T 89456

Fatih Üniversitesi

Tarih: / /1999

Sosyal Bilimler Enstitüsü Müdürlüğü'ne

TUTANAK

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"..Venture..Capital..Financing..Model..and..Turkish..Application"

adlı çalışma ..45..... dk.'lık süre içinde savunulmuş ve jüri tarafından

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FATIH UNIVERSITY
INSTITUTE OF SOCIAL SCIENCES
DEPARTMENT OF ECONOMICS

MASTER THESIS

VENTURE CAPITAL FINANCING MODEL and TURKISH APPLICATION

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Istanbul- 1999

ABSTRACT

Venture capital financing model has successfully applied in USA in 1980's. The primary example of venture capital in terms of institutionalization is American Research and Development Corporation(ARDC), which was established in 1946. In Turkey, the first workings related to venture capital has begun in 1986's, and is regulated legal framework with Comminique. Today Vakıf Venture Capital is established in Turkey.

The reel return of venture capital is very high. The year return of venture capital can reach up to percent 1000, percent 5000.

Venture capital is a long-term financing method to support the projects that have the developing potential and especially tendency to technological innovations. Venture capital is very profitable financing method but includes high risk. It is generally thought that venture capital financing model can serve important function for small and medium sized companies, and can be used privatization in Turkey.

ÖZET

Risk sermayesi 1980'li yıllarda ABD'de başarıyla uygulanmış bir finansman modelidir. Bugün farklı ülkelerde uygulanmakla birlikte modelin kurumsallaşmış ilk örneği 1946 senesinde kurulan Amerikan Araştırma ve Geliştirme Şirketi'dir(ARDC). Model Türkiye'de ilk defa 1986'lı yıllarda konuşulmaya başlanmış ve 1993'de yayınlanan tebliğ ile kanuni çerçevesi düzenlenmiştir. Günümüzde mevcut tek risk sermayesi Vakıf Risk Semayesi'dir ve halen hisse senetlerini halka arzetmemiştir.

Risk sermayesi reel getirisi oldukça yüksek olan bir finansman yöntemidir. Yıllık getirisi yüzde binlere hatta yüzde beşbinlere kadar yükselebilmektedir.

Risk sermayesi gelişme potansiyeli olan ve özellikle teknolojik yenilikleri içeren uzun vadeli bir finansman yöntemidir. Risk sermayesi çok karlı bir finansman yöntemi olmakla birlikte yüksek risk içerir. Türkiye'de ise genellikle küçük ve orta büyüklükteki işletmelerin(KOBİ) finansman sorunlarının çözümüne yönelik bir finansman yöntemi olarak düşünülmüştür. Ayrıca özelleştirme uygulamalarında İngiltere örneğine benzer şekilde bir finansman yöntemi olarak kullanılabileceği teklif edilmiştir.

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ABBREVIATIONS

3(i)	: Investors in Industry
ANVAR	: Agences Nationales de Valorasition de la Recherche
ARDC	: American Research and Development Corporations
BES	: Business Expansion Scheme
BSS	: Business Start-Up Scheme
BVCA	: British Venture Capital Association
EVCA	: European Venture Capital Association
IFC	: International Finance Corporations
JASBICs	: Japanese Small Business Investment Companies
LGS	: Loan Guarantee Scheme:
METU	: Middle East Technical University
MIT	: Massachusetts Institute Technology
MITI	: Ministry of International Trade and Industry
NASDAQ	: National Association for Security Dealers' Automated Quotations
No.	: Number
OTC	: Over – the Counter
SBA	: Small Business Administration
SBICs	: Small Business Investment Companies
UK	: United Kingdom
USA	: United States of America
USM	: Unlisted Securities Markets
VCC	: Venture Capital Company
VEC	: Venture Enterprise Center

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INTRODUCTION

The term "venture capital" is a financing method, which has practiced in the developed countries such as especially USA, UK, etc. First, in 1946, American Research and Development Corporation was established, and it has been widely believed that American Research and Development Corporations (ARDC) was the primary example of venture capital company in terms of institutionalization. And also, it was also believed that the founder of the idea of the venture capital is George Doriot.

The first workings related to "venture capital" in Turkey, has begun in 1986. But, the first serious steps towards the establishment of venture capital has been done in 1993. The principles related to the establishment, the operation, the structure, are regulated by a Communiqué regarding the venture capital issue. This Communiqué is published in Official Gazette number 21629 and date 6 June 1993. After this, the second time, Communiqué regarding venture capital is again regulated and is published in Official Gazette number 23515 and date 6 November 1998.

Venture capital is long term financing method to support the projects that have the developing potential and especially tendency to technological innovations. Venture capital is a very profitable financing method but includes high risk.

Venture capital financing model is based on three elements. Investor (venture capitalist), venture capital company (venture capitalist), and entrepreneur company. Venture capital company is an intermediate institution between investor and entrepreneur company.

Venture capital investments include different stages such as seed investment, start-up investment, expansion investment, bridge financing, and leverage buy-out investment. Venture capital company form a investment portfolio to reduce the risk. The success of venture capital financing model is related to social, economical, and cultural features of that country. For a successful venture capital, "interpretation and views" should be changed.

The main goal of this study is widely to introduce "venture capital financing model" and to discuss application possibilities in Turkey and to explain obstacle factors (such as economical, social and political, etc.) for venture capital in Turkey. At this study, especially USA Experience additionally, United Kingdom, Japan and Indian experiences are taken into consideration.

This study is based on four sections. In the first section, the definitions related to venture capital are explained, after the content, the financing instruments, the peculiarities, the evolution and the types of services of venture capital is talked about. Beyond these, BVCA (British Venture Capital Association), EVCA (European Venture Capital Association) and 3i institution are briefly mentioned.

In the second section, the stages of venture capital investment such as seed investment, start-up investment, early stage or gate financing, expansion investment, bridge financing investment and leverage buy-out investment are introduced. Besides, fund sources of venture capital and due diligence are expressed.

In the third section, country applications are examined based on the example of USA, United Kingdom, Japan and India. The results of experiences are determine that government must support venture capital sector.

SECTION I
GENERAL OUTLOOK

1.1.VENTURE CAPITAL

The term "venture capital" is a finance method to support the projects, which has the developing potential and especially tends to technological innovations. Venture capital is a long-term finance method that includes both high-risk and high return.[1] So, venture capital is the money that is used to finance the new investment opportunities. With this way, the inventions and new projects change the industrial investments.[2] Although venture capital financing model support normally technological investments, at the same time, it successfully applied to finance different industrial investments.

Venture capital finance model is a finance method to support the feasible, dynamic, creative investment ideas but not adequate financial power for the entrepreneur. Many projects and new ideas, which can not be practiced, tend to technological innovations and developments. They are converted into the investment by this model.

Although venture capital has a specialty that can finance every kind projects with high-profit potential, it is a financial instrument that especially inclines technological

[1] Halil Sarıaslan, "Venture Capital(Risk Sermayesi) Finansman Modeli ve Türkiye'de Uygulama Olanakları", Ankara Sanayi Odası Yayınları, No: 113, Ocak-Şubat 1993, p.1.
[2] Ayhan Şenyuva, Cesaret Sermayesi, Türkiye İş Bankası Kültür Yayınları, Ankara, 1990, p.1

innovations. This reason for, our century is a science–age and in this respect, investments with high-returns potential are generally within technological industry.

Principles related to the establishment, the operations, the management, and the liquidation procedures for venture capital investments companies in Turkey are regulated by "communiqué on principles regarding venture capital investment companies". (Serial: VIII, Number 21) Third number of the term "venture capital" is defined as the following.

"The form of long-term fund transfer is realized through investing in capital market instruments that issued in primary market by entrepreneur corporations which already established or to be established in Turkey having high-development potential and securities with low-liquidity is called "venture capital".

In reality, venture capital is a type of partnership based on profit and loss sharing. One of the partners is an entrepreneur- owned project or new ideas who follow or research technological and scientific developments, and who believe to be produced the products which can be provided very high-gains. The other one is venture capitalist who assess seriously and examines carefully, and after who decides to finance the new project of entrepreneur.[3]

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[3] Murat Çizakça, Tansu Çiller, *Türk Finans Kesiminde Sorunlar ve Reform Önerileri*, İSO, Yenilik Basımevi, İstanbul, 1988, pp.122

1.2. SOME DEFINITIONS

There are three elements in venture capital finance model or venture capital industry that needs three ingredients to be successful: The INVESTOR who are the resources of funds for venture capital companies such as banks, pension funds, endowments, etc, THE VENTURE CAPITAL COMPANY who provide venture capital that take from investors to the entrepreneurial companies, THE ENTREPRENEUR COMPANY that need venture capital for their new project or invention. This relation is illustrated in the following figure.

Figure 1:

THE INVESTOR	THE VENTURE CAPITAL COMPANY	THE ENTREPRENEUR COMPANY
(Venture Capitalist)	(Venture Capitalist)	

STEP-I STEP-II

1.2.1. THE VENTURE CAPITALIST:

Venture capitalist is a required capital provider based on individual and institution the entrepreneurs, and small and medium sized companies. The role of venture capitalist is very important. The venture capitalist must 1. Screen potential investment opportunities 2. Analyze potential companies and their industries 3. Negotiate the terms of specific transactions 4. Provide the support to the management 5. Liquidate investment position.[4] Here, venture capital company is referred as venture capitalist and generally venture capital company is understood from the definition of venture capitalist.

This process is basically the simplified form of a working system of venture capital finance model. This process is called "due diligence". The term "due diligence" refers to the process of screening potential investment opportunities. That is, it implies that venture capitalist sits many projects at desk as a flow of deals comes from entrepreneur and assess them, and consequently selects the opportunities which are feasible for investment.

"The venture capitalist largely fills the role of the entrepreneur in the formal capital market. That is, the task of venture capitalist is to discover information that has been overlooked by others. By exploring new business opportunities and taking risk, the industry is able to take advantage of unexploited profit opportunities."[5]

Venture capitalist consists of the pool by putting together funds that are collected from different individuals and institutions such as pension funds, insurance funds, etc, which are called investors. Funds in this pool are transferred using long-term financial techniques to the entrepreneurs who need venture capital, by venture capitalist. Venture capitalist not only provides the support of capital but also acts the active role by providing technical and managerial support.

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[4] Donald E. Fisher, *Investing in Venture Capital, the Institute of Chartered Financial Analyst*, Washington, December 6, 1988, pp.10

[5] James W. Handerson, Obtaining Venture Financing, (Principles and Practices), D.C. Health and Company, US, 1988, pp.254.

1.2.2. ENTREPRENEUR

Entrepreneur is the company or the person who create the production capacity and new wealth. Entrepreneur plays the role of leadership of economic development by discovering new markets and finance sources. Entrepreneur may develop new products, production techniques, and organization systems. Entrepreneur is a creative person and never hesitates to take risk. In spite of this, there are many obstacles or difficulties to be able to grow in front of entrepreneur such as financial, cultural.

1.2.3. INVESTOR

Investor is a venture capitalist in terms of relationship between investor and venture capital company that may be also called "venture capitalist". Investor is the supplier of funds to the venture capital company or is the resource of fund for venture capital company. Investors in venture capital funds are typically very large institutions such as pension funds, financial firms, insurance companies, and university endowments. They put a percentage of their total funds and expect a return of between %25 and %35 per year over the lifetime of the investment.[6] If we consider the first step in the figure, investor may be called "venture capitalist" but venture capital company may be not called "venture capitalist". If we consider the second step in the figure, venture capital company may be called "venture capitalist".

For choosing a financial venture capital company, investor should consider the following criteria.[7]

* Creativity of the venture capitalists

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[6] Bob Zider, "Harvard Business Review" November – December 1998, pp. 133.

[7] Christoph Schröder, *Bulding European Ventures*, Edited by Sue Birley, Elsevier Science Publishers B.V., Amsterdam, 1990, pp. 125.

* Relationship of venture capitalists within the venture capital community

* Past final performance

* The condition of venture capitalist's know-how

* Continuity of venture capital partnership

* Operating strategies and investment criteria

1.3. THE CONTENT OF VENTURE CAPITAL FINANCE MODEL

Venture capital finance model is based on three elements.

The investor, entrepreneur company and venture capitalist. Procedure is working as the following.

* It is prepared the professional feasibility study, which includes financial and technical researches for new product or projects.

* After feasibility study are prepared, the cost of project is determined.

* It is prepared a business plan based on feasibility study and this plan is sent to venture capital corporation.

* Venture capital specialists study on the plan and examine carefully business plan in detail. If they think or decide that business plan is feasible or can be applied, they accept business plan to invest.

* If it is come to the agreement, it can be begun the operations regarding establishment of corporation to realize the business plan.

1.4. FINANCE INSTRUMENTS OF VENTURE CAPITAL CORPORATIONS

In the following, it is expressed that some important finance instruments that venture capital companies use to finance the entrepreneur companies.

* "Common stock"; A direct finance instrument which is frequently used to finance the entrepreneur companies. Venture capital company can not provide control through common stocks unless it owns 51 percent. Whereas, venture capital company wants to control and to participate in the entrepreneur company to be able to maximize profit. Therefore, it is more difficult to sell common stocks in the entrepreneur company without making additional concessions.[8]

* "Convertible debenture"; here, venture capital company (venture capitalist) give money to the entrepreneur company and take debenture against this. Venture capital corporation has two alternatives. First, VCC accept to be paid back the money with the same way. Second, Venture Capita Company takes stocks whose price is initial determined against debt. Debenture is a loan to the entrepreneur companies that is convertible into common stocks. The conversion prices, the interest rate, the covenants of the loan are all negotiated between venture capital company and entrepreneur company.[9]

* "Loans and warrants"; The distinction of his finance instrument deferred

[8] David Glastone, *Venture Capital Handbook*, Prentice Hall, New Jersey,1988, pp.14
[9] Ibid., pp.14

from "convertible debenture" is that stocks in their hand are "preferred stocks". Venture capital company has the right which can buy stocks in the entrepreneur company with warrants.

1.5. THE TYPES OF THE SERVICE SUBMITTED by VENTURE CAPITAL COMPANIES

Venture capital companies not only provide the financial support but also they give some of the services, which are defined as the following.

* To determine the strategy of business and management.

* To continuously plan the financial structure of corporation at the same time period.

* To develop the budget system.

* To solve the market problems.

* To continuously follow the cost controls.

* To set the relationship with financial institutions in order to provide the needed cash.

* To find the advisor firms for the solution of the business problems.

* To help finding the qualified staff in different branches such as management, marketing, finance production.

1.6. THE PECULIARITIES OF VENTURE CAPITAL

The term "venture capital" is new in the finance-science literature and is the stage of the development. Venture capital is a finance method that firms incline generally to the start-up stage or the risky stage. There are many differences such as economic, social, cultural, structural, financial between venture capital industries which operate in very different countries. As previously expressed, venture capital is a capital that includes both high risk and high gains. It can be named as the small probability of a large gain combined with a large probability of a small loss.[10]

The Basic Characteristics of Venture Capital:

* Investment projects should be the dynamic and productive small and medium sized, and include new technologies that shows the development potential and new products. Although small and medium sized companies have a dynamic and creative structure, they can not finance their high profit potential project through capital market and money market because of their small size structure and inadequate size of balance sheet. Therefore, venture capital is very important for these firms.

* Venture capital companies not only provide the financial support to the entrepreneurial corporations but only VCC's participate to the management and the foundation of firms, and to the feasibility studies using experiment and information regarding the management, business. For this reason, it can be explained as two-sides.
First, small and medium size companies are more adequate at the ability and experience of the management relative to the venture capital companies. The other one, venture capital corporation may prefer to participate to management to reduce the risk. The

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[10] Çizakça, Çiller, *op.cit*, pp.121.

objective of this is to not obtain the management control, conversely, is to help the organization and the management.

* Venture capital financing investments are made in return stocks. In this connection there is a very important risk in these investments. But venture capital company behaves very selective the process of the project assessment to reduce the risk.

* Venture capital is a long term financing model (7-10 years)

* Venture capital is basically "equity finance" in relatively new companies.

* Venture capital investments are expected to provide superior returns at the exit time.[11]

* Despite the fact that venture capital financing model has normally a complex structure, there are basically three sides in model. Investor (Venture capitalist), venture capital corporation (venture capitalist) and entrepreneur company.

* The goal of high return of venture capitalist is not caused by the speculative gains. This high profit is because of the technological development causes the increase of the productivity.

* Venture capital investments are a natural resource investment. Venture capitalist does not participate to the entrepreneur company as a creditor, contrarily venture capitalist participate to the partnership as a partner. Accordingly, also has the authority or the power of the management.

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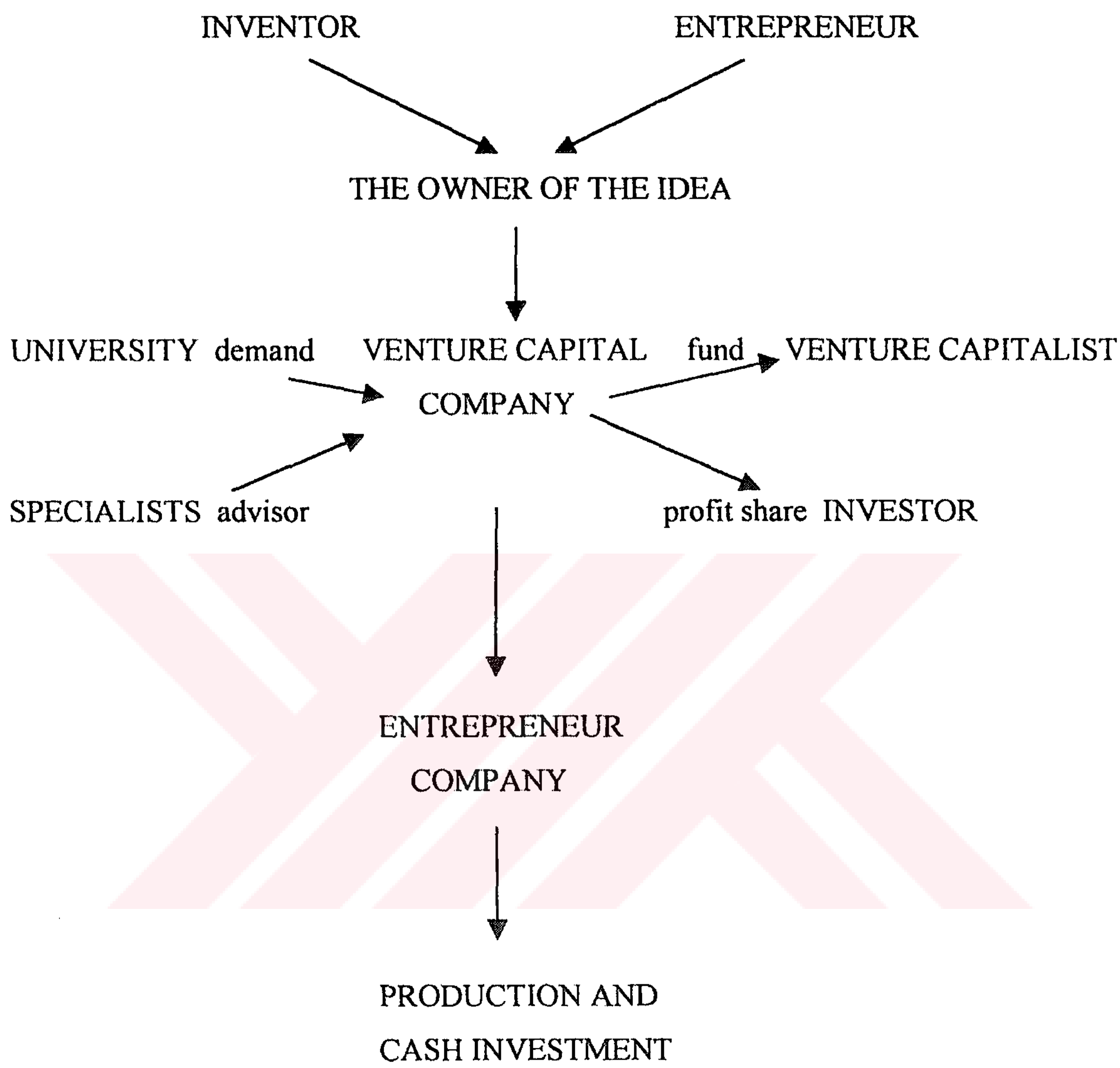
[11] S. Ramesh Arun Gupta, *Venture Capital and the Indian Financial Sector*, Oxford University Press, Delhi, 1994, pp.63.

The Basic Units of venture Capital and Relationships between These Units (Figure 2)



Source: Tülay Zaimoğlu, *Risk Sermayesi ve Türkiye'de Uygulama Olanakları*, SPK, Ankara, 1995, p.5.

1.7. The ROLE of the GOVERNMENT in VENTURE CAPITAL INVESTMENT

The role of the government in venture capital investment is very important. For instance, in the UK many applications such as LGS (Loan Guarantee Scheme), BES (Business Expansion Scheme), BSS (Business Start-up Scheme) were firstly initiated by government. The UK government has made a significant contribution to the resurgence of small and medium sized companies. Some legal regulations by government in the UK, have caused venture capital boom. Also, in the US, government has realized important developments in venture capital sector.

There are five main aspects of the State's role in the United Kingdom' venture capital boom.[12]

* Fiscal and direct grant programs for the small business companies.

* Specific incentive schemes to channel private sector finance into small business companies.

* The government's own venture capital institutions.

* Privatization of State-owned activities and partnership with private sector venture capital.

* General encouragement of entrepreneurs, political pressure on the Civil Service to favor the small business companies.

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[12] Tony Lorenz, Venture Capital Today, Woodhead-Faulker Limited, Second Edition, England, 1989, pp.171

There are very few measures implemented by government with the purpose of promoting specifically venture capital activities or institutions. Financial incentives, government schemes designed to increase the flow of the capital into the small firm sector, or to support technological developments, have had a clear positive impact in the development of venture capital industry.

1.7.1. GOVERNMENT OWNED-SPONSORED INSTITUTIONS–FINANCIAL SUPPORT

Governments have followed different approaches. Some have used already existing government-owned development banks. Others have created state-owned or state-sponsored institutions to finance equity capital small business. Generally, these institutions have been effective where and when private investments were no available. Direct government participation in venture capital operations has been successful in France and Spain. In France, government sector has been highly involved in providing venture capital under different schemes. Government has created the "Agencies Nationales de Valorasition de la Recherche" (ANVAR), which are state –owned institutions supplying mainly quasi equity instruments to firms involved in R&D. In Spain, the equity financing is provided primarily by the SODIs.[13]

In some countries, governments have set special venture capital resources. Some examples of arrangements are in the United States the Small Business Investment Companies (SBICs) and the Japanese Small Business Investment Companies (JASBICs).

[13] Silver Sagari, Venture Capital Lessons from the Developed World for the Developing Markets, the World Bank Discussion Paper, Number: 13, International Finance Corporation, Washington, D.C.,1992, pp.30,31.

In Japan, MITI (Ministry of International Trade and Industry) established the Venture Enterprise Center (VEC). VEC operates as a guarantor of the debt of the firms it supports. The support of VEC is related to a debt- instrument. The activities of VEC can not be named as a venture capital activity.

1.7.2. SPECIFIC INCENTIVES: TAX PRACTICES

IFC classifies the tax incentives to venture capital in the following groups.

* Up-front incentives (including rebates, tax credits, deductions from taxes for venture capital institutions are applied by some governments such as France, the United Kingdom, Belgium, Ireland, etc)

* Incentives to the venture capital institutions (tax relief on income received from entrepreneur companies are practiced by some governments such as Korea, Netherlands, Brazil, etc, or except from corporate tax for predetermined period such as Singapore.

It is said that In United States, the 1978 and 1981 capital gains tax reductions or exemptions were one of the key determinants of the expansion of funds in venture capital sector.[14]

1.7.3. REQUIRED MEASURES at the EXIT STAGE

The existence of exit channels from venture capital investments is a significant factor affecting the development of venture capital industry. To promoting venture capital investments is very important for the establishment of "second boards", "second tier markets", or "unlisted securities markets". For example, in the United Kingdom, in 1980 the Stock Exchange established the Unlisted Securities Market (USM). In the

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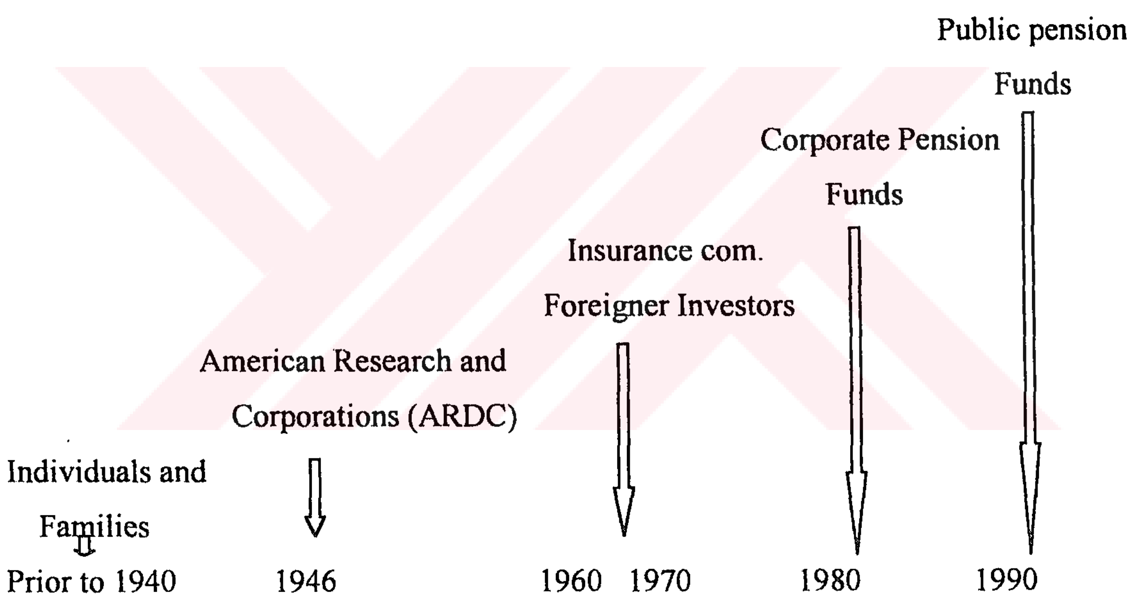
[14] Ibid, pp.33.

United States, NASDAQ (National Association for Security Dealers' Automated Quotations) is the largest OTC (Over-the counter) market in the World.[15]

1.8. The EVOLUTION of VENTURE CAPITAL INDUSTRY

The evolution of venture capital industry can be explained in two segments: Before and after 1980. The figure in the following illustrates the improvement of venture capital industry.

The improvement of venture capital industry (Figure 3)



Source: Donald E. FISHER, *Investing in Venture Capital*, the Institute of Chartered Financial Analysts, Washington, December, 1988, pp.11

The history of venture capital can be traced back to pre-revolutionary days. For instance, there were two venture capital investments in Massachusetts before 1800's:

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[15] Ibid, pp.35.

The saugus ironworks in about 1645 and the middlesex in about 1789. However, it is known that the American railroad industry was financed by venture capitalists in 1800's.[16]

Prior to 1940's, wealthy individuals, family organizations and syndicates of investors were the first sources of venture capital. Before II. World War, venture capital investments had been applied by rich persons, family corporations and the investor of partnership. However, It has been widely believed that American Research and Development Corporation (ARDC) was the primary example of venture capital in terms of the institutionalization of venture capital industry.[17],[18]

(American Research and Development Corporation (ARDC) was established by the partnership of the professors of Harvard University and MIT (Massachusetts Institute Technology), and some Boston banks. Dean of management faculty in Harvard University, George DORIOT, was appointed to the partnership as a director. ARDC made the initial investment into the digital Equipment Corporation which was a huge investment. Until 1958, in USA venture capital industry had not been recorded any important development. But at the same year, "Federal Reserve System" did different studies related to the finance of small- size companies. The result of these studies, it was observed that the needs of short-term funds and business capital for small-size companies or firms were met by trade banks and "Small Business Administration", and but that the requirements of long-term fund and equity capital were not provided by these institutions. After this, "Small Business Investment Act"(SBIA) became effective or valid, and "Small Business Investment Corporations" (SBIC's) were depended on the control and the allowance of SBA (Small Business Administration) by this law (SBIA). In 1962, the number of established SBIC's was 600. Meanwhile, managers, directors and analyses in venture capital industry could not conceive the operating system of

[16] E. Fisher, op.cit., pp.11.
[17] Ibid.,
[18] Handerson, op.cit., pp. 255.

venture capital financing method. Therefore, a lot of firms could not continue their operations because of inadequate capital, and finished their operations.

Initially, although SBICs were not successful, they played very important role in terms of the development of venture capital industry in USA.

From 1960 to 1970 venture capital industry was largely the domain of insurance companies and foreign investors. Pension funds was not in the venture capital industry. Because venture capital investments were not considered to be profitable investment. Public pension funds participated in venture capital industry in the late 1980"s.[19]

Venture capital industry has grown rapidly since 1978. However, the jumping year of venture capital was 1983, in which capital commitments reached about 3-4 billion-dollar.

Table 1: The development of venture capital fund sources is shown in the following figure. (In millions of dollars)

	1983	1984	1985	1986	1987
Public Pension Funds	$ 162	$ 300	$ 220	$ 89	$ 500
Corporate Pension Funds	895	785	547	1,283	1,132
Individuals & Families	715	467	303	392	502
Foreign Investors	545	573	548	361	544
Corporations	409	463	274	350	460
Insurance Companies	409	419	254	348	628
Endowments &Foundations	273	178	181	209	418

Source: E. Fisher, op.cit., pp.12.

[19] E. Fisher, op.cit., pp. 11.

If the economic geography of Turkey are screened carefully, the institutionalized samples of venture capital can be easily seen. Especially, in the tabacco industry in the region of "Agean Region", "partnership" named as "commenda", may be accepted or thought as an example of venture capital in agricultural business area. Here, one of the sides participates his information and his experiment to the partnership. The other one shares his capital with the partnership. Consequently, the obtained profit is shared between the partners at the determined amount.

In fact, venture capital financing model is based on the concept of "mudaraba". "Mudaraba" can be explained as profit and loss sharing based on the relationship of labor and capital. It can be said that "the system of mudaraba" is both the inspiration source or the exit point of interest –free banking and venture capital financing model. In "mudaraba system" one of the sides, the owner of capital is called as "rabb-ül mal". The other one, the owner of labor is named as "mudarip".[20]

However, in the World, the institutionalized and effective operations of venture capital is realized or applied by United States as modernity.

1.8.1. BVCA (BRITISH VENTURE CAPITAL ASSOCIATION)

British venture capital association is the lasting form of venture capital forum that is an informal club of venture capital company founded in 1980 by Equity Capital for Industry (ECI), Midland Bank Venture Capital and Citicorp Venture Capital. Venture capital forum is the start of venture capital action in England. The Forum had provided a regular gathering for an exchange of ideas and deals and a voice for venture capital industry to legislators and policymakers. The basic objective of venture capital forum is to meet facing about venture capital issue. John Mac Gregor who is Minister for small

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[20] Çizakça, Çiller, op.cit., pp.151, 152.

business and the other financial institutions approved the establishment of BVCA. BVCA (British Venture Capital Association) was formed with a founder of thirty-three funds (33) in January 1983.[21]

The main aim of BVCA is determined as the following.

* To maintain the high standards of professional practice and ethics among the members of venture capital companies and to develop them.

* To organize meetings and forums between the members of BVCA for the exchange of views with the idea of encouraging joint investment participation in projects and to decide about the future of venture capital.[22]

* To send the views and demands of the members about venture capital to the government, and to the financial institutions.

BVCA (British Venture Capital Association) membership includes the majority of funds both by number and by amount committed in equity-types venture capital investments in United Kingdom. It is estimated that BVCA Members have equity finance available in excess of 5 billion sterling to encourage and increase the growth of British Small Business Companies, and total amount already invested 3.5-4 billion sterling.[23]

[21] Lorenz, op.cit., pp.26.
[22] Ibid., pp.27.
[23] Ibid., pp.27.

1.8.2. EVCA(EUROPEAN VENTURE CAPITAL ASSOCIATION)

The establishment of EVCA (European Venture Capital Association) realized the first enterprise regarding venture capital practice in Europe. EVCA has 46 members. 36 of these are original members. EVCA is accepted as the formal organization, and the representative of venture capital industry in European Community. The basic objective of EVCA is to develop investments in venture capital industry in Europe and to encourage the required capital for innovations, and for small and medium sized companies and to provide the accepted idea of venture capital.

EVCA put to apply the program of "Venture Consort" because of this goal in 1985. This program aimed to encourage the development of small sized companies in Europe by building venture capital syndication constituted through different countries. The financing support to the syndication investments has provided by European Community. The firms supported are generally small and medium sized companies, which were founded after 1983.

Some criteria during the process of the selection of projects are given in the following.[24]

This projects:

* Should include the technological development.

* Should take place in European Community.

* Must be supported by venture capital syndication built through different countries.

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[24] Tülay Zaimoğlu, Risk Sermayesi ve Türkiye'de Uygulama Olanakları, SPK, Ankara, 1995, pp.10.

* Should have as high development potential as can be applied in European Countries.

"Venture Consort" project has played the effective role to develop relationship between different venture capital companies in Europe.

At the annual meeting of EVCA in Amsterdam in 1993, Turkey was accepted as a reserve member. Turkey was not accepted as an original member because Turkey has not been a member of European Community at any time.

Advantages of members of EVCA[25]

* Can follow nearly all the improvements in venture capital industry in Europe.

* Can take the technical help about the issues regarding the constitution of the body of current law, the establishment of companies, etc.

1.8.3. (3)i

(3)i was founded by the support of bank of England which is England central bank in 1945. Although initially was ICFC, it has changed as (3)i due to the first three alphabets of in "investment in industries".

The basic aim of (3)i establishment is to solve unemployment problems that occurred especially after 1945, and to create new employment area, to make technological production, to transfer innovations to the industry, the trade. Bank of

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[25] Ibid., pp. 10,11.

1.8.4. SBICs (SMALL BUSINESS INVESTMENT COMPANIES)

Small Business Investment companies (SBICs) represent a form of venture capital designed to help small business as an alternative financing. SBICs are for profit concerns that make long-term financing available to small companies at favorable market rates. SBICs can either make equity investments in small business or make loans to these companies with a minimum five-year maturity schedule.[26]

SBICs were founded by an act of Congress in 1958, and are licensed and regulated through the Small Business Administration (SBA). This Law limits investment scope of SBICs. Because of SBA regulations, SBICs investment policies are more restrictive than those of any other venture capital institutions. A SBIC may invest a maximum of 20 percent of paid in capital in a single small business. Foreign investment is not allowed for a SBICs.[27]

SBICs are private financing intuitions to provide into small sized companies. They are able to borrow from SBA at proportion of three times than equity capital. The cost of borrowing from SBA is lower than the cost of bank credit for SBICs. The most of fund resources of SBICs forms debts with low- interest rate. SBICs provide only financing support into small sized companies. They either may be a partnership in return of stocks or make credit. But, in practice they frequently make credit. In this respect, there are very important distinctions between SBICs and venture capital companies in terms of their philosophy. For instance, SBICs do not take the risk due to making credit. They have been the institutions that give debt money in practice contrary to venture capital company. Therefore, SBICs are not admitted as a venture capital company because of the differences of operating methods.

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[26] George Kozmetsky, Michael D. Gill and Raymond W. Smilor, *Financing and Managing Fast Growt Companies, (the Venture Capital Process)*, D.C. Health and Company, US, 1985, pp.19,20.
[27] Ibid., pp. 20.

There are two types of SBICs. 1. Independent SBICs named noncaptive which are established by individuals 2. Dependent SBICs named captive which are founded by financial/non- financial institution.[28]

[28] Zaimoğlu, op.cit., pp. 40,41.

SECTION II
PROCESS (DUE DILIGENCE)

2.1. The STAGES of VENTURE CAPITAL INVESTMENTS

It is widely believed that venture capital companies mostly invest towards to the technological innovations. But venture capital companies only do not incline technological innovations but also they invest to the different sector. Venture capital companies form a investment portfolio to reduce the risk realizing funding either as sectors or into different phases in investments.

The investment stages of venture capital companies can be classified as the following.

(Figure 4)

BRIDGE-FINANCING
or LEVERAGE BUY- OUT
INVESTMENT

EXPANSION
INVESTMENT

EARLY- STAGES
INVESTMENT

STURT-UP
INVESTMENT

SEED
INVESTMENT

This stage is the supporting of idea or project directed towards the production of a new product or service. If venture capital company accept "idea", it begin feasible studies with the owner-idea together. Then, they together establish a business firm.

Seed investments are a relatively small amount of provided to or entrepreneur company to prove a concept and to qualify for start-up capital. If the initial steps are successful, this may require product development and market research as well as building a management team and developing a business plan.[29] Seed investment generally is less than 1 million dollars and frequently can be less than 500.000 dollars.[30] The process seed investment is generally 1 year. The stage of seed investment include high risk but high-gains. Because the liquidation process of investment is very long term such as 8-10-12 year. We do not know whether investment is feasible or infeasible. However, there is high –return in the stage of seed investment because of cheapness of stocks price. Approximately, expected return is 80 percent at this stage.

2.1.2. START-UP INVESTMENT

Entrepreneur company either established or about to be established. That is, this situation indicates that entrepreneur company is at the beginning stage or early years. "Companies may be in the process of organizing, or they may already have been in business for one year or less but not sold their product commercially."[31]

The start-up round is the real venture capital round. This financing is the range of $1to $2 million[32], and this stage, there is normally the syndicate of investor

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[29] William D. Bygrave, the Portable MBA in Entrepreneurship, John Wiley & Sons, New York, 1990, pp.183.
[30] E. Fisher, op.cit., p.9.
[31] Bygrave, op.cit., pp.183.
[32] E. Fisher, op.cit., p.9.

participating. Venture capital company usually gets about 50 percent of entrepreneur company in return for the amount of capital invested because of high risk at this round, and entrepreneur company gets the other half.

At this stage, financing requirement is very- high because of the testing of product or service. However, this round is the richest source of high returns for venture capital companies. This is the dream of expectators of high-gain. At the same time, it is the center of unsuccessful projects. The rate of expected returns is approximately 60 percent.

There are five risks in a start-up company. [33]

* Development risk: Can we develop the product? It can be said that the entrepreneur does not have the technical skills to successfully complete the development, and also the funds requests are insufficient to fully capitalize the development phase.

* Manufacturing risk: If we can develop the product, can we produce it? Here, the risk is attached to large-scale production of technology.

* Marketing risk: If we can make the product, can we sell it? That is, the production can be successfully produced but can it be easily sold? At the phase of marketing, it is very important whether a market exist for the product, the size of market, and the competitive environment in the market.[34]

* Management risk: If we can sell the product, can we sell it at a profit? It refers to the possibility that management team will not be able to successfully organize the

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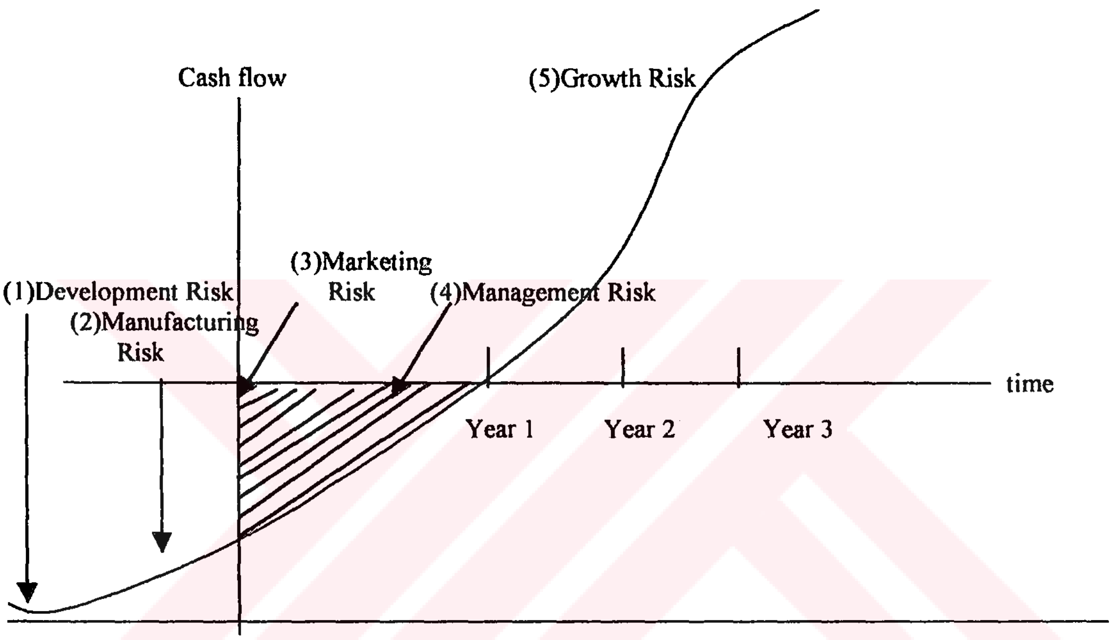
[33] A. David Silver, *Venture Capital (the Complete Guide for Investors)*, John & Wiley, New York, 1985, pp. 89.

[34] Henderson, op.cit., pp.267.

production and marketing. The success of entrepreneur company depends on the ability of management team to realize the production and sell it.[35]

* Growth risk: If we can manage the company, can we grow it? Entrepreneur company will undoubtedly require the additional financing to expand.

(Figure 5)



A. David Silver, *Venture Capital*, John Wiley & Sons, New York, 1985, pp.9

2.1.3. The EARLY STAGE or GATE FINANCING

At this point, entrepreneur company has a product or services which has been marketed but not has a very important market-share and "trade mark". The profit of firm is low, therefore, it need venture capital financing. However, there exist not the borrowing possibilities of entrepreneur company from banks and the other financial institutions due to insufficient size of the balance sheet and unquoted stocks.

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[35] Ibid., pp.266.

The early stage of financing generally includes an important round of financing. At this point, the amount of capital invested is about in the range of \$4 to \$6 million.[36]

2.1.4. EXPANSION INVESTMENTS

Here, there is a successful and profitable entrepreneur company which has completed the foundation phase. Entrepreneur company desires to expand and to grow, and therefore needs venture capital. For instance, small sized companies are an example of this stage.

The expansion financing stage is often a \$5 to \$15 million round of financing.[37] At this point, both return and risk is medium sized. The expansion of company can be in two ways:

1. Organic Growth

2. Growth by Acquisition

Organic growth can be described as new product, market, larger stock, and larger factory. Growth by acquisitions described as the buying of existing company with the same aim.

2.1.5. BRIDGE FINANCING or TURN-AROUND INVESTMENT

At this point, entrepreneur company is usually profitable but has some problems or difficulties. Venture capital company invests to abolish the solution of entrepreneur

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[36] E. Fisher, op.cit., p.9
[37] Ibid., p.9.

company. Bridge financing is $10 to $20 million round of financing. At the stage of bridge financing, entrepreneur company is expecting to go public with in six months or one year.

2.1.6. LEVERAGE BUY-OUT / ACQUISITION INVESTMENTS

This financing stage enables to a management group to acquire a business from public or private, or a firm to finance its acquisition of another companies. At this point, venture capital company is to support entrepreneur company which wants a business from public or private but has not financial power. The main feature of this financing is that the buyers of business from public or private are experts, specialist of their issues.

Table 2: Venture Capital Investments by Stage of Development of the Investee Firm

In percent of number of financing

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Seed money	4	5	7	7	6	6	6	6	9	5
Start-up	23	19	15	16	14	16	14	12	10	8
Other early stage	18	21	23	23	17	17	18	29	17	21
Total early stage	45	45	45	46	37	39	38	38	36	34
Second Stage	27	25	27	29	30	24	28			
Later Stage	15	19	17	14	21	20	20			
Total Expansion	42	44	44	43	51	44	48	53	50	54
LBO/Acquisition	-	-	6	4	6	10	6	6	10	8
Other	-	-	-	5	7	6	7	8	3	4
Total Other	13	11	11	11	12	17	14	9	14	12
Total	100	100	100	100	100	100	100	100	100	100

* Data for USA

Sources: Sagari, Op.cit, pp.15.

Table 3: The Distribution of Venture Capital Investments by different sectors for first quarter 1998 in Connecticut State

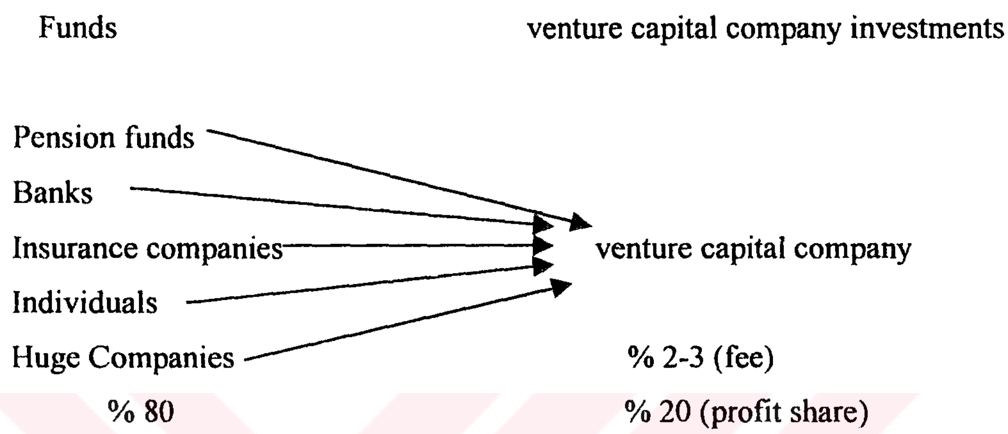
	Number of Companies	Amount of Financing	Percent of Total Funding
Consumer	1	$40.000.000	30.9
Distribution/ Retailing	2	$24.700.000	19.1
Business Services	2	$20.600.000	15.9
Electronics and Instrumentation	1	$16.400.000	12.7
Health Care	5	$16.285.000	12.6
Software and Information	3	$5.786.000	4.5
Biotechnology	1	$5.000.000	3.9
Environmental	1	$375.000	0.3
Medical Instruments And Services	1	$350.000	0.3
Communications	1	$75.000	0.1

Sources: Liam Hegarty, "Fairfield County Business Journal", Vol. 37, June 15, 1998, pp.11.

2.2. FUND SOURCES of VENTURE CAPITAL

There exist important fund sources for venture capital companies. Venture capital company collect from different fund sources such as banks, pension funds, insurance companies, government, etc. Then, venture capital company use these funds to finance entrepreneur company. That is, venture capital company is an intermediate institution. Venture capital company transfer these funds to entrepreneur company and against takes stocks. When entrepreneur company reach the level of high- profit, venture capital company sells their stocks in the security market. This transaction or operation is called as “liquidation”.

(Figure 6)



Venture capital company has both a fixed and a variable component. The fixed component is a management fee, which is 2 or 3 percent of the fund invested to the venture capital company. The variable component is approximately 20 percent of profits obtained which is commonly paid to the venture capital company. The remaining 80 percent of the fund’s profit goes to the investors. That is, Venture capital company takes herself 20 percent of the received profit as an intermediate institution. The rest of the share which is 80 percent, is distributed between investors such as banks, foundations, pension funds, etc.

The typical venture capital fund is organized as a limited partnership. Venture capital company is general partner and the other investors are limited partners. Limited partnership have fixed maturity, usually 10 years for venture capital funds. At the end of fund’s life, all cash and securities on hand are distributed to the investors.

As general partner, venture capital company plays an active role in managing the portfolio. But limited partners are not permitted to play an active role in the portfolio management. However, limited partners have voting rights regarding some decisions.[38]

Table 4: The Sources of Venture Capital Fund

Fund sources	1978	1995	1996
Banks/Insurance	16 %	5 %	18 %
Foundation/ Endowments	9	20	22
Pension funds	15	40	38
Corporations	10	18	2
Families/Individuals	32	8	17
Other	18	6	3

Source: Berlin, op.cit., pp.15

As seen the above table, in the United State, pension funds have the largest share in venture capital fund sources by 1995 and 1996 years. Pension funds have increased significantly after 1978. Pension funs were not in the venture capital industry before 1980s. Because venture capital was not considered to be a profitable investment for pension funds. The late 1980s, public pension funds participated actively in the venture capital industry. From 1960 to 1970, venture capital industry was largely the domain of insurance companies and foreign investors.

[38] Mitchell Berlin, "That Thing Venture Capitalist Do, Business Review", January – February 1998, pp.15

2.3. PROCESS (DUE DILIGENCE)

The process typically includes checks on the management team, industry studies, competition analysis of entrepreneur company, identification of major risks and other reasons. In essence, due diligence is a detailed evaluation of business plan.[39]

The due diligence process of venture capital financing model may be explained as follows:

2.3.1. COLLECTING FUNDS PROCESS:

Venture capital company collects funds from investors (pension funds, insurance company, individuals, huge firms, government, etc.) But venture capital company does not pay a fixed profit share or interest rate in returns of these funds. That is, venture capital company does not promise or does not give guarantee about profit share to investors. Because venture capital company does not know the amount of what profit will be, whether investee company will be successful or not. It is signed an agreement between sides (venture capital company and investors) based on confidence. In contrast, there is liquidation time for investment how profit sharing will be, what fund process will be.

There are two types of investment funds submitted by investors.

* Open-end Funds: investors do not determine using process of these funds.

* Close-end Funds: In practice, investors invest oftenly close-end funds. That is, investors determine time process of these funds. In practice, usually this time may be between 2 or 10.

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[39] Bygrave, op.cit., pp.181.

Venture Capital Company declares to open close-end funds pool to investors. When these funds get enough level, Venture Capital Company closes these funds pools. Venture Capital Company form investment portfolio by evaluating investment risk and investment process.

2.3.2. BUSINESS PLAN

Investment proposals submitted by Entrepreneur Company to venture capital company is called as "business plan". That is, Entrepreneur Company gives investment proposals through "business plan".

" Business plan" is very important along the due diligence process whether investment proposals will be accepted or not, depends on the content or outline of "business plan". Venture capitalist decides whether to finance or not to finance entrepreneur company examining carefully "business plan".

" Business plan" must:

* Be personally prepared by managers of entrepreneur company. Venture Capital Company wants to know or learn the level of information, experiment, and specialization of managers.

* Have a realistic implicit or content (it must be based on serious researches)

The most of business plans have an optimistic characteristic and do not reflect realistic situation. Therefore, they are not attractive and can be not accepted by venture capitalists. In practice, it has been accepted about 1-2 percent of business plan.

2.3.2.1. SOME CRITERIA for BUSINESS PLAN

2.3.2.1.1. MANAGEMENT

Entrepreneur company, which submits investment proposal, must be very strong managers group. If capable managers do not exist, the success possibility of entrepreneur company grow difficult. In this respect, venture capitalist must not be anxious about the existence of financial, trade, marketing abilities for manager group.

2.3.2.1.2. PRODUCT and SERVICES

There is a "life cycle" for products and services. The life cycle of a product must meet the expenses of the research and development, the establishment, the production and the marketing for entrepreneur company, moreover, it must provide the profit. That is, life cycle of a product is very-long term. If not, (otherwise), product may be out of date (old fashioned), and can not be sold or marketed.

2.3.2.1.3. MARKET SHARE

Marketability has vital importance for a product and a service. To determine the marketability of a product special researches may be needed. Venture capitalist wants to learn:

* Whether products and services are marketable.

* Whether competitive conditions are favorable or unfavorable.

* Whether competitive power of entrepreneur company is sufficient or not.

* The expansion possibilities of market.

Some obstacles for entrance to market. There are some difficulties and risks entrance to the market. For example, competitive firms may produce same or similar products, However, there are some difficulties, which prevent the entrance of competitive firms. These are:

* Legal difficulties (patent law)

* Technical difficulties

* Financial difficulties

* Market difficulties

* Other difficulties

2.3.2.1.4. FINANCE REQUIREMENT:

There are some important points in finance requirement.

- The amount of financing is very important for venture capital company and it must be in the capacity of venture capital company.

-The amount of financing should be balanced with investment risk.

- Venture capitalist wants to know important risks related financing, however, and the effects of these risks on the financing and needs of investee company

Outline of "business plan" must be as follows.

* Contents

* Summary (the summaries of developed strategies and the future points)

* Information about the establishment, the existing operations and the products of entrepreneur company.

* Management groups (the level of information, experiment and education of managers).

* Competitive situation, production technology and product differences of entrepreneur company.

* Market shares (as national and international)

* The pools of investee company.

* Risks and possibility of its realizing.

* Financial situation (balance sheet, profit and loss table, and fund flow, and cash flow tables of entrepreneur company related last 3 years.)

* Marketing (detailed information about prices, promotions and delivery)

* Production (the quality of product, technical and operational design of production system.

* Financing requirement (the amount of financing and the using aim of financing.

2.3.3. ASSESSMENT

Venture capital company carefully examines investment proposals or business plan and then if they think that these proposals are feasible, they carefully examine attractive proposals of these again. Then, venture capital company makes a feasible study together with investment project specialists (experts). The researches realized about this issue show that about 1-2 percent of investment proposals have been accepted by venture capital company.

2.3.4. SYNDICATION

If financing support demanded by entrepreneur company is large, venture capital company may not desire or want to take the responsibility of investment risk alone (single-handed). Therefore venture capital company as leader form an investment syndicate to reduce or to distribute associating other venture capital companies. So, large-sized investment proposals are realized by the syndication of venture capital companies.

2.3.5. PARTNERSHIP

Venture capital company participates as a partner to the entrepreneur company taking stocks of entrepreneur company in turn of financing support. However, venture capital company may participate to the management of partnership as an active partner. Especially, of the stages of seed and start-up, venture capital company manage the partnership company due to have the most of stock share. Venture capital company especially wants more share than the entrepreneur company in partnership. Venture capital company wants to reduce " risk rate " using experiment, information and ability because at stages of seed and start-up "risk rate" is very high. As a result, venture capital company transfers his information and experiment about the management of company as well as financial support.

Generally at the stages of expansion and bridge financing, venture capital company does not participate to the entrepreneur companies as a direct partner. Venture capital company takes either "convertible debenture" or "warrant" from the entrepreneur company in turn of provide financing support. This method expresses that venture capital company has option postponing the partnership to the future time.

"Convertible debenture" and "warrant" normally are debt financing. If entrepreneur company gets profitable condition, debt financing changes equity capital financing. Therefore, this method is less risky for venture capital company.

2.3.6. LIQUIDATION (EXIT STAGE)

The main aim of venture capital company is to convert (to change) their investment funds and expected profits from entrepreneur company into the liquid form by selling their shares after entrepreneur company gets (receives) profitability level. Obtained profit is divided (distributed) between venture capital company and investors who have funds at the rate of 20/80 percent.

Liquidation which is named as the turn of investment to the cash. It may be in different ways. But generally it is realized in two ways. First, entrepreneur company can be sold as a whole. Second, the stocks of entrepreneur company can be directly gone to the public that this condition is named "public offering".

At the liquidation stage, the existence of security market and other secondary market, and whether these markets are developed or not in the country, is very important. Secondary market is the except of organized security market.

There is OTC (over the counter) in ABD and USM (unlisted securities market) in UK as secondary market. The characteristics of these markets (secondary market) are regulated being paid attention to the futures of small sized companies.

SECTION III
COUNTRY PRACTICES

3.1. In BRITAIN

3.1.1. VENTURE CAPITAL BOOM in BRITAIN

In 1979 the number of venture capital companies was observed a burst together with the coming of Conservative Party. From the latter part of 1980, an enormous boom took place regarding private venture capital funds in Britain. The most important development of these was establishment by the stock exchange of Unlisted Securities Market in November 1980.[40] The characteristic of Unlisted Securities Market is that was lower than the criteria for quotation of Stock Exchange. The progress of USM and alternative market outside stock exchange gave enthusiasm to the venture capital companies and entrepreneurs.

In 1976, at the time of labor Party, Equity Capital for Industry was established including 3I by 350 financial institutions. The behalf of investment portfolio of Equity Capital for Industry have financed to the stages of start-up investments. Today, Equity Capital for Industry has been operating as a private venture capital company.[41]

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[40] Rodney Clark, "Venture Capital in Britain, America and Japan", Croom Helm Ltd, London&Sydney, 1987, pp.75,76

[41] Sarıaslan, op.cit., p.9.

Table 5: The differences of the criteria for quotation between USM and Stock Exchange are as follow.

	Stock Exchange	USM
Minimum acceptable market capitalization	£50-10m	£3-5
Shares in public hands	25 %	10%
Minimum profit record	5 years	3 years
Unqualified audit report	5 years	3 years
Pre-tax profits	£1m	£0.5 m
Approximate costs	£250.000	£150.000

Notes: These are practical, not formal requirements.
Source: Clark, op.cit., pp.76.

However, it has effected that in Britain, the success of American venture capital companies had attracted widespread attention, and huge US venture capital companies such as Alan Patrico of Associates and TA Associates had come to the Britain to raise their fund and established venture capital pools in the UK.[42]

3.1.2. BES and BSS

In April 1983, government established Business Expansion Scheme (BES) after Business Start-up Scheme which was established in 1981, was canceled. Under the BES, a private investor is exempted from income taxes on investments up to £ 40.000 for unquoted companies in any year. Certainly, unquoted companies must meet requirement

[42] Clark, op.cit., pp. 75,76.

criteria for quotation. Under the BES, venture capital funds were formed or established. A number of financial institutions have established BES funds to enable investors to distribute or to spread their risks. Funds increased by these have contributed to the venture capital pool. That is, government has stimulated the establishment of fund pools for venture capital and money has flowed to these pools through BES.

3.1.3. 3(i) INSTITUTIONS

"3i" (Investors in Industry) was established in 1945 by Bank of England (which has percent of shares) and financial institutions (the major clearing bank). "3i" is not accepted as a venture capital company but "3i" as a venture capital company provides the long-term finance to the growing firms.[43]

"3i" is in effect a private sector institution. It does not finance projects favored by government and therefore, it has never been an investment of government policy.[44]

Normally, the operating of venture capital companies does not include "interest". However about behalf of net funds of "3i" come from bank borrowings and bond issues and interest. "3i" must meet these by fees, dividends and interest paid by companies in its portfolio.

In England venture capital practices, "3i" has provided the support of managers, experiments, advice, help to the venture capital companies. "3i" executives (managers) are technically trained with industrial experience. Therefore, these executives have provided the contribution of establishment of venture capital companies in England. That is, a large number of "3i"s manager have left "3i" to join to the new venture capital firms.

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[43] Sarıaslan, op.cit., p.9

[44] Clark, op.cit., pp.72.

3.1.4. ACQUISITION and BUY-OUT FINANCING

To buyout a part of public company by venture capital company is named as" Buyout" , and also, to acquire a small private company by venture capital company is called as "Acquisition". That is, the difference between "Acquisition" and "Buyout" is in terms of public and private. After "buyout" and "acquisition", the new company can be established as a new entity in the venture capital portfolio. In the company, venture capital company has management and capital base.[45]

Venture capital companies expand their investment portfolio through "acquisition" and "buyout". Venture capital companies expect high returns from these investments, and they think that these are profitable.

Table 6:

	1981	1982	1983	1984	1985	1986*	1987*	1988*
No.companies	163	321	438	582	597	1,170	1.174	1,326
Amount(fm)	66	110	166	228	279	480	934	1,298

*On a fuller response basis than previous years
Source: Lorenz, op.cit., p.9

The table shown above relates only to investments in the United Kingdom. In table the number and amounts of venture capital investments in the United Kingdom are

[45] G. Steven Burrill, John J. Huntz, Craig T. Norback, *The Ernst & Young Guide to Raising Venture Capital*, Liberty House, 1988, pp.65.

shown. As seen, venture capital investments have increased continual along the period 1981 and 1988.

Table 7: A Comparison between the UK and USA by Fund Sources

	UK 1985-87	US 1987-88
Pension funds	36	43
Foreign institutions	28	13
Insurance companies	13	13
Private individuals	9*	10
Banks	5	_
Fund management groups	4	_
Corporations	3	11
Academic institutions/endowments, foundations/other	2	10
	100	**100**

*Business Expansion Scheme Subscribers and Private Investors in Public Company Venture Capital Funds.
Source: Ibid., pp.10

3.2. In JAPAN

3.2.1. SOME OBSTACLES for VENTURE CAPITAL in JAPAN

In Japan, today venture capital practices are part copies of American originals. That is, the operating of venture capital financing model in Japan is similar to American model. But Japanese industrial and social structure (context) is very different from the American. We can say that venture capital experience in Japan have not become as successful as American because of social, cultural, and industrial differences. The major reasons are these.

3.2.1.1. ECONOMIC and FINANCIAL STRUCTURE (HUGE COMPANIES)

First, in Japan economic and financial structure are formed by large, huge corporations. Large Japanese companies have been able to increase their technological level and have been able to practice or apply new methods and techniques themselves in different industries. Huge companies such as Sony, Matsushita, have mastered the making of first radios, televisions, video tape recorders, and now compact discs and small computers.

However, huge companies have had the large opportunities and advantages in Japan. They have been able to transfer the best qualified people from university and have pre-empted the resources. As a result, it has been difficult the development of small business companies.

3.2.1.2. LIFE-TIME EMPLOYMENT

The great difficulty facing venture capital companies is the system of " life-time employment". This is a very different culture for Japan differs from American. Large companies take qualified, talented young people from university and keep them until they retire from their company. They guarantee "life-time" job to the employees and workers. Therefore, small business companies for new enterprises can not find skilled workers and experienced managers because of "the life-time employment" practices of large companies.

3.2.1.3. ANTIMONOPOLY LAW

In Japan, venture capitalist is not permitted to take place in the board of entrepreneur company as a director or manager.

3.2.1.4. OTHERS

Japanese universities have not been as effective as American universities in the supporting and stimulating of new companies. That is, Japanese universities have not played active role.

3.2.2. DIFFERENCES AMONG JAPAN SBICs and AMERICAN SBICs

First enterprises regarding venture capital issue in Japan lies to date 1963 and first examples realized by public institutions. First practices have begun with setting up three "small business investment companies" in Tokyo, Nagoya and Osaka, under the frame of small business investment law of 1963 which was largely by American Small Business Investment Act of 1958.

Japanese Small Business Investment Companies (JSBICs) is very different from American SBICs.

* As it is seen, American SBICs, which are private firms, borrow money from government, banks and SBA (Small Business Administration) and lend to the small business companies as well as investment. But SBICs of Japan, which have semi-public characteristics, are not lending but make equity investment in small business companies.

* Japanese SBIC's have number of restrictions. They are permitted to invest in equity only with the way of direct shares or bond convertible. However, they can not acquire the share less than 15 percent and more than 50 in entrepreneur company.

Because of these restrictions, Japanese SBICs have not been able to become successful. In fiscal 1985, they only invested 3.3 billion-Yen as cumulative. The last period twenty years their cumulative investments have not reached 60 billion-Yen.[46]

About the number of companies in portfolio of SBICs was 2000. But only 17 of these went to public by 1985.

Table 8: Investments of three Small Business Investment Companies

	Cumulative investments		new investments	
	Number	Yen(billion)	number	Yen(billion)
Tokyo	791	23.4	51	1.6
Nagoya	500	12.2	23	0.6
Osaka	783	22.8	29	1.1
Total	2074	58.4	103	3.3

Reference: Ibid., pp.38.

MITI (The Ministry of International Trade and Industry) established "Venture Enterprise Center"(VEC) in 1975 which12 years after small business investment companies had been established.

VEC has two types of activities. First, VEC provides the guarantee up to 80 percent for the loans of the small business companies made by banks. So, VEC has enabled the loan by banks to the small business companies in the last twelve years, VEC provided the guarantees 8.5 billion Yen for 251 projects of small business companies.

[46] Clark, op.cit., pp. 37.

It can be said that the other activity of VEC is much more important. VEC has become an important information source about venture capital issue in Japan. VEC has established an association formed thousand members such as small and large enterprises, financial institutions related to venture capital in Japan. However, VEC publishes a monthly journal named "venture forum" which contains very useful articles about venture capital.[47]

3.2.3. PRIVATE VENTURE CAPITAL FIRMS in JAPAN

In 1972 first time, "8" of private venture capital firms were established by banks. But these venture capital companies have not been able to become successful. Because the recession of 1973 –74 began due to petrol shocks. Otherwise the lack of "unlisted securities market" or "over the counter market" has caused the failure. Soon, they have turned either a "factoring house" or "financial institutions".

The early 1980 were seen "second boom" in private venture capital market. A number of capital companies began to be established by banks, securities houses and foreign institutions by 1985, there were sixty venture capital companies. In five years either the number of or the investment of private venture capital companies has increased a substantial size. These companies have invested $750 million.[48]

3.3. USA EXPERIENCE

As expressed in previous chapter, The origin of the venture capital industry is known with the beginning of operations of American Research and Development Corporations (ARDC) by General George Doriot in Harvard University in 1946. Doriot

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[47] Ibid., pp.41

[48] Ibid., pp.42,43,44.

is referred as the father of venture capital financing model. Neither conventional debt method nor public wanted to support venture enterprises. Therefore, it can be said that there was a gap in the financial system. However, new businesses have innovative projects but also risky projects. It was difficult these projects to support through the conventional debt method. ARDC was the first venture capital company that served as the financial intermediary between investor and entrepreneur company. The most successful investment of ARDC was in Digital Equipment Corporation (DEC).

There are four elements which form cornerstones of venture capital industry.

* Investors,

* Venture capitalist,

* Entrepreneur,

* Government.

The government is an important element of venture capital process. Its sponsorship is the first variable necessary to the development of venture capital industry. Government can either create or remove the incentives which draw the potential participants of venture capital process through regulatory and taxation powers. These incentives enable venture capital participants to develop their investments without governmental interference such as regulatory constraints and tax burden.[49]

When we consider the potential return for venture capital investments, they had attractive for many new groups. Therefore, $500 million was reached in the US between 1969-1973. In 1970's American venture capital companies concentrated the early stage

[49] George Kozmetsky, Michael D. Gill, Jr. Raymond W. Smilor, op.cit., pp. 67.

investments which express high-risk and high return. The most of finding came from institutional investor such as banks, insurance companies, endowments, etc.

Venture capital industry in the US has rapidly grown in 1980's due to some favorable factors, which can be named as changes in the capital gains taxation, legal provisions enabling pension fund investment in venture capital partnership. Venture capitalists invested more than $ 10 billion in 1997, but only % 6 went to stars-up. According to estimated, less than $ 1 billion of the total venture capital pool went to R & D.[50]

The present types of venture capital industry in the US are independent firms, small business investment companies (SBIC), and the venture capital subsidiaries of large financial institution or corporations. Independent firms are the major sources of venture capital industry. There are more than 400 independent firms in the US.[51] Venture capital firms are organized as "general partner" who gains a fee and share in profit. In partnership "limited partners" are generally institutional investors such as pension funds, insurance companies, etc.

Venture capital industry has promoted a number of successful enterprises in the USA, namely, Apple Computers, INTEL, Federal Express, Lotus Development, Microsoft, Digital Equipment, Compaq Computers and Genentech. However, venture capital companies in the USA has stimulated the growth of venture capital activities in the other countries.

The question why venture capital emerged in the USA is often asked. The answer[52];

* This country has a geographical advantage.

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[50] Zider, op.cit., pp.132.
[51] Gupta, op.cit., pp.51.
[52] Ibid., pp. 53, 54

* USA has a homogenous market that speaks one language and her industrial structure has never been affected by war.

These characteristics have contributed to the development of its venture capital industry to this day. Although venture capital has grown dramatically over the past ten years, it still constitutes only a tiny of the U.S. economy.[53]

Table 9: Estimated Size of Venture Capital Industry by Countries, (1987)

	Total Number of VC Firms	(%)	Total Venture Capital Pool(£ m)	(%)
USA	627	(50.48)	17,100	(59.58)
United Kingdom	120	(9.66)	5,200	(18.11)
Japan	70	(5.63)	2,000	(6.96)
France	115	(9.25)	1,400	(4.87)
Canada	71	(5.71)	1,100	(3.83)
Netherlands	70	(5.63)	700	(2.43)
West Germany	55	(4.42)	500	(1.74)
Belgium	17	(1.36)	200	(0.69)
Sweden	40	(3.22)	200	(0.69)
Ireland	7	(0.56)	100	(0.34)
Denmark	30	(2.41)	100	(0.34)
Australia	20	(1.61)	100	(0.34)

Source:Lorenz, op.cit., pp.14.

[53] Zider, op.cit., pp. 139.

3.4. INDIAN EXPERIENCE

It can be said that venture capital in India have commenced in the late 1980's. Government in 1988 took the first steps for institutionalization of venture capital. Government has announced " venture capital guidelines" in India in this year. Venture capital companies and venture capital funds were entitled with tax relief through the Indian Income Tax Act.

In western country developments such as USA, England has affected the emergence of venture capital in India. In fact, in India specialized financial institutions provide long-term finance to the companies. But also, a gap was felt "equity finance" to new projects.

Indian venture capital firms are allowed to make investments only in India. So far, 61 percent investment has been in star-ups, with seed investment (9 percent) development stage (13 percent) and mezzanine stage (15 percent).

In Indian practices, both "equity financing" and debt financing" has been financed in Indian venture capital industry. Debt financing include both "conventional loans" and " conditional loans" , which are loans that there is no fixed interest rate but there is a royalty attended to the sales turnover.[54]

In India venture capital industry is relatively young and is the still in the evolution stage. Therefore, it is too early for an assessment of its performance. Venture capital industry in Indian has been promoted by private firms, and has been supported by banks and financial institutions. However, the strong structure of loan finance in India

[54] Arun Gupta, op.cit., pp. 62.

has affected venture capital performance. Also, management buy-outs have not ever been considered as venture capital investments.

Government policies and legal and taxation framework are of great importance in the growth of Indian venture capital industry.

Table 10: Venture Capital Funds by Country

	1996	1997
Japan	17.2	17.5
Japan Offshore	5.7	8.8
Hong Kong	5.1	7.0
Singapore	3.8	5.9
China	6.2	4.7
Australia	3.1	3.2
South Korea	2.9	3.2
Taiwan	1.3	2.1
India	1.3	1.5
Malaysia	0.6	0.7
Vietnam	0.5	0.4
Indonesia	0.4	0.4
Philippines	0.1	0.2
Thailand	0.2	0.2

*Source: "Asian Business Review", March 1998.

SECTION IV
TURKISH APPLICATION

4.1. LEGAL REGULATION for VENTURE CAPITAL in TURKEY

The principles related to the establishment, the operation, the structure, the liquidation procedures for venture capital investment companies in Turkey are regulated by Communiqué on principles regarding venture capital investment companies (serial VIII, Number: 21) with Article 22/0 and Article 36 of Law Number 2499 as amended by Law Number 3794. This communiqué is published in Official Gazette number 21629 and date 6 June 1993.

According to this regulation, venture capital investment is defined as following.

"Venture capital investment is a long-term fund transfer realized through investment in capital market instruments which are issued in primary markets by entrepreneur companies, established or to be established in Turkey, have high development potential, and have securities with low liquidity"

Also, according to this regulation basic some characteristics for venture capital investment and venture capital companies are determined as follow.

* Venture capital companies can not deal with "debt financing"

* They can not collect deposit

* They can not involve in commercial, agricultural and industrial.

* They can not operate about capital market except venture capital investments.

4.2. VENTURE CAPITAL for The SOLUTION of PROBLEMS of SMALL and MEDIUM SIZED COMPANIES in TURKEY"

Small and medium sized companies in Turkey have difficulties to provide financing. They operate on equity capital. It is not sufficient to develop or grow only equity capital financing. They need more much fund. They have the developing potential but they can not develop because of financing problem.

Small and medium sized firms have different alternatives to provide financing problem from institutions such as banks, financial institutions. But they think that providing finance from banks or financial institutions are not profitable. Because this method includes both high cost and many bureaucratic obstacles. However bank do not want to give financing to them as a creditor. Because of small sized companies have not-paying risk and they are not security for banks.

4.2.1. The FINANCING and MANAGERIAL PROBLEMS of SMALL and MEDIUM SIZED FIRMS in TURKEY

The problems financing of small and medium sized companies in Turkey can be summarized as follows.

* Insufficient financing (short-term and long term financing difficulties)

* Insufficient equity capital

* Expensive-financing method from banks for small and medium sized companies.

4.2.2. The IMPORTANCE of VENTURE CAPITAL for The SOLUTION of PROBLEMS of SMALL and MEDIUM SIZED COMPANIES

The importance of venture capital for small and medium sized companies is expressed as follows.

* Venture capital can cancel the financing problem of small and medium sized companies providing cheap fund. Because venture capital is a long term financing method and does not include " interest". However, small and medium sized companies need long term-financing to be able to continue their operates and to increase their capacity.

* Venture capital enables the commercialization of new technology, products and process. Because small companies have new ideas but they have not capital to realize. Venture capital makes possible the commercialization of new ideas and provides the support to the economic development.

* Venture capital encourages entrepreneurs and small companies. Venture capital can increase employment because of the increase of the number of small companies or the increase of production capacity of small companies.

4.3. PROBLEMS of VENTURE CAPITAL in TURKEY

The problems of venture capital in Turkey are below.

* The background for science and technology has not formed or developed in Turkey. Technology is "import" and is transmitted from the developed countries. Turkey can not been producing the technology. At the same time, the technology transferred from the developed countries is not sufficient.

* The research and development expenditures is not adequate, sufficient in Turkey. THE rate of research and development to national income is about %0.24 in Turkey. Whereas, this rate is %2 in the developed countries. Per-capita research and development expenditures is 440$for US, is 380$ for Japan, is 3.5$ for Turkey. This condition shows that research and development expenditures are too much less. This rate must be increased at least %1 for Turkey. [55]

* "Brain draining"

* A number of entrepreneurs have not information deal with technical explanations, market structure, and cost estimation. Small and medium sized firms are not be enformed of alternative financing possibilities. There is not effective and explanatory news for small entrepreneurs or there are bureaucratic obstacles and difficulties to get finance.

* The center of science- license can not been established.

* The relationship between university and industry or university and private sector can not been formed. Therefore, information produced by universities, can not been practiced for industry, private sector.

* The lack of social assurance (security)

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[55] Zaimoğlu, op.cit., pp.196.

* The lack of education and motivation for entrepreneurs.

4.4. OBSTACLES FACTORS for VENTURE CAPITAL in TURKEY

4.4.1. ECONOMIC OBSTACLES:

There are some obstacles in terms of economics for venture capital financing model in Turkey.

* High Inflation: There has been high inflation approximately 90 percent in Turkey since very long years. Real returns of investments decrease due to high inflation.

* The rate of high-interest: The rate of interest has increased because of high inflation. Interest rates compared to venture capital for fund suppliers has been attractive. Investors do not want to take risk. They prefer guarantee returns rather than venture capital investments

* Budget Deficit: There has been a spiral between banks and government because of budget constraint. Government gives treasury bills and bonds to banks and in turn of these takes debt money from banks. Interest rates related to treasury bills and bonds are very high and have high returns. Banks invest about 60 percent of their deposits to these instruments and gain high returns. Because of advantages of easy returns from these instruments venture capital financing model is not profitable for banks or other financial institutions and huge companies which prefer easy returns in Turkey.

4.4.2. POLITICAL OBSTACLES

There is no political stability in Turkey. The life period of governments selected in democratic system in Turkey is too short-term. Therefore the new regulation of Law for the solution of problems has not be able to done. Whereas, political stability is very important for economic developments in a country. Especially we can say that the last 10 years business cycle has prevent to the new economic development regulations in Turkey.

4.5. FUND SOURCES for VENTURE CAPITAL in TURKEY

Fund sources for venture capital in Turkey will be explained in two segments. These are expressed as fallow.

4.5.1. BANKS (SAVE DEPOSIT INSURANCE FUND):

Due to the financial crisis occurred in 1994, deposits were taken in assurance accordingly to deposit insurance fund. This process was applied in order to gain reliance to the system consider current economic conditions. Management, functionary and supervision of the fund are done by fund regulations. According these regulations banks should pay premiums for this insurance. According to 94/ 5565 statement of council of ministers, premium ratio within 3 months periods is 0.25 % for banks for which total domestic and foreign currency deposits "capital sufficient ratio" is 8% and 0.26% for banks for which this ratio is less than 8%.[56]

The suggestion that we will make here is the following: increasing these premium ratios to at least 0.5% (with the other conditions unchanged) and using the additional

[56] Erkan Özdemir, "Active", Ekim- Kasım, 1998, pp.16

funds obtained as venture capital to support small and medium sized corporations and transmitting technological changes to industry.

4.5.2. SPECIAL FINANCIAL INSTITUTIONS

Conventional banks accept deposits and make loans. Special financial institutions have very different operations and new financial instruments. They collect funds from people who do not want to hold their funds in conventional banks, and use to towards companies through new financial instruments which are named generally "mudaraba", "musaraka", "murabaha", "icara"...etc. "Mudaraba" and "musharaka" are named "participation to the loss profit-sharing", "murabaha" is named "production support" and "icara" is named "leasing" in Turkey.

Mudaraba consist of a transaction between the provider of the capital "rabbel mal" and the borrower "mudarip" under intermediation of the institutions. The transaction takes place on the basis of profit and loss sharing but no guarantees are given in this respect.[57] The resulting profits are distributed in a mutually agreed proportion among two parties while or loss is borne by the provider of the capital. That is, any profit and losses resulting from the invested would be reflected to the savers. This constitutes one of the main differences between special financial institutions and conventional banks. Conventional banks will have to pay the pre-determined interest, without having any connection to their profitability.

There are difficulties with the contemporary application of mudaraba. We can say that the frequency of use of mudaraba is not very high in Turkey. About two percent of deposits of special financial institutions are used as mudaraba. In Turkey both of

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[57] Abdülgaffar Ağaoğlu, "METU Studies in Development", 21.4.1998, pp.480.

mudaraba and musharaka which are named as participation in business project, constitute about 2-3 percent of total fund of special financial institutions.

Murabaha consists of a transaction for physical goods and commodities demanded by a trader or producer would first be purchased by the bank and sold to them at a profit (also known as cost plus negotiated margin transaction) The trader or producer pays the loan back is money according to the terms which were agreed upon.[58]

Murabaha has become one of the most popular financing techniques among special financial institutions. It has been estimated that 70 to 80 percent of total finance provided by special financial institutions is through murabaha.

In Turkey, the frequency of the uses of murabaha is also very high as a financing technique. The proportion of its use in special financial institutions operations is 90 percent. For this reason, this financial instrument is quite easy.

Venture capital is generally thought as a method used to finance small and medium sized companies in Turkey. Whereas, venture capital is a financing method which is used to finance new technologies and development-potential companies. Venture capital is a long term financing method. Special financial institutions also provide the financing contribution to small and medium sized companies. But they use the proportion of 90 percent murabaha techniques. Finally, it can be said that venture capital is similar to mudaraba technique. In two financing methods, for both venture capital and also mudaraba the main logic is the same. Each two are either based on profit or loss sharing and also long term financing method. To be able to effective of mudaraba in operating special financial institutions, mudaraba technique must be increased.

[58] Ibid, pp. 480.

CONCLUSION

Venture capital financing method has successfully applied in USA in 1980s. Venture capital has provided considerable contribution especially to the development of technological industry with pension funds participated in the venture capital system in USA. The largest fund source of venture capital is pension funds in USA and is banks in European Countries. The most of the developed countries in the World has been practicing venture capital financing technique. Therefore, there are lessons for developing countries to be taken on lessons from venture capital practices in the developed countries such as USA, England, Japan, etc. And, researchers have to examine carefully all these applications in detail.

In transferring new ideas and new projects, venture capital may play a very important role. Venture capital is a long-term financing source for small and medium sized companies that have the development potential. In Turkey, small and medium sized companies are in the financial difficulties. It is not logical to provide debt financing with high-interest rates from banks to small companies or they can not attain debt-financing with low-interest rates which is provided by government because of bureaucratic obstacles. Venture capital can be an alternative financing technique for small and medium sized companies in Turkey.

Venture capital financing model has successfully applied in the process of privatization in England. Venture capital companies have supported the entrepreneur companies, which wanted to be involved in the privatization of Public Economic Enterprises but have not sufficient financial power. This process is called as "buy-outs" and "acquisition". In several studies the use of funds, which are received from privatization in venture capital system, has already been suggested. Here, our suggestion is that venture capital financing model may be used in the process of the privatization of Public Economic Enterprises in Turkey as England Experience.

In Turkey, high inflation and high interest rates have been existed for very long years. Investors risk averse and they prefer guarantee returns. There has been a spiral among banks and government because of budget deficits. Government gives treasury bills and bonds to banks and in return of these takes debt money from banks. Banks invest nearly 60 percent of their deposits to these instruments, and gain high profits. Normally, banks should collect deposits from individuals and make credit to entrepreneur companies. But, in Turkey, banks avoid the original, the fundamental functions because of today conditions. Therefore venture capital financing model is very risky for banks, financial institutions, and huge companies in Turkey.

Here, the suggestion that we will make is as expressed in previous section, determined insurance premium ratios should be increased to at least % 0.5 for banks. These additional funds should be used to support to small and medium sized companies, and in transferring technological changes to industry.

It is mentioned that special financial institutions have more different financial instruments than banks. The main logic of the special financial institutions is based on the participation to the loss- profit sharing. These instruments are named as "mudaraba" and "musaraka". But "murabaha", an other instrument, is less risky than other instruments for special financial institutions in Turkey conditions. The frequency of the use of "murabaha" is higher than mudaraba financing technique in Turkey. The proportion of its use in operations of special financial institutions is nearly 90 percent In order to make special financial institutions' work as venture capital, the use of mudaraba technique must be increased.

It is understood from the different country experiences regarding venture capital practices such as US, England, India, etc, that venture capital companies and venture capital funds must be provided tax relief through the country tax acts. Government is very important factor of venture capital process. It is expressed that government can either create or remove the incentives that draw the potential participants of venture capital process. It must be avoided governmental interference such as regulatory constraints and tax burden. It is emphasized that the sponsorship of government is too necessary for the success of venture capital process. Finally, because legal and taxation framework is of vital importance in the growth of venture capital industry, government policies in Turkey should be determined towards this.

In in India, venture capital industry is relatively young and is still in the evolution stage. Venture capital industry in India, has been promoted by private firms, and has been supported by banks and financial institutions. Government plays the important role in Indian venture capital industry. Turkey and India are among the developing countries. Therefore India Experience should be considered, and two countries should be compared.

Venture capital system can be an important financing source for small medium sized companies. As it is known, new enterprises are very important for employment and high growth rates. Therefore, government should take into account venture capital system in supporting small and medium sized companies.

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