Acta Universitatis Danubius
ŒCONOMICA

Comparative Analysis of Theories and Features of Venture Financing

Suleyman Suleymanzade[1]

Abstract: The article examines various theories and models of venture financing. Theories and models are analyzed and compared, highlighting their advantages and disadvantages. The characteristics, specifics, and features of each venture financing theory are presented. Different stages, elements, and mechanisms of each theory and model of venture financing are explored. The significance of each theory and model is interpreted by identifying their positive and negative aspects. Features of the financial mechanism of venture investments are characterized. The direction of financial flows and the specifics of venture investments in the high-tech market are described.

Keywords: Venture financing; startup; innovation; high-tech market; venture investments

1. Introduction

Financing is one of the primary tools in the formation of various processes in the planning of production and service provision. Sources of financing can vary: from private investments to government funding. The growth and development of companies often face challenges primarily related to a lack of financial resources. In the early 20th century, entrepreneurs like Andrew Carnegie and John D. Rockefeller invested their own funds in developing new enterprises, supporting innovative ideas and fostering industrial growth. These entrepreneurs acted as business angels. In some cases, the government becomes the main sponsor of companies, especially in

[1] Azerbaijan State University of Economics (UNEC), Azerbaidjan, Address: 135 Academician Hasan Aliyev St, Baku, Azerbaidjan, Corresponding author: snzade98@gmail.com.

fundamental research, which spans many years. Thus, sources of company financing include venture funds, private investors, corporate venture divisions, and institutional investors (Leroy, 2022). These participants invest their funds in exchange for a share in the company and participation in management, allowing not only to finance projects but also to actively assist in their development and strategic planning.

Interest in venture financing is driven by its ability to support startups and small innovative enterprises, which, despite high risks, have the potential for significant growth and transformation of entire industries (Kaplan & Strömberg, 2004, pp. 2173-2206). This type of financing provides young companies with the necessary resources to develop and commercialize advanced technologies, ultimately contributing to the creation of new jobs, improved quality of life, and national economic growth. In the genesis of venture capital development, it can be divided into the early stage covering the period from 1940 to 1960, the growth and consolidation period from 1970 to 1980, global expansion and globalization from 1990 to 2000, and the modern period from 2000 to the present. A widely prevalent trend of supporting the high-tech market is becoming a promising direction for economic development in most countries. Even countries with traditional economic inclinations are interested in creating tech farms, parks, hubs, and innovation incubators. Fundamental research and the creation of new innovative products require significant financial resources of a mixed nature and sources of financing. To implement and create tech enterprises and startup platforms, government financial support is insufficient, and attracting investors to the high-risk sector becomes unprofitable. Therefore, venture capital and its participation in this segment become necessary.

2. Comparative Analysis of Conceptual Views

Factors explaining successful venture financing include the theory of innovation ecosystems (Moore, 1993). This theory is based on the interaction between various participants in the innovation process, including startups, venture funds, large corporations, universities, and government structures. Innovation ecosystems create favorable conditions for knowledge exchange, collaboration, and innovation implementation, contributing to the growth and development of startups. An example of a successful innovation ecosystem is Silicon Valley in the USA, where the dense concentration of tech companies, venture funds, and research institutions creates unique conditions for the rapid growth and commercialization of new technologies. Similar ecosystems have begun to form in other parts of the world, such as Shenzhen in China and Tel Aviv in Israel, indicating the global and successful nature of this model. The theory of staged financing emphasizes a phased approach to venture investing, where startups receive financing at various stages of

their development. This approach allows venture capitalists to minimize risks and manage their investments more effectively. The stages of venture financing include:

- Seed financing: initial investments to help the startup develop the concept and conduct preliminary market research.

- Round A: investments aimed at scaling the business, developing the product, and attracting the first customers.

- Round B and subsequent rounds: further financing for business expansion, entering new markets, and strengthening competitive positions.

Each of the aforementioned financing stages is accompanied by a thorough evaluation of the startup's potential and its compliance with investors' requirements. Venture capitalists provide not only financial resources but also strategic support, increasing the chances of startup success. Another venture capital theory is the network capital approach, focused on the importance of social and business networks for successful venture financing (Agrawal, Catalini & Goldfarb, 2011). Network capital includes connections and relationships that venture capitalists and startups establish with other market participants through extensive use of electronic programs and mobile data exchange applications. In the context of globalization, network capital gains special significance as startups and investors can interact with partners and customers worldwide. Online platforms and social networks play a crucial role in creating and maintaining these connections, promoting the development of global venture ecosystems. The final theory, asymmetric information, interprets problems arising from uneven information distribution between startups and venture capitalists (Akerlof, 1970, pp. 488-500). Startups often possess more complete information about their products and prospects than investors, leading to risks and uncertainties. To overcome these issues, venture capitalists use various mechanisms such as conducting due diligence, setting milestones, and involving experienced managers. These measures help reduce risks and ensure more transparent and predictable investment conditions.

All the above theories of venture financing reflect the complexity, multifaceted nature, and intricacy in the era of technological changes under globalization conditions.

3. Comparative Analysis of Theoretical Models of Venture Financing

Various model approaches to venture financing provide the necessary investment capital influx. Enterprises developing a specific lifecycle strategy for an innovative product are based on the need for timely market entry, starting from the idea's inception, market entry, business scaling, and transitioning to the traditional product market (Gompers & Lerner, 2001). Different venture financing models have certain

advantages and disadvantages. The startup model includes several stages, each requiring specific strategies and financing approaches. The idea stage involves entrepreneurs formulating the concept of a future product or service, conducting initial research, and analyzing market opportunities. Financing at this stage is usually limited to the founders' own funds or small investments from business angels. The seed stage receives initial funding to develop a prototype, conduct market research, and build a team. Venture funds and business angels play a key role at this stage, providing capital and expertise to assess risks associated with market entry or product adaptation. The early growth stage involves the startup beginning to commercialize the product, attracting the first customers, and scaling operations, naturally requiring more financial resources than previous stages. Additional financial flows at this stage allow scaling and increasing production capacity. The expansion stage entails the company entering new markets, increasing production capacities, and diversifying the product line. Investments at this stage aim to maintain high growth rates and strengthen competitive positions. The final exit stage involves the company entering stock exchanges to sell company securities through IPO (initial public offering) or selling the company by venture investors to other economic entities. This stage concludes the startup lifecycle from a venture financing perspective. The feature of this model is the representation of a specific financing strategy for startups by venture investors. Advantages of the startup model include more detailed investment planning achieved through phased implementation of the investment package, as well as a focus on technological developments. The disadvantages of this model are the high risks at the initial investment stages due to uncertainties leading to potential financial losses and its limited applicability in other areas not related to innovation creation. The venture capital development model focuses primarily on portfolio investments, creation, and management of a venture fund (Metrick & Yasuda, 2010, pp. 393-449). The main components of this model include the following elements:

- Fund formation involves attracting capital from institutional investors, private and family businesses, and high-net-worth individuals. Fund formation includes setting investment goals, strategy, and management structure.

- Project selection and evaluation involve analyzing potential investment opportunities, due diligence, and startups with high growth potential.

- The investment process involves concluding contracts and agreements, as well as setting milestones for progress monitoring.

- Portfolio management includes regular monitoring, participation on the board of directors, and providing access to resources and partners.

- Exit and investment realization imply investment through IPO, mergers and acquisitions (M&A), or selling shares on the secondary market. This process aims to reduce the payback period of invested funds by the fund and partners.

The venture capital development model provides a structured approach to asset management and their interaction with portfolio companies to financially support innovative startups. The advantages of the venture capital development model include systematic approaches to venture fund management, their transparency and efficiency, as well as active investor participation in the process of forming and making decisions in company activities, significantly increasing development potential and reducing risks. The disadvantages of this model are direct dependence on the financial state of market trends, including various factors such as the macroeconomic environment, and high management costs associated with portfolio management, involving venture investors' participation. As we can see from the analysis, each venture financing model has its strengths and weaknesses, which should be considered when applying them. Exploring these aspects allows venture capitalists and entrepreneurs to choose the most suitable strategies and approaches for successfully developing innovative projects in the modern economy.

4. Conclusion

The aforementioned theories and models of venture capital enable the effective use of the scientific, technical, and creative potential of startups, innovative farms, and small promising enterprises specializing in creating new products. The theoretical basis of venture financing has formed based on natural market tendencies and the psychological-personal factors of investors themselves. When considering investors based on behavioral factors, it becomes clear that some prefer more stable earnings, while others prefer extreme investment where profits are yet undetermined, and risks are highest. Venture investors belong to the latter type.

Venture financing has its specifics, enclosed in the form of funding sources. Thus, modern theoretical models provide a basis for understanding the processes of functioning and investing financial resources in innovative companies. All the aforementioned theories and models have certain advantages and disadvantages, but the identity of conceptual views is enclosed not so much in the form of financing as in supporting innovative companies in creating new products. Famous brands used today, such as Google, Apple, and Amazon, owe their success to the timely support of venture capital. None of these companies' products, initially startups, could have become recognizable brands or brought substantial profits to investors if not for timely support at the initial development stages. Furthermore, analyzing venture investments in the high-tech market shows that this area is one of the most promising and dynamically developing. Technologies and innovations are the driving forces of the modern economy, and venture investments allow the implementation and commercialization of new ideas. In conclusion, it can be stated that venture financing in the modern world is an integral part of the economic development process, promoting the emergence and growth of innovative companies, and thereby

contributing to overall economic growth and improving people's quality of life. The complexity and multifaceted nature of venture financing require continuous improvement of theories and models to adapt to changing market conditions and technological progress.

References

Agrawal, A.; Catalini, C. & Goldfarb, A. (2011). The Geography of Crowdfunding. *NBER Working Paper No. 16820*.

Akerlof, G. A. (1970). The Market for Lemons: Quality Uncertainty and the Market Mechanism. *The Quarterly Journal of Economics*, 84(3), pp. 488-500.

Gompers, P. A. & Lerner, J. (2001). The Money of Invention: How Venture Capital Creates New Wealth. *Harvard Business Review Press*.

Kaplan, S. N. & Strömberg, P. (2004). Characteristics, Contracts, and Actions: Evidence from Venture Capitalist Analyses. *The Journal of Finance*, 59(6), pp. 2173-2206.

Leroy, A. (2022). *Venture Capital.* New York: Business Expert Press.

Metrick, A. & Yasuda, A. (2010). Venture Capital and Other Private Equity: A Survey. . *European Financial Management*, 16(3), pp. 393-449.

Moore, J. F. (1993). Predators and Prey: A New Ecology of Competition. *Harvard Business Review*.