

Venture Capital in India: A Birds' Eye view



Commerce

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Dr. Rajkumar B. Salgar

Assistant Professor, Department of Commerce and Management, Government First Grade College, Chittgappa Tq: Humnabad, Dist: Bidar-Karnataka

ABSTRACT

Venture Capital is money provided by professionals who invest and manage young rapidly growing companies that have the potential to develop into significant economic contributors. According to SEBI regulations, venture capital fund means a fund established in the form of a company or trust, which raises money through loans, donations, issue of securities or units and makes or proposes, to make investments in accordance with these regulations. The funds so collected are available for investment in potentially highly profitable enterprises at a high risk of loss. A Venture Capitalist is an individual or a company who provides. Investment Capital, Management Expertise, Networking & marketing support while funding and running highly innovative & prospective areas of products as well as services. . In India, presently, there are about a dozen institutions providing venture capital finance. There is an urgent need for encouragement of risk capital in India, as this will widen the industrial base of, high tech industries and promote the growth of technology. The present paper is an attempt to highlight the issues and challenges faced by Indian venture capital companies.

Introduction;

Venture Capital is money provided by professionals who invest and manage young rapidly growing companies that have the potential to develop into significant economic contributors. According to SEBI regulations, venture capital fund means a fund established in the form of a company or trust, which raises money through loans, donations, issue of securities or units and makes or proposes, to make investments in accordance with these regulations. The funds so collected are available for investment in potentially highly profitable enterprises at a high risk of loss. A Venture Capitalist is an individual or a company who provides. Investment Capital, Management Expertise, Networking & marketing support while funding and running highly innovative & prospective areas of products as well as services. Thus, the investments made by Venture Capitalists generally involves the following,

- Financing new and rapidly growing companies.
- Purchasing equity securities.
- Taking higher risk in expectation of higher rewards
- Having a long frame of time period, generally of more than 5 - 6 years.
- Actively working with the company's management to devise strategies pertaining to the overall functioning of the project
- Networking and marketing of the product /service being offered

In an attempt to bring together highly influential Indians living across the United States, a networking society named IND US Entrepreneurs or TiE was set up in 1992. The aim was to get the Indian community together and to foster entrepreneurs for wealth creation. A core group of 10 - 15 individuals worked hard to establish the organization. The group (TiE) has now over 600 members with 20 offices spread across the United States. Some of the famous personalities belonging to this group are Vinod Dham (father of the Pentium Chip), Prabhu Goel, and K.B. Chandrashekhar (Head of \$ 200mn. Exodus Communications, a fiber optic network carrying 30% of all Internet content traffic hosting websites like Yahoo, Hotmail and Amazon.

Venture Capital Financing

It generally involves start up financing to help technically sound, globally competitive and potential projects to compete in the international markets with the high quality and reasonable cost aspects. The growth of South East Asian economies especially Hongkong, Singapore, South Korea, Malaysia along with India has been due to the large pool of Venture Capital funds from domestic / offshore arenas

Venture Capitalists draw their investment funds from a pool of money raised from public and private investors. These funds are deployed generally as equity capital (ordinary and preference shares) and some times as subordinated debt which is a semi secured investment in the company (through debenture) ranking below the secured lenders that often requires periodic repay-

ment. Today, a VC deal can involve common equity, convertible preferred equity and subordinated debt in different proportions.

The Venture Capital funding varies across the different stages of growth of a firm. The various stages are

1. **Pre seed Stage:** Here, a relatively small amount of capital is provided to an entrepreneur to conceive and market a potential idea having good future prospects. The funded work also involves product development to some extent
2. **Seed Stage:** Financing is provided to complete product development and commence initial marketing formalities.
3. **Early Stage / First Stage:** Finance is provided to companies to initiate commercial manufacturing and sales.
4. **Second Stage:** In the Second Stage of Financing working capital is provided for the expansion of the company in terms of growing accounts receivable and inventory.
5. **Third Stage:** Funds provided for major expansion of a company having increasing sales volume. This stage is met when the firm crosses the break even point.
6. **Bridge / Mezzanine Financing or Later Stage Financing:** Bridge / Mezzanine Financing or Later Stage Financing is financing a company just before its IPO (Initial Public Offer). Often, bridge finance is structured so that it can be repaid, from the proceeds of a public offering.

There are basically four key elements in financing of ventures which are studied in depth by the venture capitalists. These are

1. **Management:** The strength, expertise & unity of the key people on the board bring significant credibility to the company. The members are to be mature, experienced possessing working knowledge of business and capable of taking potentially high risks
2. **Potential for Capital Gain:** An above average rate of return of about 30 - 40% is required by venture capitalists. The rate of return also depends upon the stage of the business cycle where funds are being deployed. Earlier the stage, higher is the risk and hence the return
3. **Realistic Financial Requirement and Projections :** The venture capitalist requires a realistic view about the present health of the organization as well as future projections regarding scope, nature and performance of the company in terms of scale of operations, operating profit and further costs related to product development through Research & Development.
4. **Owner's Financial Stake:** The financial resources owned & committed by the entrepreneur/ owner in the business including the funds invested by family, friends and relatives play a very important role in increasing the viability of the business. It is an important avenue where the venture capitalist keeps an open eye.

Venture Capital in India

In India the Venture Capital plays a vital role in the development

and growth of innovative entrepreneurs. Venture Capital activity in the past was possibly done by the developmental financial institutions like IDBI, ICICI and State Financial Corporations. These institutions promoted entities in the private sector with debt as an instrument of funding. For a long time funds raised from public were used as a source of Venture Capital. This source however depended a lot on the market vagaries. And with the minimum paid up capital requirements being raised for listing at the stock exchanges, it became difficult for smaller firms with viable projects to raise funds from public. In India, the need for Venture Capital was recognised in the 7th five year plan and long term fiscal policy of GOI. In 1973 a committee on Development of small and medium enterprises highlighted the need to faster VC as a source of funding new entrepreneurs and technology. VC financing really started in India in 1988 with the formation of Technology Development and Information Company of India Ltd. (TDICI) - promoted by ICICI and UTI. The first private VC fund was sponsored by Credit Capital Finance Corporation (CFC) and promoted by Bank of India, Asian Development Bank and the Commonwealth Development Corporation viz. Credit Capital Venture Fund. At the same time Gujarat Venture Finance Ltd. and APIDC Venture Capital Ltd. were started by state level financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high net-worth individuals. The venture capital funds in India are listed in Annexure.

Major players in India

- IDBI's Venture Capital Fund.
- TDICI
- Credit Capital Venture Fund(India) Ltd.
- Cabank VC fund
- Gujarat Venture Finance Ltd.
- SBI Capital Venture fund.
- PICUP.
- ICICI

Problems of Venture Capital Financing

VCF is in its nascent stages in India. The emerging scenario of global competitiveness has put an immense pressure on the industrial sector to improve the quality level with minimization of cost of products by making use of latest technological skills. The implication is to obtain adequate financing along with the necessary hi-tech equipments to produce an innovative product which can succeed and grow in the present market condition. Unfortunately, our country lacks on both fronts. The necessary capital can be obtained from the venture capital firms who expect an above average rate of return on the investment. The financing firms expect a sound, experienced, mature and capable management team of the company being financed. Since the innovative project involves a higher risk, there is an expectation of higher returns from the project. The payback period is also generally high (5 - 7 years). The various problems/ queries can be outlined as follows.

- a. Requirement of an experienced management team
- b. Requirement of an above average rate of return on investment
- c. Longer payback period
- d. Uncertainty regarding the success of the product in the market.
- e. Questions regarding the infrastructure details of production like plant location, accessibility, relationship with the suppliers and creditors, transportation facilities, labour availability etc.
- f. The category of potential customers and hence the packaging and pricing details of the product.
- g. The size of the market
- h. Major competitors and their market share.
- i. Skills and Training required and the cost of training.
- j. Financial considerations like return on capital employed (ROCE), cost of the project, the Internal Rate of Return (IRR) of the project, total amount of funds required, ratio of owners investment (personnel funds of the entrepreneur), borrowed capital, mortgage loans etc. in the capital employed

Prospects of Venture Capital Financing

With the advent of liberalization, India has been showing remarkable growth in the economy in the past 10 - 12 years. The government is promoting growth in capacity utilization of available and acquired resources and hence entrepreneurship development, by liberalising norms regarding venture capital. While only eight domestic venture capital funds were registered with SEBI during 1996-1998, 14 funds have already been registered in 1999-2000. Institutional interest is growing and foreign venture investments are also on the rise. Many state governments have also set up venture capital funds for the IT sector in partnership with the local state financial institutions and SIDBI. These include Andhra Pradesh, Karnataka, Delhi, Kerala and Tamil Nadu. The other states are to follow soon.

In the year 2000, the finance ministry announced the liberalization of tax treatment for venture capital funds to promote them & to increase job creation. This is expected to give a strong boost to the non resident Indians located in the Silicon valley and elsewhere to invest some of their capital, knowledge and enterprise in these ventures. A Bangalore based media company, Graycell Ltd., has recently obtained VC investment totaling about \$ 1.7mn. The company would be creating and marketing branded web based consumer products in the near future. The following points can be considered as the harbingers of VC financing in India.

- ❖ Globally competitive human resource capital.
- ❖ Existence of a globally competitive high technology
- ❖ Second Largest English speaking, scientific & technical manpower in the world.
- ❖ Vast pool of existing and ongoing scientific and technical research carried by large number of research laboratories.
- ❖ Initiatives taken by the Government in formulating policies to encourage investors and entrepreneurs.
- ❖ Initiatives of the SEBI to develop a strong and vibrant capital market giving the adequate liquidity and flexibility for investors for entry and exit

In a recent survey it has been shown that the VC investments in India's I.T. - Software and services sector (including dot com companies)- have grown from US \$ 150 million in 1998 to over US \$ 1200 million in 2002. The credit can be given to setting up of a National Venture Capital Fund for the Software and I.T. Industry (NFSIT) in association with various financial institutions of Small Industries and Development Bank of India (SIDBI). The facts reveal that VC disbursements as on September 30, 2002 made by NFSIT totalled Rs 254.36mn

Conclusion

The world is becoming increasingly competitive. Companies are required to be super efficient with respect to cost, productivity, labour efficiency, technical back up, flexibility to consumer demand, adaptability and foresightedness

There is an impending demand for highly cost effective, quality products and hence the need for right access to valuable human expertise to guide and monitor along with the necessary funds for financing the new projects. The Government of India in an attempt to bring the nation at par and above the developed nations has been promoting venture capital financing to new, innovative concepts & ideas, liberalising taxation norms providing tax incentives to venture firms, giving a Philip to the creation of local pools of capital and holding training sessions for the emerging VC investors.

There are large sectors of the economy that are ripe for VC investors, like, I.T., Pharma, Manufacturing, Telecom, Retail franchises, food processing and many more. The nation awaits for the burgeoning VC business in India in spite of the existing shortcomings in the Indian infrastructure. Looking ahead for a bright future for India Inc

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