Venture Capital: Overview 2021

Venture capital (VC) financing takes educated risks on great ideas and smart people, giving young companies the opportunity to take their ideas to market, and grow. This section provides a brief primer on venture capital financing.

Venture Capital Financing – Investors

The large majority of capital invested in the VC investment ecosystem is disbursed by limited partners (LPs) and general partners (GPs). Limited partners – so called because they typically invest through a fund legal structure called a "limited partnership" – are investors who commit capital to a VC fund or VC fund-of-funds. These may be institutional investors, pension funds, family offices or other large investors, who commit capital to a VC fund in order to generate a return on their investment. Other investors could include high net-worth individuals, often referred to as "angels", who may have a personal connection to the company's founders or its market segment, and are willing and able to accept the high risk that comes from investing in a young company. GPs are the partners of a VC fund management company that raises financing from LPs and generally manages the fund, including making all investment decisions.

While a number of alternative models of VC funds have emerged in recent years, a basic distinction may be drawn between VC funds and VC funds-of-funds. VC funds generally invest capital directly into a portfolio of operating companies through the purchase of equity, based on the fund's overarching strategy. In contrast, VC funds-of-funds primarily invest in a portfolio of VC funds – though these funds-of-funds may also make a proportionally smaller number of investments directly into operating companies.

VC investments are effectively "locked in" until a recipient firm achieves an exit event that allows investors to realize a return on their investment, often through either an acquisition or an initial public offering (IPO). At the end of a VC fund's life, the capital, including any GP fees charged to investors over the life of the fund, are returned to the LPs and the profits are then divided among the LPs and the GP who earns a share of the net profits called "carried interest". Most VC funds typically have an active investment period of five years. After that time, they enter into a "support or harvesting period" of another five years, during which the general partner can choose to invest further capital into the portfolio companies identified in the investment period, but usually not into any new companies. If the limited partners agree, this second five-year period can be extended for two years.

Venture Capital Financing – Recipients

Venture capital funds tend to invest in early-stage, high-risk, technology-focused companies operating in key strategic industries or verticals that have the potential for significant future growth. As a number of VC-backed companies will fail to achieve success, VC funds generally rely on a small percentage of portfolio companies to out-perform and generate a high multiple of invested capital through significant growth and value creation. VC investors provide companies with capital, as well as mentorship and access to their network, in exchange for an equity stake.

Venture Capital Financing – Process

The diagram below presents a stylized illustration of the VC investing process including LPs, VC funds of Funds, VC funds, and venture-backed firms. It illustrates the relationship between this players with respect to both investment and returns.

Further information on the VC asset class may be found on the Canadian Venture Capital Association website

INVESTORS IN VC FUNDS

Limited Partners

GOVERNMENTS | CORPORATIONS | FAMILY OFFICES | PENSIONS/BANKS

Investment *Returns*

FUNDS OF FUNDS

Investment *Returns*

Investment *Returns*

VENTURE CAPITAL FUNDS

Investment, monitoring and advice

Financial return by selling the company

VC-BACKED START-UPS