IMPACT OF COVID-19 ON VENTURE CAPITAL IN SMALL AND MEDIUM-SIZED ENTERPRISES - CRITICAL PERSPECTIVE

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Abstract

The COVID-19 pandemic has dramatically remodeled the country's economy toward small and medium-sized enterprises (SME). The economic growth of each developing country is now mostly influenced by SMEs. Supporting SMEs is one of the most important driving forces in developing the country's economy to accelerate growth and become self-sufficient. Venture capital is the main source of equity for SMEs as a start-up business. This study explores how SMEs and venture capital have been halted by the COVID-19 pandemic. This study has further highlighted the practical implications of venture capital in the crisis. The methodological tool of the research method is a descriptive analysis that was conducted without an empirical study. The main aim of the study is to investigate venture capital impacts for SMEs from the COVID-19 perspective. This paper will include the following logical sequence: introduction, literature review, methodology, changes in venture capital investment, the new dimension model in venture capital investment, and the conclusion of the study. The outcome of the study can enlighten the existing literature review in venture capital of SMEs. However, the COVID-19

pandemic has created a financial distance between SMEs and investors, and the seed capital for SMEs have also been affected due to uncertainty. The result of the study can be useful to provide significant implications and insights into the venture capital and the SMEs from the COVID-19 perspective. Finally, a future study will explore to develop a resiliency model to venture capital for SMEs.

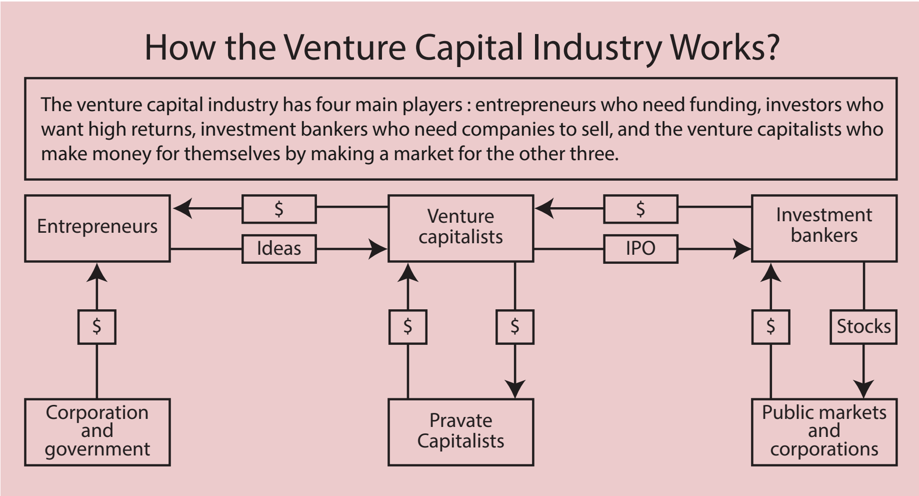
Keywords: COVID-19, Small and medium-sized enterprises, and Venture capital.

1. Introduction

Venture Capital (VC) has made great progress globally where SMEs are desperately looking for finance to launch the business. The small and medium business is the backbone of any economy in the world, thus the increase in VC investment is the most welcoming sign for the business community. Currently, Venture Capitalists (VCs) look more like financial institutions, but they're using investment knowledge and operational know-how as capital. In this context, VC is not a long-term investment, but the idea of investing in a particular entity to expand the business, and once the business reaches a matured stage, it can continue to exist with the help from investing in financial institutions. COVID-19 has created a financial distance between SMEs and investors. The startup or seed capital for SMEs has also been affected due to uncertainty. Global Pandemic has impacted a decrease of 60% of the total volume of investment raised between the first quarter in 2019 and the first quarter in 2020 (Brown & Rocha, 2020). Overall, VCs has to monitor the business environment and be more proactive in strategic planning for managing the uncertainty of the business. The innovation of young companies depends on the continuous inflow of venture capital, but it has been halted by the COVID-19. The international venture capital market has been completely locked down. Each country is keen to develop its own self-sufficient economy since the borders are closed. SMEs are idealistic businesses to be started, however this has been postponed for an indefinite period due to the lack of investors in the financial market.

SME focused funds and accelerators will experience performance deterioration and harder fundraising (Strusani, Verma , & Manent, 2020). The VC investors are from families or of people with high net and less institutionalized investors. The growth of SMEs has been affected in short and medium terms due to a decline in revenue and profitability. Most SMEs do not have to service debt and increase borrowing cost, adding to the high-risk aversion that will lead to defaults and liquidation. The entire global value chains have been challenged by the pandemic. The VC investment can create more opportunities in relation to technology, transfer know-how, innovation, digitization, and increase operational capabilities into SME investment. More debate on the impact of COVID-19 has thus far centered on existing SMEs (Bartik et al., 2020). This article examines how COVID-19 has impacted VC in SMEs.

The following way of VC works in the corporate world (Figure:1).



Sources : Bob Zider, How Venture Capital Works? HBR, 1998

Figure:1 How the Venture Capital works in the financial market

2. Literature View

The VC has declined due to COVID-19. VCs are working on extra time to monitor and evaluate the existing portfolio (Jones, 2020). In this context, VCs have been involved in the business operations to reduce costs, focus on cash, redesign the business model, and raise additional funding toward financing the working capital requirements. The investor's portfolio in the VC has been deteriorating dramatically. The stock market is also halted by the COVID-19, and the market has faced tough times, so the company cannot issue the initial public offer (IPO) to the public to raise additional funding for the business.

The business activities are entering a recession and there are more possible signs of recovery, though risks still remain significant (Blee, 2020). Ulrike Hinrichs (2020) stated that the demand for venture capital should not drop noticeably because of the pandemic. The pandemic has created more business opportunities for technology innovation so that VC can finance to start up new business. The challenge will always be in the business environment to start up new business venture. Venture capital investments are more toward the new idea generation and innovation businesses (Schweickhardt, 2020).

Technology companies are more resilient businesses, however, there is a high risk involved. VC has become a scarce resource in the present business environment. Sri Lanka is directed toward many innovations and methodologies in the capital market and digitalization of the business that will benefit both the investors and issuers. SMEs can reduce inequality among the society and enhance the economic growth of the country (Lambert, 2017). The investors and entrepreneurs shall align together in the best interests of the VC market.

The top brand companies such as Amazon, Apple, Facebook, Google, Intel and Microsoft started with the support of VC in the early stages of their businesses. All the companies are developed with innovative ideas on the market (Gompers, Gornall, Kaplan, & Steven, et al. 2021). VC shall be a key element for economic value, and is considered as a viable financial model with the proficiency of escalating access to finance for the growth of SMEs. VC is an alternative source of financing and equity, and fulfills the gap generated in the financial market by conventional lending institutions.

VC assists in financing the innovation and creativity of businesses, the academics, and practitioners which has drawn more attention. The impact of the COVID-19 in VC on SMEs is three times higher than the global financial crisis (Block and Sandner, 2009). VCs have described "COVID-19 as the Black Swan of 2020 and the global VC market was completely locked up". In this context, the pandemic has changed VC perception and attitude in the global business environment.

3. Methodology and Research Methods

The research objective is on the impact of the COVID-19 on VC in SMEs from a critical perspective. The empirical study will confirm the existing literature review of VC in SMEs based on proper explanation of the research findings. A critical perspective of VC in SMEs in the COVID-19 context is based on secondary data such as published journals, books, website searches, and articles. The author of this study has been working in Papua New Guinea for the last 13 years and has used his knowledge and experience widely on the subject matters to write this research. No formal research has been conducted for this study. The author used descriptive analysis to identify and re-assess critical analysis from different dimensions of VC. The outcome of the study can enlighten the existing literature review in VC and SMEs.

4. Changes in the Venture Capital Investment Activity

The COVID-19 pandemic has impacted the entire operation of the world, including venture capital investment. The venture capital investors have not assessed the real impacts of the global pandemic. COVID-19 has created less momentum in the investment pool and extra risk aversion (Sabadell, 2020). The venture capital investment activity has been reduced on a global scale. The small and medium businesses have been halted in the second half of the year 2020, and most of the businesses have been liquidated due to the COVID-19 impacts. Investors overcome this by extensive monitoring and control procedures (Kaplan and Stromberg, 2001). In this context, VCs have increased their monitoring and are more concerned with portfolio re-evaluation due to COVID-19 impacts. During shocks and crisis in events, levels of uncertainty escalate at such velocity that their impacts become highly debilitating for entrepreneurs and entrepreneurial actors such as banks and investors (Block and Sandner, 2009; Conti et al, 2019; McMullen and Shepherd, 2006; Packard et al., 2017). More distressed-oriented investors can enter the market and create an unhealthy business environment due to the downward valuation with less traditional investors in the VC market.
COVID-19 has created more negotiable power for VCs due to the low flow of investment to SMEs.VC has been changed in the paradigm from offline to online globally. VCs are positioned in the digital ecosystem. VC is mainly from foreign investment, and it has been decreased due to the closure of international borders.

Starting up of business of the SMEs have been delayed due to the unfavorable situation existing in the business world and the impact on venture capital investment due to the continuing uncertainty of the future .

5. The New Dimension in the Venture Capital Investment

Venture capital investment has been reduced in the global market, whereas investment in the domestic market has increased due to funds diverting from foreign market to the local market. Due diligence engagement has also been affected due to the reduction of face-to-face discussions. The seed venture capital investment has continuously declined due to the investors looking for well-established and matured companies for their investments. However, the new investor is more concerned about the portfolio valuations when the valuation of the matured company is declining due to COVID-19. The Initial Public Offers (IPO), mergers and acquisitions are also delayed in the global market. The cross-border venture capital investment has declined in the second and third quarters of 2020 (Sabadell, 2020).
Global travel restrictions have created a vacuum in venture capital investment for SMEs. Therefore, venture capital investment has increased in the domestic market.

6. Venture Capital Investment Activities for SMEs under COVID-19

SMEs are looking for prospective investors and VCs can perform the following activities under COVID-19 context.

6.1 Startups and Supportive

VC is requested to start up businesses and most are ready to invest in it. Nevertheless, on this premature period, it is difficult to forecast the achievement of the business. Liquid cash and seed capital are requested at the early stage of the business. Therefore, the risk of investment to be written off due to the uncertainty of the COVID-19 impacts is higher.

> **COVID-19 has affected venture capital investment in SMEs dramatically while the growth of the business for survival is crucial during this crisis.**

6.2 Follow up on the funding for the startups

The VCs are not interested in new business investments; however, they are more concerned with providing additional funds to the existing SMEs for survival. There are challenges of additional funding due to the travel restrictions and non-performance of due diligence processes. IPOs have been reduced. The decision to postpone investment is a very strategic movement due to the uncertainty in the world.

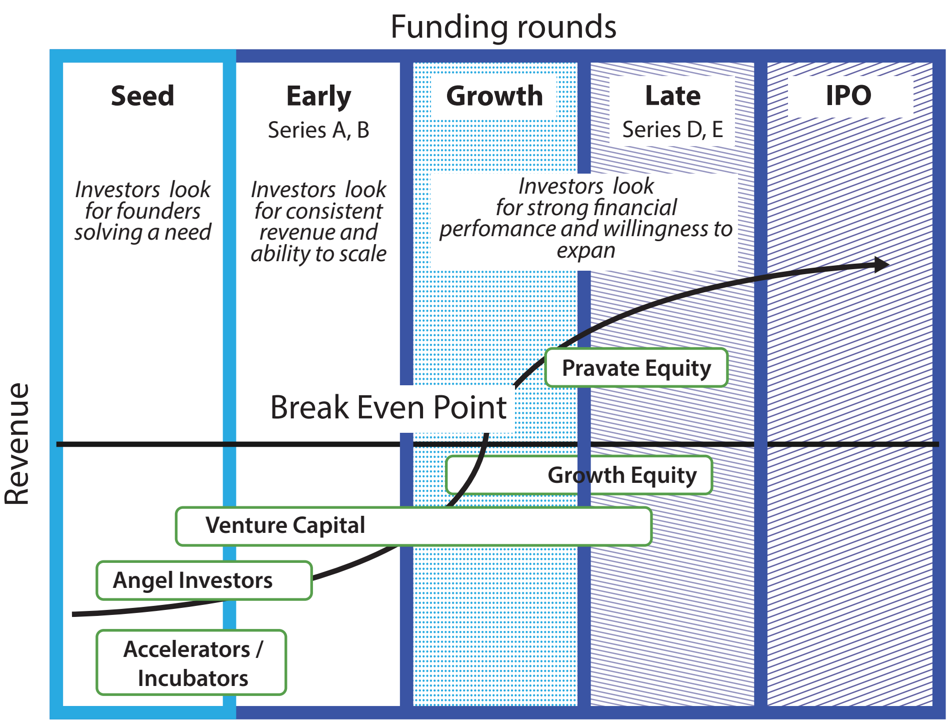
6.3 Limited Partners and fundraising

The institutional investors are not interested in the VC investment since it involves risks on assets, whereas high-net-worth personnel and family officers are expecting a super return on the investment.

6.4 Leveraging and Technology returns

VC investees often provide digital services, platforms, or deep tech solutions, and have the agility to pivot business models to react to the crisis (Strusani, Verma, and Manent, 2020). Some SMEs are extra resilient and ready to take the lead throughout the crisis, and the business also has an inherently innovative strategy. The technology innovation company can create benefits to the VCs in the medium term due to opportunities and trends in the post-Covid-19 period. The redesigned strategic planning, post-COVID-19, technical assistance, and operational knowledge can be used to navigate the crisis readjustment (Brown and Rocha , 2020). The SME is trying its best to provide the best services to customers by using the power of technology, digitization and overall changes in the business model.

Figure:2 Venture Capital Investment to the SMEs.



Sources : Bradley Miles, Breakinto VC : How to break into Venture Capital?

The above Figure 2 shows how VC can break into five different stages of the company's life.

The VC involved in these stages; from seed, early stage, growth, and mature stages. The VC has been fully involved in the early stage and growth of the SMEs. Digital technology in the VC can shift to the potential for growth since the crisis has demanded innovation, new entrepreneurial ideas, and high investing in essential services such as healthcare and logistics. In this context, SMEs have started to adopt the digital platforms such as innovative digitization business model and increase in new digital city consumers in the nascent market segmentation.

7. Conclusion

The COVID-19 pandemic has created the worst crisis in the 21st century. The severity of this decrease exceeds the decreases witnessed in more established markets for entrepreneurial finance such as the US (Howell et al., 2020). The financial performance of the SME's asset has deteriorated due to the valuation deduction in the entity's portfolio, foreign exchange volatility, and challenges in existing investments. SMEs are requesting financial support for the working capital for survival since the entity had faced dry powder during the prolonged pandemic crisis.

The COVID-19 impacts on the financial market will take over the global financial crisis as it already has an impact on the entire operation of the world. The global supply chains have been transformed to localization and diversification. The level of dry powder in SMEs has been deteriorating due to the prolonged COVID-19 crisis. It has worsened the global crisis in the 21st century. For over a century, uncertainty has long been recognized as a central pillar influencing entrepreneurial decision-making (Knight 1921). The length of VC fundraising cycle was increased due to the higher uncertainty in the market. However, a more prudent approach to the long-term investment is requested during the crisis. Public investment has been reduced and every country has budgeted a stimulus package to the SMEs business, but the practical implication of a stimulus package is the biggest challenge in the global context. The secure online engagement between the SMEs and VCs is encouraging a new dimension during this COVID-19 crisis, as it can save costs. The post-recovery stage of the SMEs is for future research, and it will create more literature reviews of COVID-19 impacts on the emerging financial market globally. SMEs have faced difficulty in estimating the budget and business plan due to the prolonged crisis. COVID-19 has created chances for others who are unable to join the previous investment.

The negative impacts of COVID-19 are expected to be higher on VC funds in the short term than on the Growth Equity funds (Strusani, Verma, and Manent, 2020). The current SME business model has been transformed to avoid any strategic drift since COVID-19 has changed the paradigm of business practices. The SME growth is done with the support of all stakeholders including business angels, who support the venture capital investment. The SMEs have developed a comprehensive resilience matrix to focus on the increased changes in the business environment.
Enterprise policy makers need to become better attuned to monitoring real-time data sources to mitigate chronic entrepreneurial uncertainty via strategic policy responses (Brown and Rocha, 2020)

Finally, to conclude, COVID-19 has affected venture capital investment in SMEs dramatically while the growth of the business for survival is crucial during this crisis.

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