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A Review of the Impact of Venture Capital Investment on Enterprises' Innovation and Entrepreneurship Activities

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Abstract: *In face of unknown risks and fleeting market opportunities, start-up enterprises will inevitably suffer the "Liabilities of Newness" due to lack of resources, etc. Owing to resources advantages in terms of funds, experience, expertise and the relationship with suppliers and cooperative partners, etc., venture capital investment institutions naturally fit with such enterprises and become a force to be reckoned with in promoting listing of start-ups. At present, Enterprises' innovation and entrepreneurship activities are inseparable from the support of funds. As a unique financing method for entrepreneurial enterprises, venture capital not only provides a rare financing channel for start-ups, but also plays an important role in their innovation. This article discusses the relationship between venture capital and enterprises' innovation and entrepreneurship activities, providing a reference for venture capital and enterprises' innovation activities.*

Keywords: *Venture Capital; Innovation; Entrepreneurship Activities*

1. Introduction

In recent years, China's entrepreneurial financing environment has witnessed enormous changes. Supported by venture capital, well-known Internet companies such as Tencent, Alibaba, Baidu, and Jingdong have emerged one after another. [1] Research on the history of innovation shows that major early innovations mainly relied on informal relationship-based financing, such as family funding, assistance from relatives and friends, and sponsorship by wealthy people, etc. The special financing such as venture capital for investment of high-tech entrepreneurial enterprises was not formed and developed until 1946 when the American Research and Development Corporation (ARD) was established. A large number of theoretical and empirical studies have shown that the unique financing contract, limited partnership system and bilateral incentive mechanism of venture capital provide a solution to the problems with the cooperation between capital and entrepreneurship and innovation. Currently, as the common financing model of start-ups, venture capital not only provides funds and technical resources for enterprises' innovation and entrepreneurship activities, but also play a role in financial policies, capital market, transaction mechanisms, etc., thus improving the performance of small and medium-sized enterprises by creating a satisfactory development environment and reducing the risks for their innovation and entrepreneurship activities.

2. Literature Review

2.1 The concept of venture capital

In a broad sense, venture capital includes the investment of funds for all meaningful pioneering and entrepreneurial economic activities. In a narrow sense, it is mainly an investment method where long-term equity investment is provided for unlisted emerging companies with high growth potential in the entrepreneurial stage to promote fast commercialization of new technological achievements and obtain the investment returns through the capital appreciation of the invested companies. [2]

The National Venture Capital Association of the U.S. had explained that venture capital is equity capital and that venture capitalists preferred emerging scientific and technological industries when seeking investment in enterprises to gain the returns. [3] Although these industries have a broad development prospect, there are great risks due to their lack of development history. The investment made by investors after a decision-making is the injection of equity capital into enterprises, which is

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also referred to as the venture capital.

2.2 Characteristics of venture capital

2.2.1 Long-term

This development and growth history of enterprises shows that they will normally and inevitably undergo several critical stages such as budding, the introduction, growth, and the maturity. After identifying such development prospect of an enterprise, an industry or a project, investment companies will often increase investment whose entire process usually lasts for 3-5 years or more. [4]

2.2.2 Professionalism

Venture capital is not simply about provision of requisite funds with which enterprises which can obtain requisite conditions and resources for development. Many venture investment companies even have their own industry experts who will use professional knowledge and experience to provide enterprises with consulting services related to operation and management. These are also valuable resources accessible by enterprises during their development, providing important foundation and support for the next stage.

2.2.3 Risks

Venture capital mainly targets at small and medium-sized high-tech enterprises with high development potential. Since such enterprises are in the start-up stage, it is difficult for them to seek guarantee due to lack of collateral. Furthermore, because of prolonged period for recovery of investment, it is highly risky to obtain high returns. In addition, high-tech enterprises have to undergo the stages of R&D, experimentation, production, and sales in technical innovation, and each stage is highly uncertain with high risks. In a short term, they cannot gain high return but may face failure. Therefore, venture capital is highly risky. [5]

2.3 Innovative and entrepreneurial enterprises

Differing from conventional mature enterprises, entrepreneurial enterprises refer to innovative and pioneering enterprises with high growth potential and high risks in the entrepreneurial stage. Their main characteristics include the following:

2.3.1 Strong spirit of innovation and creativity

Originated from Creativity and innovation, most entrepreneurial enterprises are born with new products or services which are the key factor as well as a breakthrough in traditional products and services. This requires that entrepreneurs should have unique research on a specific industry in order to create new products and services.

2.3.2 High risks and high returns

Entrepreneurial enterprises have obvious drawbacks in terms of strength, resources and market, etc. in the early stage. The immaturity in various aspects and the high uncertainty in the external market have posed greater risks to their operation. Furthermore, they are vulnerable to risks. Of course, with the help of venture capital, an entrepreneurial enterprise can gain enormous benefits once it successes due to the strong innovative spirit and creativity, bringing high returns to entrepreneurs and venture capital institutions. Entrepreneurial enterprises are also characterized its strong demand for resources and high uncertainty of future development. Among them, high uncertainty of future development is the main characteristic. Venture capital can help entrepreneurial companies better cope with uncertainty and continue to innovate in a fickle environment.

2.4 Venture capital's promotion of entrepreneurial enterprises

Kortum and Lerner[6] carried out empirical study on the relationship between venture capital and technological innovation at earlier time. Based on the panel data from 20 manufacturing industries in the United States during 1965 to 1992, they found that venture capital not only generated significant positive impact on the number of patents in an industry, but is also more efficient than other capital. They estimated that venture capital generates three times as many patents per dollar invested as other capital.

Tykvova[7] also reached similar conclusions using German industry-level data, but the promotion

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effect of venture capital on technological innovation is weaker in Germany than in the United States. The above studies have supported the conclusion that venture capital can promote technological innovation from the industry level. After carrying out the tests using the data from 173 high-tech start-ups in Silicon Valley, Hellman and Puri found that innovative companies are easier and earlier to obtain venture capital than imitation companies and that companies (especially innovative companies) with venture capital can launch products to market in a faster manner. Most of previous research has supported the argument that venture capital can promote technological innovation at the industry level.

3. The Impact of Venture Capital on Enterprises' Innovation and Entrepreneurship Activities

3.1 The value-added effect of enterprises' entrepreneurship activities

When making investment decisions in face of many entrepreneurial enterprises, venture capitalists need to go through six stages, including ①seeking projects; ②screening as per venture capital institutions' own standard; ③screening as per general standard; ④evaluation of project value; ⑤ assessment of investment obstacles of the project; ⑥conclusion of investment contract.(As shown in figure1) The screening should follow the basic principles of clear cognition, expected achievable rate of return and excellent managers. Clear cognition means that an enterprise has the potential for sustained growth, be able to fast implement new business plan, and have relevant clear competitive advantages; expected achievable rate of return means an enterprise is clear about the exit channels of investment and can gain high returns; Excellent managers mean that the management team of an enterprise has strong management capabilities, cohesion and rich experience.

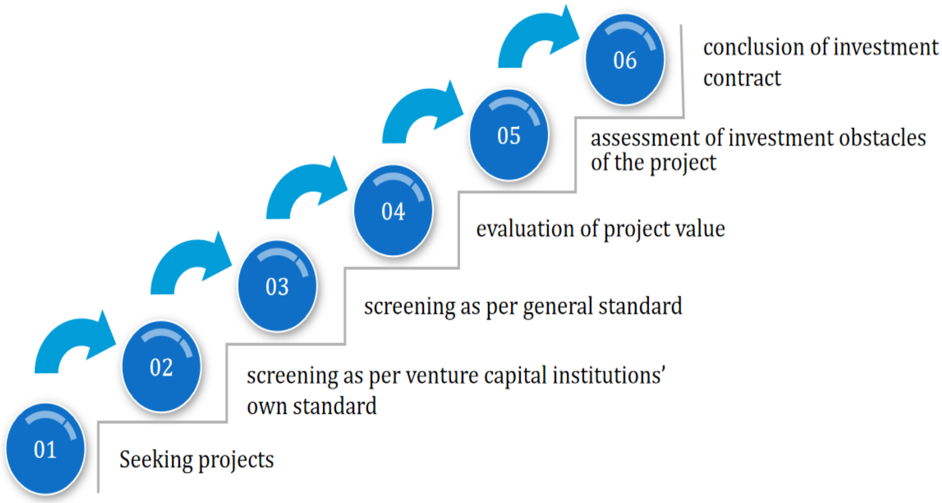

Figure 1: Six Stages of Venture Capital Decision Making

After choosing the most potential entrepreneurial enterprise through screening and evaluation, venture capitalists will enter into a contract with the entrepreneur to bind both parties regarding the rights and obligations. This also means that when determining final investment project, a venture capital investment institution also highly recognizes the high return and specific value of the enterprise, and are willing to provide more opportunities for the entrepreneurship activities of entrepreneurs.

3.2 Dual support of funds and management

Entrepreneurial enterprises need to invest a lot of funds throughout production and operation, while venture capital builds a bridge between capital and high technologies through provision of a special flexible investment, whereby providing an important financial guarantee for the cultivation and growth of many potential innovative scientific and technological companies that cannot carry out financing through channels like banks. Compared with the conventional credit loan where only funds are provided without interference into enterprises' operation and management, venture capital is mostly equity investment. Therefore, investors also participate in management after investment of funds, such as product development, production, sales, the establishment of corporate institutions and the selection and hiring of personnel. Through participation in operation and management of enterprises, venture capital helps enterprises solve the problems in R&D, production, and sales, and provides guiding

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opinions for formulation of business strategies, thus achieving increased investment returns.

3.3 Reduction of enterprises' transaction costs

The result of venture capital should be the transformation and realization of the achievements in enterprises' innovation and entrepreneurship. On this basis, venture capital will be mutually recognized with property rights to form a contractual capitalization mechanism. The achievements in enterprises' scientific and technological innovation activities should go through multiple stages such as scientific and technological transformation, product production, and market transactions before obtaining benefits. The innovative technologies are intangible assets of transactions, and are more reflective of their own potential transaction value which can only be verified and realized after a period of time. As such, investors and enterprises can hardly achieve the unity of interests due to deferred valuation. From this point of view, if the two parties can agree on the transaction cost in deferred valuation and the potential value of the technology in addition to regulation on the benefit of both parties, the enterprise can reduce the transaction costs and invest more funds on scientific and technological innovation. The present venture capital can reduce the transaction costs of innovative enterprises. As to information asymmetry in the capital market, enterprises should explain in detail the technical part in seeking financing for innovation projects, so as to avoid increased transaction costs due to information communication barriers.

4. Conclusion

In summary, the practice of venture capital has grown by leaps and bounds globally, with venture capital funding and management supporting innovation and rapid growth, access to new resources and opportunities. As a special model of entrepreneurial financing, venture capital is not only adept at selecting startups with innovative potential for investment, but its involvement can bring additional value-added services that drive continued innovation in entrepreneurial companies.

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