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Risk Types and Precautionary Measures of Venture Capital

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Abstract

Venture capital, also known as venture capital, is a new investment method. Firstly, the paper analyzes the main characteristics of venture capital, that is, high risk is, high return is; Venture capital has strong participation; Low liquidity of venture capital. Then, the main risks faced by venture capital are analyzed. Finally, it analyzes the experience and enlightenment of dealing with the risk of venture capital abroad.

Keywords

Venture Capital; Risk Type; Policy Enlightenment.

1. Introduction

Venture capital, also known as venture capital, is a new way of investment. According to the definition of American Venture Capital Association, venture capital is a kind of equity capital invested by professional financiers in rapidly developing enterprises (especially small and medium-sized enterprises) with great competitive potential. In March 1998, at the First Session of the Ninth CPPCC National Committee, the Proposal on Developing China's Venture Capital Undertakings as soon as possible submitted by the Central Committee of the People's Republic of China held that venture capital is an investment behavior that invests funds in the development of high-tech and its products with the risk of failure, aiming to promote the commercialization of high-tech achievements as soon as possible, so as to obtain high capital returns. Venture capitalists should not only invest capital, but also play their long-term accumulated experience and knowledge as equity owners, and use information networks to help enterprises operate and manage. This paper analyzes the basic investment of venture capital, the main risks faced by venture capital, the experience of foreign countries in dealing with the risk of venture capital and its enlightenment.

2. Characteristics of Venture Capital

As far as the practice of venture capital is concerned, it mainly chooses small and medium-sized enterprises with high growth potential that are not publicly listed, especially innovative or high-tech oriented enterprises, to participate in the investment of enterprises in the form of convertible bonds, preferred shares, and stock options, and at the same time participate in the management of enterprises, so that enterprises can obtain professional management and adequate financial resources, and promote the rapid growth of enterprises and achieve their goals. After the enterprise matures, venture capital gains higher returns by transferring the equity of the enterprise through the capital market. Venture capital is different from general investment and has its own characteristics:

2.1. High Risk and High Profitability

The high risk of venture capital is related to its investment object. Traditional investment targets are usually mature products with high status and reputation, so the risk is very small.

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The object of venture capital is the technological innovation activities of high-tech SMEs that have just started or have not yet started. It focuses on the potential technological capabilities and market potential of the investment object, so it has great uncertainty, that is, risk. In Silicon Valley of the United States, there is a widely spread so-called "thumb law", that is, if venture capital invests in 10 high-tech start-ups a year, three companies will collapse in about five years of development; Another 3 companies are stagnant; 3 companies can be listed and have good performance; Only one company can stand out, develop rapidly, become a dazzling star, and give investors huge returns, and this enterprise becomes the "thumb" in the "thumb law". According to statistics, about 50% of the investment projects of American venture capital funds are completely failed, 40% are not profitable or have small profits, and only 10% are successful. High return is associated with high risk, and venture capital is a strategic investment focusing on the future. Investors do not turn a blind eye to the high risks of the project they are investing in, but because the huge profits behind the risks, that is, the expected high growth and high value-added, are the motivation for their investment.

2.2. Venture Capital has Strong Participation

Unlike the traditional industrial credit, which only provides funds and does not involve in enterprise or project management, venture investors also participate in the operation and management of enterprise projects while investing in high-tech enterprises, thus showing strong "participation". Once venture investors invest in high-tech venture enterprises, they form a symbiosis of risk sharing and benefit sharing with venture enterprises. This relationship requires venture investors to participate in the management of the whole process of venture enterprises.

2.3. Low Liquidity of Venture Capital

Venture capital is a kind of long-term equity capital with low liquidity. The general purpose of financial investment is to earn fees or interest income, while the purpose of venture capital is to own the company's equity, operate and manage the company, and finally recover the investment capital through equity transfer to obtain investment income. What venture capital seeks is not basically predictable short-term returns, but the high profits brought by long-term equity growth. Because of this, people call venture capital "patient and brave" capital. In addition, when venture capital finally exits, if the export is not smooth, it will be very difficult to withdraw capital, which also makes the liquidity of venture capital low.

3. Risk Type of Venture Capital

Venture capital flows from capital supplier - investor to capital operator - venture capitalist (venture capital company), and then flows to capital user - venture enterprise (entrepreneur) after the latter's screening decision. Through the operation and development of venture enterprises, venture capital gains value appreciation, and then flows to venture capital companies, which return the income to investors. The cycle of venture capital has formed the turnover of venture capital. The tripartite participants in the venture capital system: investors, venture capitalists and entrepreneurs, form a dual entrustment relationship between investors and venture capitalists, venture capitalists and venture enterprises through the hub of venture capital. The interests of the client depend on people's actions. Investors generally do not participate in the investment, operation and management decisions of venture capital. Although venture capitalists participate in the management of venture capital, they cannot participate in the daily operation and management of enterprises as venture entrepreneurs do. This gives people the opportunity to hide information from the client. When the interests of the person and the client are inconsistent, the person may make use of this asymmetric information to make a behavior choice that is unfavorable to the client, and the risk arises.

3.1. Investors and Venture Capitalists Form the First Trust Relationship in the Venture Capital System

The contractual carrier of this relationship is venture capital companies. Then comes the human problems caused by uncertainty, information asymmetry and transaction costs. Venture capitalists may damage the interests of investors by virtue of their advantages in information. The specific performance is as follows: (1) Venture capitalists distort the situation of the enterprise to be invested to shareholders and mislead investment decisions according to personal conditions or personal relationships. (2) After the investment, when participating in the management of the invested enterprise, they abuse their power, collude internally and externally, and seek personal gain every year. (3) Venture capital funds are used to speculate rather than invest, damaging the interests of investors, so as to maximize their own profits in the short term.

3.2. The Second Trust Relationship between Venture Capitalists and Venture Enterprises

With their new ideas, new ideas and new projects, entrepreneurs form a demand for the capital and management experience of venture capitalists. The product of the combination of the two is a venture enterprise, and forms the second entrustment relationship in the venture capital system. As an investment intermediary, venture capitalists (and their venture capital companies) choose projects with high growth (good market prospects) for financing and investment and establish venture enterprises according to the fundamental standard of whether they can bring high investment returns. Here, the venture capitalist is the principal and the nominal owner of the property, and the entrepreneur is the person who actually manages the use of capital and property in the process of operating the enterprise. The specific risks are as follows: (1) After obtaining the investment, enterprises use false accounts or transfer assets to deal with accounts, resulting in false financial information, resulting in real profits but account losses; (2) Entrepreneurs may make high-risk investments at all costs, regardless of whether the invested projects are "optimal", or put the industrialization and marketization of high-tech behind them, and invest in "low-quality" projects for the sake of personal status in the high-tech field.

4. Risk Prevention System of Foreign Venture Capital

4.1. Investors and Venture Capitalists

(1) Limited partnership: among venture capital organizations in the United States, limited partnership companies account for about 80%, and the rest are venture capital companies affiliated to enterprises or financial institutions and small business investment companies supported by the government. Limited partnership organizations can become the mainstream model of venture capital organizations because they can pass the responsibility. The basic institutional arrangement of interest and a series of incentive and constraint contracts between them effectively reduce risks and protect the interests of investors. Incentive mechanism: The limited partnership system usually stipulates that the general partner (venture capitalist) contributes 1%, while obtaining 20% of the benefits from the venture capital fund, the limited partner (investor) contributes 99%, and obtains 80% of the benefits from the venture capital fund. This institutional arrangement fully considers the interest incentive for venture capitalists. In order to pursue their own interests, venture capitalists will do their best to achieve success. At the same time, the limited partnership system stipulates that only general partners can participate in fund management, and limited partners do not directly interfere in business activities, which ensures the independent status of venture capitalists in management activities and helps them to play their business management ability without external

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interference. Restraint mechanism: First, venture capitalists, as general partners, contribute 1% of their capital, but bear unlimited joint and several liability for debts, while investors (limited partners) are only responsible within 99% of their capital contributions, setting a ceiling for risk bearing. Especially in countries where venture capital is developed, such as the United States and the United Kingdom, most of the capital contributions of limited partners take the form of a commitment system, leaving room for them to control risks. Second, the mandatory distribution policy solves the problem of income distribution from the sale of investment assets, and prohibits venture capitalists from engaging in some self interest transactions. Third, in the limited partnership system, many provisions can be made on the default of the general partner. For example, the duration of the fund, the voting rights of the limited partners, and the manager must report the fund operation regularly, which also reduces the information asymmetry to a certain extent. (2) Through the fund manager's incentive and restraint function on market reputation. In an effective fund manager market, fund managers are always inclined to choose actions that maximize the utility of investors for reputation reasons, so as to gain the trust of the market, so that they can manage more funds. And venture capitalists with good industry and market reputation will be easier and faster to raise new funds at a lower cost. "For those who have high ability and whose ability has been demonstrated through previous success, when they want to expand their business, they will be less constrained by their personal wealth endowment." The biggest capital of fund managers is their industry reputation and qualifications, which is positively related to the amount of funds they can raise. Through the above system design and incentive and restraint mechanism arrangement, the problem of venture capitalists as fund managers (people) rather than owners (clients) has been overcome to some extent, so that people can choose the most favorable action for the clients from their own interests, thus effectively avoiding and reducing risks.

4.2. Venture Capitalists and Venture Entrepreneurs

(1) Phased investment strategy. The staged investment strategy is that venture capitalists only inject a small part of the capital needed for project development at the beginning, and later financing is fully linked to the success of intermediate goals, or to the observation of venture capitalists on the actions of venture entrepreneurs. It endows venture capitalists with the right to give up additional investment and reserve the right to purchase additional investment first. For venture entrepreneurs, facing the pressure of venture capitalists to stop investing, and after the enterprise value has risen continuously, the shares that can be exchanged by equal amount of capital will decrease with the growth of the enterprise, the dilution of the shares of venture entrepreneurs will decrease, and the income share of successful venture entrepreneurs will increase, which constitutes an incentive for venture entrepreneurs. (2) Convertible Preferred Stock Contracts. Venture capitalists determine the conversion ratio of convertible preferred shares according to the performance of venture enterprises. Flexible conversion conditions will change the distribution of risk income, which can prevent venture entrepreneurs from overestimating profit forecasts. At the same time, it gives venture capitalists greater voting rights, which can give priority to compensation in liquidation, thus reducing the motivation of venture entrepreneurs to run their enterprises into bankruptcy, It gives more shares to venture entrepreneurs than common stock contracts, so that they are fully encouraged. In addition to the conversion characteristics, convertible preferred shares also have some restrictive provisions, such as restrictions on new share issuance, mandatory share repurchase and share transfer, so as to minimize the risk of entrustment. (3) The incentive and restraint functions of stock options. The implementation of stock option system in venture enterprises gives venture entrepreneurs the right to buy the company's shares at the agreed price at a specific time, and enhances the incentive of venture entrepreneurs. The stock option is a long-term incentive. The venture entrepreneur can only exercise it after obtaining the option for a period of time. The more the company's stock price exceeds the agreed price of the option when exercising the

option, the greater the venture entrepreneur's income will be. When venture entrepreneurs fail to perform their duties, the enterprise value will decline, options will not be executed and they may be dismissed. When the venture entrepreneur performs his duties, the enterprise value increases, and the venture entrepreneur can obtain additional income through stock options, which is much higher than his fixed salary. Therefore, venture entrepreneurs will take due diligence strategies to maximize enterprise value and achieve a win-win situation. (4) Investment supervision is carried out by actively participating in enterprise management and providing consulting value-added services. In the entrustment relationship between venture capitalists and venture entrepreneurs, due to the greater uncertainty and information asymmetry of business operation, venture capitalists are required to actively participate in business management activities to prevent and control risks. Since venture enterprises are not constrained by mandatory information disclosure, venture capitalists can usually take a direct part in the business decisions of the invested enterprises. By providing various consulting and value-added services for venture enterprises, they can grasp the actual situation of venture enterprises in close cooperation, thus helping to overcome the risks of venture enterprises.

5. Inspiration from the Risk Management Experience of Foreign Venture Capital to China

5.1. Innovate the Organizational Structure of Enterprises, Relax the Restrictions on Venture Capital Companies in the Company Law, and Explore the Establishment of Venture Capital Organizational Forms with Chinese Characteristics

Limited partnership is an important way for venture capital institutions to perfectly combine incentive mechanism and constraint mechanism to improve investment efficiency. However, at present, in China, limited partnership enterprises do not have the legal person status, which can not be said to be a major defect in the organizational system of enterprises in China. However, the general partners in the limited partnership system still need to hire professional managers to deal with the investment business. They still need to control the risks at this level and provide effective incentives to avoid the impetuosity and eagerness for quick success in venture capital. Therefore, some companies also explore the organizational form of venture capital companies adopting quasi partnership system (project partnership system or internal fund-raising system). The specific implementation method is as follows: the project will be raised internally when it is ready for investment through the necessary review and evaluation procedures. There are four necessary conditions for this link, and the project can only be passed if it meets the requirements at the same time. (1) The project manager or project team members must promise that if the company invests, the project manager or project team members must also invest, and the company has a basic investment amount according to the size of the project. (2) After the investment decision is passed, the decision-makers who vote in favor shall have a basic investment amount. (3) For public offering to the whole company, there is a minimum basic requirement for the total number of investors, generally three or more. (4) The total amount of internal raised investment must reach a lower limit of the basic investment amount. After the internal raising, the employees signed an entrustment agreement with the company, stating their respective risks and interests, and confirming the principle of voluntary investment. At the same time, the company will pay a certain percentage of the project income as the company's bonus, 50% of which will be given to the project personnel, reflecting the preference of the commission performance to the project personnel. Project partnership is actually an internal control and incentive system, which is effective for solving human problems. Under the circumstance that the limited partnership system in China has not been recognized by law at present, the trial implementation of project partnership system, to some extent, represents the development direction of the organizational form of venture capital companies in China at this stage, and has great theoretical and institutional innovation significance.

5.2. Actively Participate in the Management of Venture Enterprises, Strengthen the Construction of the Property Rights System of Venture Enterprises, and Establish and Improve a Scientific and Effective Incentive and Restraint Mechanism

First of all, we should strengthen the construction of the property rights system of venture enterprises and promote the clarity of the property rights of venture enterprises. Only on the basis of the clarity of the property rights of venture enterprises can venture capital clarify its right to monitor the operation and management of venture enterprises. Both ordinary shares and preferred shares should be selected reasonably according to the different investment periods. We can also develop convertible preferred shares to increase the flexibility of venture capital to obtain income and participate in supervision. Secondly, establish a scientific and effective incentive and restraint mechanism. Third, implement staged investment and reserve the right to give up or add investment, which is both a pressure and an incentive for the enterprise's management. Once the venture capitalist stops investing, it means that the enterprise has great risks, and it will be difficult to obtain support from other investors and banks. Effective institutional arrangement and property right design in the venture capital system can greatly reduce or even avoid risks.

5.3. Establish and Improve the Venture Capital Intermediary Service System

Venture capital involves venture capital, venture capital companies, intermediaries, venture enterprises and other elements. Intermediaries have gathered professionals from all aspects, which can make up for the shortage of venture capitalists and venture entrepreneurs. Therefore, we must establish and improve the intermediary service system to provide financing, investment, science and technology, audit, legal advice and other intermediary services for the development of venture enterprises and the operation of venture capital companies. Whether the intermediary institutions are sound is one of the important indicators to measure whether a country's venture capital industry is developed

5.4. Vigorously Cultivate Venture Capital Talents and Venture Entrepreneurs Who are Familiar with Venture Capital Business and have High Comprehensive Quality

At present, China is still very short of such venture capital talents. Therefore, we must actively create conditions, establish a sound education and training system for venture capital talents, and provide a complete supporting mechanism including economic, political, scientific and technological aspects to provide necessary opportunities for the rapid growth of venture capital talents.

5.5. Construct a Good External Environment for the Development of Venture Capital and Effectively Reduce the External Factors Arising from Venture Capital Risks

(1) Strengthen the legislative work of venture capital, so that venture capital can obtain legal guarantee. Venture capital involves two stages of financing from the public and investing in venture capital enterprises. It involves more complex relationships. In addition, its own high-risk nature requires the establishment of a complete legal framework for its operation. At present, China is still short of laws on venture capital enterprises and venture capital funds. Therefore, we must strengthen the legislative work of venture capital, study and formulate complete laws and regulations on venture capital market and supervision, and issue supporting policies and measures to provide legal protection for the normal operation of venture capital.

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(2) We will further improve China's capital market and launch the Growth Enterprise Market as soon as possible to ensure that venture capital can "come in and go out". Venture capital is mainly invested in the form of shares. As a medium and long-term investment, the main way to realize its value is also the best way to realize the company's listing. Therefore, we should appropriately relax the listing conditions for high-tech enterprises, establish the GEM market as soon as possible, promote the circulation of venture capital and investment, enable venture investors to exit smoothly, and establish an effective venture capital exit mechanism.

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