
The Role of Venture Capital Firms in Funding Startups

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Abstract:

This research paper aims to provide theoretical foundations on the mechanism of Venture Capital Firms and highlight its importance in supporting startups. It was found that venture capital is the most effective means of supporting startups. The relationship between the investor and the startup owner is based on a partnership that involves sharing risks during the establishment and growth phases and reaping profits if the project succeeds. Therefore, Venture Capital Firms can be a source of financing for startups and is the most suitable mechanism to activate the role of startups, which suffer from underutilization due to their high risk.

Keywords: Venture Capital Firms, Startups, Mechanisms and Support Structures.

Jel Classification Codes : G24, G32, M13.

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1. Introduction:

The startup sector and entrepreneurship, which rely on individuals' skills and creative capabilities in institutional work, are among the most important fields that contribute to creating a new business model, exploiting technological qualifications, directing funds towards investment, and creating job opportunities. Developing economies must work to provide a suitable and nurturing environment to help develop the fabric of these institutions, which modern economies depend on as one of the most important pillars of economic development.

Given the significant importance of startups and the efforts to promote and diversify the national economy and improve growth rates outside of hydrocarbons, the government authorities have supported and promoted these institutions to improve their situation in creating added value and driving economic growth. Thus, investing in and supporting this sector has become a priority for Algerian economic policymakers. Public authorities have introduced solutions to the financial problems facing these institutions by implementing programs and measures to improve their business environment. However, the biggest problem facing most startups, whether new or expanding, is obtaining bank financing due to high risks and insufficient guarantees, along with their inability to access financial markets due to limited own resources. Therefore, it is necessary to search for alternative financing options that align with the financial nature of this sector. Programs and measures have been designed to improve the business environment, encourage creative initiatives, and motivate young people to establish their innovative institutions through programs designed to support, develop, and ensure the success of startups. These programs increase their chances of success and sustainability by providing financial support, consultations, expertise, and various logistical aids. A new financing technique has been created specifically for this purpose, known as venture capital, where everyone shares in the profit and loss, aligning interests and goals. This research will study the advantages of venture capital in financing startups by addressing the following problem:

What is the role and effectiveness of venture capital in financing startups?

Our study is based on the hypothesis that venture capital is one of the most important solutions to the financing problem of startups and plays an effective role in supporting them.

1.1. Research Significance:

The significance of this research stems from the importance of the subject itself. Venture capital is one of the most important support and assistance methods for developing and nurturing startups globally by providing financial support at various stages, from the idea formulation stage to transforming them into leading projects to accelerating the growth of existing and successful institutions. This involves profit and loss sharing, one of the main principles of Islamic finance. This study aims to reveal how venture capital works in supporting startups

and how well it matches the characteristics of these institutions, whose owners are often researchers and innovators lacking managerial experience and necessary funds to turn their ideas into investment projects, thus increasing the risks of their success.

1.2. Research Objectives: This study aims to:

- Explain the concept of startups and their global reality.
- Provide theoretical foundations on the concept and operations of venture capital.
- Highlight the importance of venture capital in supporting startups.
- Study the requirements for activating venture capital funding methods for startups.

First: The Reality of Startups Internationally:

2. Concepts Around Startups:

2.1. Definition of Startups:

Startups can be defined as enterprises that aim to market and launch a new product or innovative service targeting a large market. Regardless of the company's size, sector, or field of activity, they are characterized by high uncertainty and high risk in exchange for achieving strong and rapid growth with the potential for huge profits if successful (Bou Shoror, 2018, p. 420).

2.2. Characteristics of Startups:

Startups possess a set of characteristics, the most important of which are outlined below (Cook , 2025):

- **Fast-paced:** Whether it's making decisions and changing priorities quickly, or growing and scaling the business in a short period, things move rapidly in startups.
- **Founders:** A startup is the creation of its founders, usually one to three individuals who are key to the company's operations. The founders have an idea they want to bring to market and are committed to achieving it.
- **Funding:** Startups tend to be self-funded or receive investments from angel investors or venture capital firms. What distinguishes these from other funding sources is often a closer partnership between investors and founders. This is especially likely with angel investors, who may also provide guidance or advice to the startup.
- **Global Perspective:** One key difference between startups and small businesses is that a startup has an idea that can be applied and marketed globally. In contrast, small businesses are tied to a specific location or market. This is why many startups are tech companies offering products or services that only require an internet connection.
- **Growth:** A startup may begin as a small-scale operation by one or two people but aims to grow and expand rapidly to serve a large market in a relatively short time.

- **Constraints:** Startups begin as simple ideas, whether constrained by resources, size, or time (or a combination of the three).
- **Innovation:** There is consensus that a startup is a new business. A business is considered a startup in its first few years of operation (up to about five years).
- **Problem-solving:** One of the main goals of a startup is to solve a problem with a new product or service that is better than what is currently available. This often means working without a clear path or guidelines for success.
- **Registered Business:** To be considered a startup, some argue it must be a formally recognized entity. Without the necessary paperwork and business status, it is merely a business idea.
- **Team Culture:** Despite some debate about the number of team members a startup should have, it is agreed that it is a small business where each individual and the team collectively have a direct impact on the business.
- **Uncertainty:** With any new business, uncertainty is inherent to startups. They often start by experimenting, and things can change daily. Risk and failure are key aspects of startups many ideas and concepts will be tested, some will work, and others will not.

1.3. Types and Forms of Startups:

There are many types of startups around the world, but there are six commonly recognized types or forms, which are as follows (Abboud, 2025):

- **Small and Medium-Sized Startups:** A small or medium-sized startup is a type of startup characterized by its small-scale activity. It does not intend to grow significantly, with a maximum of 2000 employees. Therefore, it is referred to as small and medium-sized enterprises (SMEs) and sometimes micro-enterprises.
- **Large Startups:** This category includes commercial enterprises aiming for innovation, creating significant waves in their industry, and achieving unlimited growth, potentially reaching a global scale.
- **Social Startups:** This type refers to startups with a social character, aiming to work within the community they are established in to improve it or make a difference in a general or specific issue within it. They contribute positively to social causes or charitable endeavors, hence are called social enterprises, as their goals are primarily service-oriented and often non-profit.
- **Scalable Startups:** These startups are created with the intent to expand their activity and scope over time, ultimately becoming major entrepreneurial companies in their industry or field.
- **Saleable Startups:** These startups are established with the goal of developing, expanding, and then selling them in significant deals once they have gained a major position in the market and among competitors in the same field or industry.
- **Lifestyle Startups:** Known as Lifestyle startups, these refer to any startup whose activity is primarily based on behaviors, activities, or lifestyles that the target audience feels passionate about and interested in.

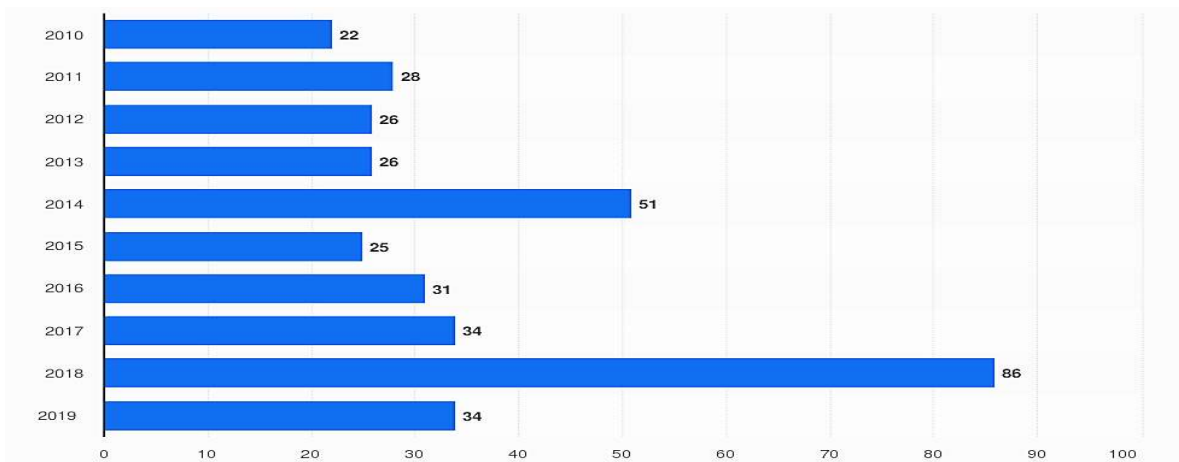
2. Overview of the Reality of Startups Globally:

A startup is a young company that has developed a unique business idea aimed at making an immediate impact and dominating the market. Many of the world's most valuable companies started modestly as startups, most of which operate in the technology sector, launching new products and services thanks to the latest technological innovations.

2.1. Development of Startup Funding Globally:

The following figure represents the value of capital invested in startups worldwide for the period 2010-2019.

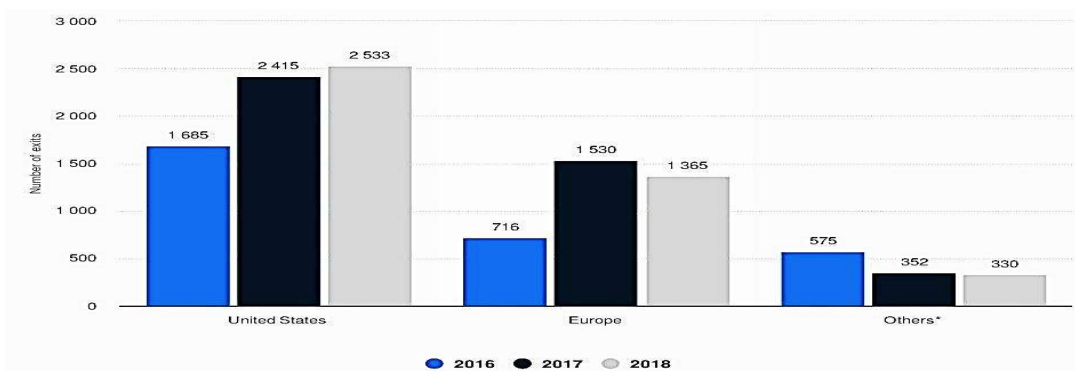
Figure 1: Development of Startup Funding Worldwide for the Period 2010-2019



Source:(Statista, 2025).

According to the above figure, we observe that the amount of capital invested in startups increases from year to year, reaching very high levels in 2018 and early 2019. This indicates the international interest in this type of enterprise. The following figure shows the development in the number of startups by region during the period 2016-2018:

Figure 2: Development in the Number of Startups Worldwide for the Period 2016-2018



Source: (statista, 2024)

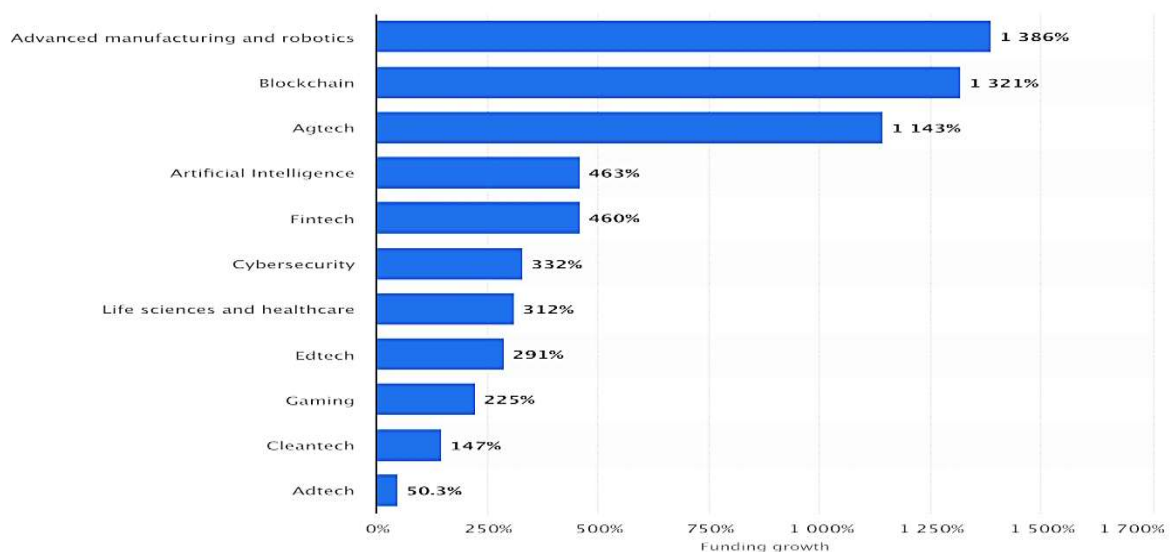
From the previous figure, we observe that the United States dominates with the largest number of startups, which increase in number year after year, followed by European countries. Other regions of the world also have

a considerable number of these enterprises, with Asian countries having the most among them. According to the "Startup Ecosystem in the Middle East and North Africa 2019" report by MAGNiTT, 2019 witnessed a record high of 564 investments in startups in the Middle East and North Africa, with a total value of \$704 million. The number of deals increased by 31%, and the total funding value rose by 12% compared to 2018.

2.2. Nature of Startup Activities Worldwide:

The following figure shows the growth rate of startups in various countries according to their nature of activity during the period 2012-2017.

Figure 3: Growth Rate of Startups Worldwide by Nature of Activity During the Period 2012-2017



Source: (Statista, 2025).

From the previous figure, we observe that the dominant activity among startups during the period 2012-2017 was advanced industries and robotics, followed by blockchain transactions, agricultural technology, artificial intelligence, and then financial technology. This indicates the dominance of new technological industries in this sector during the period from 2012 to 2017, which was marked by very high growth rates ranging from 460% to 1386%. Technology companies in the region began to expand and became the most attractive to global investors.

Second: The Importance of Venture Capital in Supporting Startups

3. The Concept of Venture Capital:

3.1. Definition of Venture Capital:

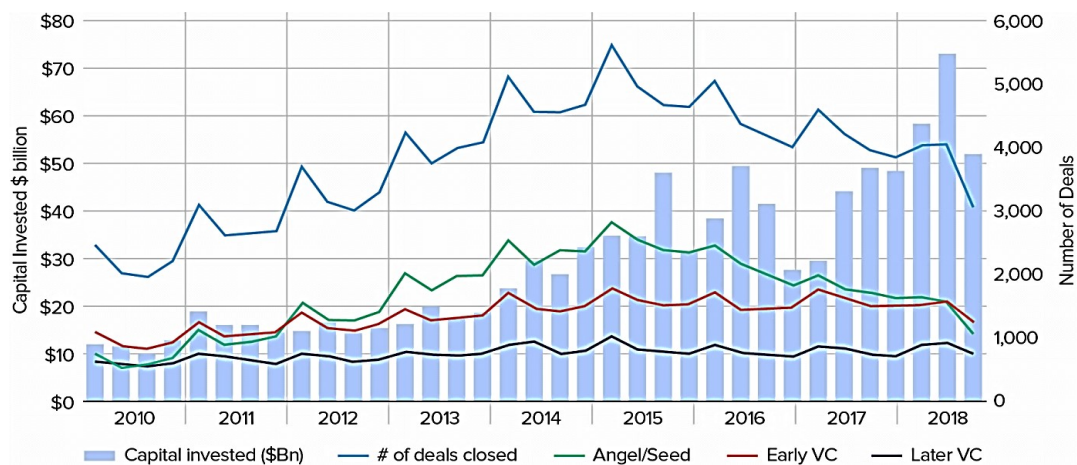
Also known as risk capital, it is defined by the National Venture Capital Association (NVCA) of the United States as "an active investment of long-term private funds in companies with strong potential, carried out by specialized investors" (Dubocage & Danset, 2006, p. 6). The European Venture Capital Association (EVCA) defines venture capital as all capital employed by a specialized financial intermediary in high-risk private projects with a significant potential for growth. However, it does not immediately guarantee income or ensure the

recovery of the capital by the specified date, which is the source of the risk, hoping for a high capital gain in the relatively distant future when selling the share of these companies after several years (Diaf & Hamana, 2016, p. 171).

The first modern venture capital firm was established in 1946 under the name "Karl COMPTON George DORIOT," by the American Research and Development Corporation (ARD), aimed at investing in companies seeking to develop high-tech products. In 1958, the first venture capital company was founded under the regulation of "Limited Partners" (LPS), which became the predominant legal form for companies engaged in venture capital or private equity activities in the United States (Bougueffa & Baaloudj, 2017, p. 197).

The following figure shows the size of global venture capital funding according to the stages of company growth during the period 2010-2018.

Figure 4: Global Financing Volume for Venture Capital by Stages of Enterprise Growth for the Period 2010-2018.



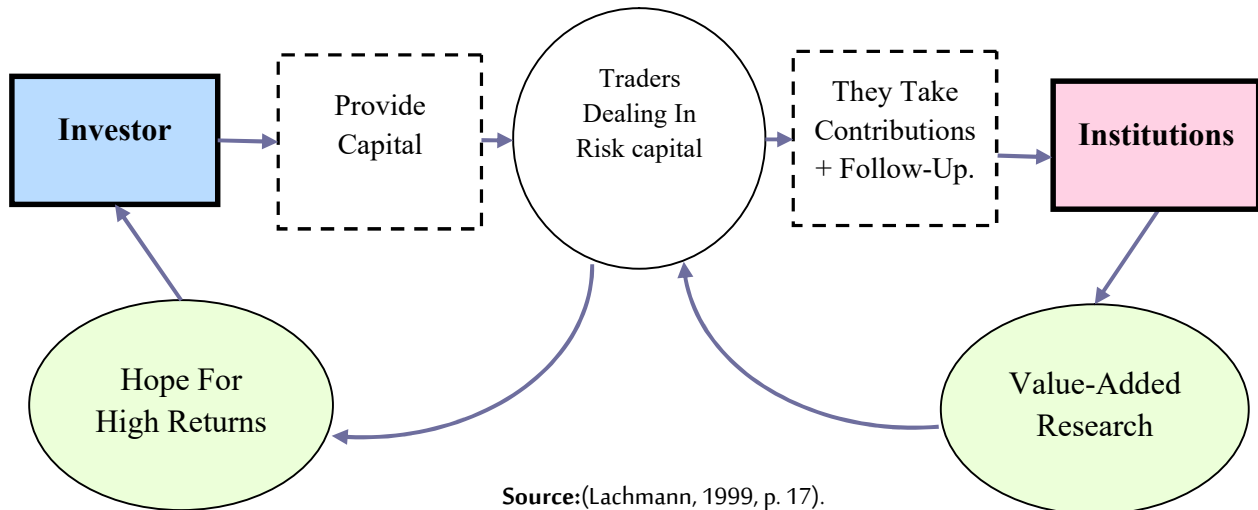
Source:(Graham, 2025, p. 6)

From the figure, it is evident that the volume of venture capital financing increases annually at varying rates, with its growth rate accelerating in recent years, correlating with the increase in the size of emerging enterprises worldwide, especially in the technological sector. Additionally, we note that the highest amount of this financing occurred during the initial stages of these enterprises' launch, where their financial needs are significant compared to their self-capabilities.

3.2. Mechanism of Venture Capital Companies:

The principle underlying venture capital companies is: advanced technology - high risks - promising profits. Therefore, the success of these enterprises requires patience for approximately three years to ensure substantial profits. They operate on a profit and loss sharing basis, which is illustrated in the accompanying figure.

Figure 5: Principles and Foundations of Venture Capital Companies



From the figure, we can summarize the financing procedures through venture capital companies at all stages of enterprise development, and those stages can be divided into four stages (Ait Akach & Douadi, 2016, p. 10):

- **Pre-startup stage (capital d’amorçage):** In this stage, the venture capital company finances research and development expenses, as well as expenses for conducting experiments, including the launch of a new product or commodity into the market.
- **Startup stage (capital de démarrage):** In this stage, the company implements the project in reality, where it finances the setup, purchase of equipment, and even carries out advertising and marketing operations.
- **Expansion stage (Capital- développement):** In this stage, the company finances established institutions. When the idea of expansion is realized by the institution itself, it leads to financial constraints, so the venture capital company intervenes to fill the gap and increase the production capacity of the institution, and explore new markets. There is a special case for the intervention of venture capital companies, which is financing the revival of the institution, where they finance the needs of the troubled institution in the form of contributing to its capital for a specified period not exceeding seven years, provided that this period is sufficient for the institution to rebalance and stabilize its production, financial, and administrative apparatus.
- **Exiting the project:** It is noted that venture capital companies attach great importance to the investment period because they are not interested in owning emerging institutions for a long time, but rather they are interested in financing these institutions until they reach certain levels of growth, then they exit them, opening the way for other investors.

Therefore, the process of exiting investments is of great importance to a venture capital firm, and its importance and the various methods used in it are presented through the following:

- **The importance of the investment exit process:** Venture capital investments are characterized by a low liquidity level, as they cannot be easily and quickly sold like securities in the stock market. They focus on investing in institutions at the startup or post-startup stage, and their investment period ranges from seven to ten years. The successful exit from investments represents an attraction element for investors through high returns, and it also allows raising capital for the venture capital firm.
- **Methods of exiting investments:** There are five main methods for exiting financing through venture capital companies. The first method is through Initial Public Offerings (IPOs), where the emerging institution enters the stock market for the first time. The second method is through sale, where the emerging institution is purchased by major institutions, and both the entrepreneur and the venture capital firm sell their shares in the institution. The third method is through secondary sale, where the venture capital firm sells its share in the emerging institution to another venture capital firm or to another institution, while the entrepreneur retains their share. The fourth method is through buyback, where the entrepreneur buys the venture capital firm's share in the institution. The fifth method is through liquidation, where investors exit with small or negligible returns.

3.3. The importance of venture capital financing in supporting startup enterprises:

The importance of venture capital financing in supporting startup enterprises is significant, especially for small and innovative ones, which lack the financial resources and expertise to grow on their own and face difficulties in obtaining funding from banks and other institutions due to the lack of sufficient guarantees on one hand and the high risk associated with them on the other. Here, the importance of venture capital in financing these enterprises, especially during the early stages, becomes evident, which positively impacts the national economy as a whole. The importance of venture capital for the funded startup is manifested in several aspects, including:

- Increase in the private funds of the institution due to the participation of the venture capital company in its capital.
- The participation of the venture capital company is not limited to the financial aspect only but also includes follow-up and advice, which enables the funded institution to effectively manage its projects and benefit from modern management techniques and experiences.
- Venture capital financing occurs in stages, not all at once. After completing any stage, the institution resorts again to the venture capital company (if it still needs financing), which ensures the seriousness of the

investment by presenting the results achieved for each funded stage, giving the institution a new opportunity to rectify its failures before losses accumulate.

- Venture capital companies support startup institutions in developing human resources, capabilities, and developing new ideas, especially in the technological field, as well as contributing to marketing inventions, technology transfer, and promoting risk culture. They also provide advice in management, planning, training, marketing, technical support, obtaining necessary financing, and ensuring a sound start for institutions, raising the continuity rate in activity.
- Venture capital companies do not withdraw from the institution until the latter becomes capable of production and growth on its own.
- The funds of the venture capital company are not recoverable or obligatory if the situation of the institution does not allow it since they have become part of its own funds, and they share in the losses with the institution.
- At the macroeconomic level, the importance of venture capital emerges as a source of funding in the following:
 - Developing the national economy by encouraging innovative industries to continue their activities, given the support provided by venture capital companies to them at the beginning of their activities.
 - Increasing the productivity capacity of the economy by directing funds to more productive activities, in addition to continuous monitoring of the results achieved by the funded project.
 - Reducing the unemployment rate, given the need of venture capital-funded institutions for job positions, considering them newly established institutions.

4. Conclusion:

Venture capital technology has significantly evolved on a global level. It no longer focuses solely on supporting startups in their early stages but rather accompanies them throughout their entire lifecycle using various support methods and financing models. These models are primarily based on profit-and-loss sharing while seeking to mitigate risks. This evolution has enabled the industry to play a crucial economic role in attracting savings and encouraging job-creating investments, aligning with key principles of Islamic finance.

Through our research, we have reached several conclusions, outlined as follows:

- Startups are a key driver of economic development, serving as a source of creativity and innovation, increasing productive capacities, generating employment, and contributing to economic stability.
- The financial challenge is the primary obstacle to startup growth, due to their high risks, lack of guarantees, and limited internal resources.
- Venture capital institutions are an innovative and effective mechanism for financing startups.

- Venture capital aligns with Islamic participatory financing models by sharing risks in return for profit-and-loss distribution, adhering to the principle of "gain comes with risk" (Al-Ghunm Bil-Ghurm).
- The mechanism of venture capital closely resembles traditional Islamic participation contracts, such as musharakah and mudarabah, as it follows the principle of profit and risk sharing.
- Venture capital is the optimal method to activate participatory financing models within Islamic banks.

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