizon the shareholders aim at obtaining high profits by selling the shares when the enterprise becomes successful in the market.

References


