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# A Study on Venture Capital Financing for Micro Small & Medium Enterprises (Msme) in India

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**ABSTRACT** *The venture capital (VC) finance focuses on companies, which are not listed in a stock exchange. The VC- finance is usually equity finance, which can be directly placed on the share capital or through mezzanine finance form indirectly to shares. Venture capital investment is timely limited, in general for 3 - 5 years. Venture capital financier has a target to bring with capital also the know- how which investor supplies to the company in a form of consulting or advising the company. The venture capital investment is based on the shareholders agreement between investor and the company. The agreement includes of the pricing principles of the shares from the start phase to the exit stage.*

**KEYWORDS : MSME, Funding Methods, Seed Money, SEBI.**

**Introduction:**
The MSME sector in India is incredibly heterogeneous in terms of size of the enterprises, variety of products and services produced and levels of technology employed. As per the Micro, Small and Medium Enterprises Development Act of 2006, enterprises with the capital investment (plant, machinery and equipment) levels within 10 crore INR (for services worth 5 crore INR) qualify as MSMEs. The MSME sector contributes in a significant way to the growth of the Indian economy with a vast network of over 32 million units, creating employment of about 70 million, manufacturing more than 6000 products, contributing about 45% to manufacturing output and about 40% of exports, directly and indirectly. It is an acknowledged fact that the MSME sector can help realise the target of the proposed National Manufacturing Policy of raising the share of the manufacturing sector in GDP from 16% at present to 25% by the end of 2022. However, this sector has faced certain impediments to growth, owing to some historical factors discussed below.

Venture capital means funds made available for start-up firms and small businesses with exceptional growth potential. Venture capital is money provided by professionals who alongside management invest in young, rapidly growing companies that have the potential to develop into significant economic contributors. Generally, venture capital is financing for new and rapidly growing companies, Purchase equity securities, Assist in the development of new products or services, Adding value to the company through active participation.

The concept of venture capital was formally introduced in India in 1987 by IDBI. The government levied a 5 percent cess on all know-how import payments to create the venture fund. ICICI started VC activity in the same year.Later on ICICI floated a separate VC company – TDICI.

Venture Capital is emerging as an important source of finance for small and medium-sized firms, especially for starting the business and business expansion. An entrepreneur usually starts the business with his own funds, and those borrowed from banks. It is during expansion that they find it difficult to raise funds. SMEs have traditionally been dependent on Bank finance for expansion and working capital requirements. However, in the recent past, bankers have curtailed lending to SMEs due to the greater risk of non-performing assets (NPAs) in a downturn. Thus, even though many SMEs have profitable projects and expansion plans, they find it difficult to get finance for their projects, as bankers may not be willing to fund high risk projects.

In order to provide financial support to such entrepreneurial talent and business skills, the concept of venture capital emerged. Venture capital is a means of equity financing for rapidly-growing private companies. Finance may be required for the start-up, expansion or purchase of a company. Venture capitalists comprise of professionals in various fields. They provide funds (known as Venture Capital Fund) to these firms after carefully scrutinizing the projects. Their main aim is to earn higher returns on their investments, but their methods are different from the traditional moneylenders. They take active part in the management of the company as well as provide the expertise and qualities of a good bankers, technologists, planners and managers.

**Objectives:**
- **To study the true notion of venture capital in MSME's in India.**
- **To focus on the development of Venture Capital in India.**
- **To study the benefits and policies of Venture Capital in MSME's in India.**
- **To study the steps and methods in Venture Capital Financing in India suitable to MSME's.**

**Venture Capital for MSMEs in India**
Traditionally, Venture Capitalists in India have shied from the MSME sector. The non-corporate structure and small size of majority of MSMEs in India makes the Venture Capitalists and Private Equity Players reluctant to investing in them due to higher transaction costs and difficulties in exits out of such investments. However, the VC scenario in India is rapidly changing. Alternative funding like VC is picking up in the India, including in the MSME sector. Moreover, the VCs are expanding their reach into areas besides the traditional VC sectors like Information Technology (IT); nowadays interest in sectors like clean energy, healthcare, pharmaceuticals, retail, media, etc. is also growing. In recent years, the government controlled financial institutions have initiated positive and progressive measures to provide MSMEs access to funds at a reasonable and affordable costs and without any usual hurdles. Venture capital funding institutions have been floated to induct fund at low cost, share the risk and to provide management and technology upgradation support to these enterprises. Government-funded schemes exist at both the national and the state levels. They tend to be relatively small — they typically do not exceed US$ 5 million.

The Small Industries Development Bank of India (SIDBI) is the main public financial institution involved in VC funding operations. SIDBI operates through wholly owned subsidiary, SIDBI Venture Capital Limited (SVCL). It co-finances state-level funds, and sometimes co-invests with private sector VCs on a case-by-case basis.

Since 2006, some new VCs are also operating at the SME level, such as Helion Venture Partners,Erasmic Venture Fund (Accel India Venture Fund), Seed Fund, and Upstream Ventures. While technology remains the most sought after investment fields, interest has been shifting from internet companies to other types of operations—especially ICT enabled services and bio-technology.

A few VCs also operate at the early-stage, including Erasmic Venture Fund, Seed Fund, InfinityVenture, IFI sponsored facilities such as Swiss Tech VCF, and the government schemes such as SIDBI VC and Gujarat VF. Early stage VCs seek smaller deals, typically in the US$ 1 - 3 million range. However, they rarely go below the half million dollar mark, where there is a strong appetite for financing, but very few opportunities. Possible sources of smaller investments are represented by local public-sector facilities, business angels, business incubators funds, and isolated cases of seed VCFs, such as the microventure schemes like Aavishkaar India Micro Venture Capital Fund (AIMVCF).

### Review of Literature:
SEBI has defined Venture Capital Fund in its Regulation 1996 as 'a fund established in the form of a company or trust which raises money through loans, donations, issue of securities or units as the case may be and makes or proposes to make investments in accordance with the regulations'.

Bettignies and Brander (2007) in his article said that "The venture capital investor takes the full risk and has no collaboration on investment. The difference between venture capital finance and bank finance is analyzed".

Ljungqvist and Richardson (2003), explained that "Given the volume of literature on venture capital, it may seem surprising that there are only a few papers analyzing the returns on private equity. The main obstacle to research has been the limited availability of data."

Mohammed Yunus (2006) "Venture Economics uses the term to describe the universe of venture investing (see Private Equity). It does not include buyout investing, mezzanine investing, fund of fund investing or secondaries. Angel investors or business angels would also not be included in the definition."

"Ventures Economics uses the term to describe the universe of all venture investing, buyout investing and mezzanine investing. Fund of fund investing and secondaries are also included in this broadest term. VE is not using the term to include angel investors or business angels, real estate investments or other investing scenarios outside of the public market."

### Research Methodology
The study aims to answer the objectives of the study by employing three complementary research methods:

1. **Literature review**
2. **Quantitative study**

### Sources of Data:
Since the study is related to secondary data, the data was gathered from SEBI,MSME and other related government websites, magazines and newspapers.

### MSMEs Test rates and Test stations

| Year | Revenue Earned (Rs. lakh) | | Recurring Expenditure (Rs. lakh) | | No. of jobs completed | | No. of MSMEs benefitted | |
|---|---|---|---|---|---|---|---|---|
| | TCs | TSs | TCs | TSs | TCs | TSs | TCs | TSs |
| 2007-08 | 326.06 | 106.81 | 430.40 | 111.84 | 12214 | 14261 | 2428 | 4662 |
| 2008-09 | 348.11 | 122.91 | 568.32 | 175.21 | 14013 | 21916 | 2608 | 5844 |
| 2009-10 | 387.96 | 137.04 | 638.37 | 209.92 | 14497 | 22471 | 6805 | 8163 |
| 2010-11 | 389.77 | 175.12 | 701.76 | 229.10 | 13981 | 26488 | 6304 | 8497 |
| 2011-12 | 425.28 | 213.37 | 727.38 | 187.34 | 19436 | 24542 | 7302 | 8906 |
| 2012-13 | 468.23 | 249.07 | 775.41 | 214.91 | 15472 | 17123 | 5602 | 8627 |
| 2013-14 | 581.69 | 275.90 | 787.70 | 238.40 | 14135 | 17545 | 6657 | 8155 |

### PSBs remain the largest lenders to MSMEs
The MSME sector has been accorded high priority in the industrial policy owing to its vital role in the economy. During FY11, the total outstanding credit by banks to MSMEs in India stood at ` 4,859.43 bn, growing at a CAGR of 39.8% during FY07-FY11.

Among bank categories, public and private sector banks have registered impressive growth of 35.28% and 36.14% in MSE lending in FY11. However, Public Sectors Banks (PSBs) account for a major share compared to private and foreign banks. During FY11, total priority sector advances by PSBs grew by 19.1% y-o-y to ` 10,286.15 bn, as against ` 8,637.77 bn in FY10. Total advances provided by the public sector banks to the MSE sector for FY11 grew by 35.3% y-o-y to ` 3,766.25 bn. Advances to MSE formed around 37% of the total priority sector advances of PSBs, versus the 32% share during FY10. Moreover, the share of MSE credit to net bank credit stood at 9.9% in 2011 against 13.4% in 2010.

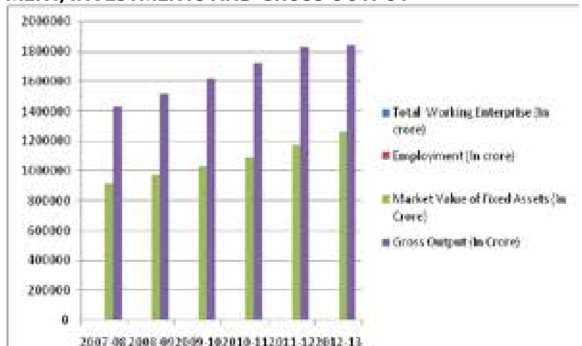
### TABLE 1: PERFORMANCE OF SSI / MSME UNITS, EMPLOYMENT, INVESTMENTS AND GROSS OUTPUT GROWTH AND PERFORMANCE OF MSME SECTOR

| Sl. No. | year | Total Working Enterprise (In Crores) | Employment (In Crores) | Market Value of Fixed Assets (In Crore) | Gross Output (In Crore) |
|---|---|---|---|---|---|
| I | II | III | IV | V | VI |
| 1 | 2007-08 | 3.7737 | 8.4223 | 917437.46 | 1435179.26 |
| 2 | 2008-09 | 3.9370 | 8.8114 | 971407.49 | 1524234.83 |
| 3 | 2009-10 | 4.1082 | 9.2219 | 1029331.46 | 1619355.53 |
| 4 | 2010-11 | 4.2877 | 9.6569 | 1094893.42 | 1721553.42 |
| 5 | 2011-12 | 4.4773 | 10.1259 | 1176939.36 | 1834332.05 |
| 6 | 2012-13 | 4.6756 | 10.6152 | 1269338.02 | 1844192.02 |

† Including activities of wholesale/retail trade, legal, education & social services, hotel & restaurants, transports and storage & warehousing (except cold storage) for which data were extracted Economic Census 2005, Central Statistics Office, M/o SPI.

* Estimated on the basis of per enterprises value obtained from sample survey of unregistered sector for activities wholesale/retail trade, legal, education & social services, hotel & restaurants, transports and storage & warehousing(except cold storage) which were excluded from Fourth All India Census of MSME, unregistered sector # Projected.

### Chart 3: PERFORMANCE OF SSI / MSME UNITS, EMPLOYMENT, INVESTMENTS AND GROSS OUTPUT

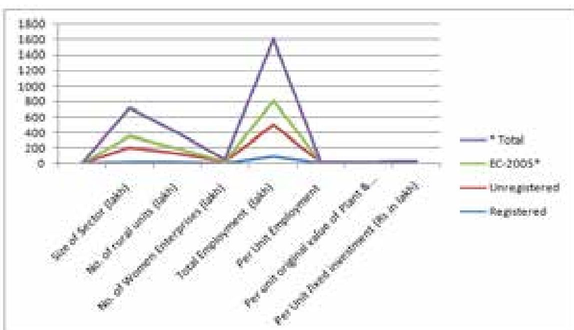


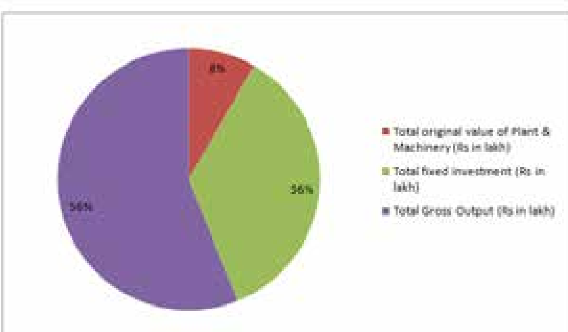
**Summary Results: Fourth All India Census of MSME.**

| Sl.No. | Character-istics | Registered Sector | Unregistered Sector | EC-2005* | * Total |
|---|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5) | (6) |
| 1 | Size of Sector (lakh) | 15.64 | 198.74 | 147.38 | 361.76 |
| 2 | No. of rural units (lakh) | 7.07(45.20%) | 119.68(60.22%) | 73.43(49.82%) | 200.18(55.34%) |
| 3 | No. of Women Enterprises (lakh) | 2.15(13.72%) | 18.06(9.09%) | 6.4(4.34%) | 26.61(7.36%) |
| 4 | Total Em-ployment (lakh) | 93.09 | 408.84 | 303.31 | 805.24 |
| 5 | Per Unit Employ-ment | 5.95 | 2.06 | 2.06 | 2.23 |
| 6 | Total orig-inal value of Plant & Machinery (Rs in lakh) | 10502461 | 9463960 | - | 19966421 |
| 7 | Per unit original value of Plant & Machinery (Rs in lakh) | 6.72 | 0.48 | - | - |
| 8 | Total fixed investment (Rs in lakh) | 44913840 | 24081646 | - | 68995486 |
| 9 | Per Unit fixed investment (Rs in lakh) | 28.72 | 1.21 | - | - |
| 10. | Total Gross Output (Rs in lakh) | 70751027 | 36970259 | - | 107721286 |

*Economic Census 2005

**Chart 4 & 5: Fourth All India Census of MSME.**



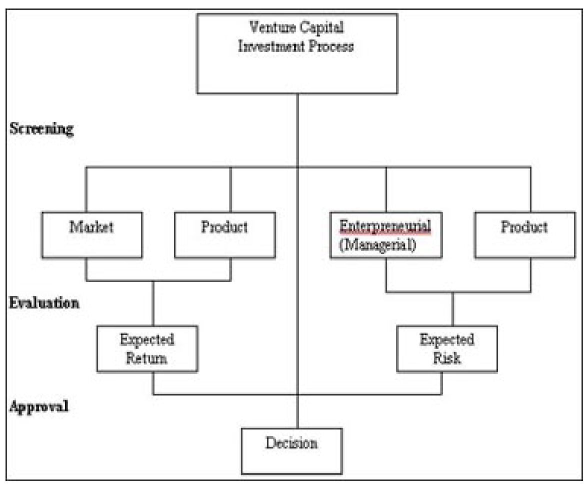




**Stages of Financing Venture Capital:**

1. **Seed Money: Low level financing needed to prove a new idea.**
2. Start-up: Early stage firms that need funding for expenses associated with marketing and product development.
3. First-Round: Early sales and manufacturing funds.
4. Second-Round: Working capital for early stage companies that are selling product, but not yet turning a profit .
5. Third-Round: Also called Mezzanine financing, this is expansion money for a newly profitable company
6. Fourth-Round: Also called bridge financing, it is intended to finance the "going public" process

**Risk in Stages:**

| Financial Stage | Period (Funds locked in years) | Risk Perception | Activity to be financed |
|---|---|---|---|
| Seed Money | 7-10 | Extreme | For supporting a concept or idea or R&D for product development |
| Start Up | 5-9 | Very High | Initializing operations or developing prototypes |
| First Stage | 3-7 | High | Start commercials production and marketing |
| Second Stage | 3-5 | Sufficiently high | Expand market and growing working capital need |
| Third Stage | 1-3 | Medium | Market expansion, acquisition & product development for profit making company |
| Fourth Stage | 1-3 | Low | Facilitating public issue |




**Methods of VC in MSME's:**

The financing pattern of the deal is the most important element. Following are the various methods of venture financing:

- **Equity**
- **Conditional loan**
- **Income note**
- **Participating debentures**
- **Quasi equity**

**Benefits of VC over other Funding Methods:**

Venture capital has a number of advantages over other forms of finance:

- **It injects long term equity finance which provides a solid capital base for future growth.**
- **The venture capitalist is a business partner, sharing both the risks and re-**

wards. Venture capitalists are rewarded by business success and the capital gain.

- The venture capitalist is able to provide practical advice and assistance to the company based on past experience with other companies which were in similar situations.
- The venture capitalist also has a network of contacts in many areas that can add value to the company, such as in recruiting key personnel, providing contacts in international markets, introductions to strategic partners, and if needed co-investments with other venture capital firms when additional rounds of financing are required.

**Venture Capital Funds in India**

In India, venture capital funds (VCFs) can be categorized into the following groups:-

- Promoted by the Central Government controlled development finance institutions. For example:
  - o ICICI Venture Funds Ltd.
  - o IFCI Venture Capital Funds Ltd (IVCF)
  - o SIDBI Venture Capital Ltd (SVCL)

- Promoted by State Government controlled development finance institutions. For Example:
  - o Punjab Infotech Venture Fund
  - o Gujarat Venture Finance Ltd (GVFL)
  - o Kerala Venture Capital Fund Pvt Ltd.

- Promoted by public banks For Example:
  - o Canbank Venture Capital Fund
  - o SBI Capital Market Ltd

- Promoted by private sector companies For example:
  - o IL&FS Trust Company Ltd
  - o Infinity Venture India Fund

- Promoted & established as an overseas venture capital fund. For example:
  - o Walden International Investment Group
  - o HSBC Private Equity management Mauritius Ltd

**Financing of MSMEs**

MSMEs require timely and adequate capital infusion through term loans and working capital loans, Particularly during the early and growth stages. Historically the MSMEs have relied on following sources for financing their needs:

- Retained earnings, funding through sale of assets
- Ancestral capital, personal savings, loans from relatives, loans from unregulated market
- Institutional financing from scheduled commercial banks
- Venture capital funds/ seed funds

Among the formal financial institutions, commercial banks constitute the largest source of financial assistance for the MSME sector at about 87% as of 31st March 2011. The outstanding MSE credit by SCBs recorded a strong growth of 34% in FY 2011 on a strong base of 3,62,291 crore INR as of 31st March 2010.

**Rules and Regulations for VC in India:**
**By SEBI:**

- VCF are regulated by the SEBI (Venture Capital Fund) Regulations, 1996.
- The following are the various provisions:
- ➢ A venture capital fund may be set up by a company or a trust, after a certificate of registration is granted by SEBI on an application made to it. On receipt of the certificate of registration, it shall be binding on the venture capital fund to abide by the provisions of the SEBI Act, 1992.
- ➢ A VCF may raise money from any investor, Indian, Non-resident Indian or foreign, provided the money accepted from any investor is not less than Rs 5 lakhs. The VCF shall not issue any document or advertisement inviting offers from the public for subscription of its security or units
- ➢ SEBI regulations permit investment by venture capital funds in equity or equity related instruments of unlisted companies and also in financially weak and sick industries whose shares are listed or unlisted
- ➢ At least 80% of the funds should be invested in venture capital companies and no other limits are prescribed.
- ➢ SEBI Regulations do not provide for any sectoral restrictions for investment except investment in companies engaged in financial services.
- ➢ A VCF is not permitted to invest in the equity shares of any company or institutions providing financial services.
- ➢ The securities or units issued by a venture capital fund shall not be listed on any recognized stock exchange till the expiry of 4 years from the date of issuance .
- ➢ A Scheme of VCF set up as a trust shall be wound up
- ➢ when the period of the scheme if any, is over
- ➢ If the trustee are of the opinion that the winding up shall be in the interest of the investors
- ➢ 75% of the investors in the scheme pass a resolution for winding up or,
- ➢ If SEBI so directs in the interest of the investors.

**Discussion:**

- The regulatory, tax and legal environment should play an enabling role as internationally venture funds have evolved in an atmosphere of structural flexibility, fiscal neutrality and operational adaptability.
- Resource raising, investment, management and exit should be as simple and flexible as needed and driven by global trends.
- Venture capital should become an institutionalized industry that protects investors and investee firms, operating in an environment suitable for raising the large amounts of risk capital needed and for spurring innovation through start-up firms in a wide range of high growth areas.
- In view of increasing global integration and mobility of capital it is important that Indian venture capital funds as well as venture finance enterprises are able to have global exposure and investment opportunities
- Infrastructure in the form of incubators and R&D need to be promoted using government support and private management as has successfully been done by countries such as the US, Israel and Taiwan. This is necessary for faster conversion of R&D and technological innovation into commercial products.

**Future prospects of Venture Capital in India:**

- Venture Capital can help in the rehabilitation of sick units.
- Venture Capital can assist small ancillary units to upgrade their technologies
- VCFs can play a significant role in developing countries in the service sector including tourism, publishing, health care etc.
- They can provide financial assistance to people coming out of universities, technical institutes, etc thus promoting entrepreneurial spirits.

**Conclusion:**

On the basis of the research it seems evident that the strategy approach to the venture capital finance is essential. The key elements scope, synergy, competitive advantage and economic performance are most relevant issues in this approach. In the venture capital finance it is important to recognize strategic elements, which lay the basis for the success of the selected company. The decision of the scope of the VC fund is also relevant, because it guidelines the allocation of selection. It seems evident that the link to the research is important in creating new high technology companies The second approach is to venture capital finance is analysis of management team of the high technology firm. The development of high technology firm is at the beginning technology oriented, where high expertise is relevant.

The organizing skills and business management skills become more important. The most relevant contribution of this dissertation is in introducing new theoretical model, which combines the elements of strategy-performance approach with venture capital finance. Venture capital investment decision requires firstly the strategic approach. The understanding of the strategy of potential portfolio company is the core part of decision making. The SP-model opens the tool pattern, which helps to understand how most relevant elements of synergy, competitive advantage and performance. The dissertation introduces a new strategy performance-innovation model. The development and building of the management team and organization requires resources, which venture capital investor supplies. The time to exit seems to take more time than planned. The economic fluctuations effect strongly to the level of revenues in exit. The listing on stock exchange in exit phase has been minimal in recent years. It seems evident that in Finland VC- investors have realized best revenues in MBO/MBI exits.

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