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# Birth And Growth Of Venture Capital Industry In India

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ABSTRACT

*In India, venture capital has been around for some time now. The performance has been mixed. So what are these venture capital funds? How and to whom are they helpful? Do they serve any useful purpose? Let us understand what venture capital funding is all about and place them in an Indian context.*

*The fundamental principal underlying venture capital fund is "No return without risk and greater the risk, greater the return". Venture capital is a booster for new entrepreneurs. A venture capital fund is a fund, which in many ways is like mutual fund. It raises funds from several investors, who generally have a large appetite for risk and are looking out for greater returns. These funds are then invested in several fledging enterprises, which need funds, but are unable to access them through the conventional sources such as banks and financial institutions. Typically, such enterprises are started by first generation entrepreneurs. Because such enterprises generally do not have any major collateral to offer as security, banks and financial institutions are averse to funding them.*

*Since most of the ventures financed through this route are in new areas, the probability of their success is very low. The venture capitalist is however not worried because the deal, which succeeds, nets a very high return on his investments. The return generally comes in the form of selling the stocks when they get listed on the stock exchange. If the venture fails (more often than not), the entire amount gets written off.*

*Venture capital funding may be by way of investment in the equity of the new enterprise or by way of debt or a combination of both, though equity is the most preferred route.*

*To conclude, a venture financier is one who funds a startup company, in most cases promoted by a first generation technocrat promoter with equity. Exit is preferably through listing on stock exchanges.*

Keywords : venture capital, first generation entrepreneurs, appetite for risk, Exit Route.

**What Is Venture Capital?**

Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for start-up companies.

Venture capitalists generally:

- Finance new and rapidly growing companies
- Purchase equity securities
- Assist in the development of new products or services
- Add value to the company through active participation
- Take higher risks with the expectation of higher rewards
- Have a long-term orientation

Investment Philosophy

Early stage funding is avoided by most funds apart from ICICI ventures, Draper, SIDBI and Angels.

Funding growth or mezzanine funding till pre IPO is the segment where most players operate. In this context, most funds in India are private equity investors.

Size of Investment

The size of investment is generally less than US$1mn, US$1-5mn, US$5-10mn, and greater than US$10mn. As most funds are of a private equity kind, size of investments has been increasing. IT companies generally require funds of about Rs30-40mn in an early stage which fall outside funding limits of most funds and that is why the government is promoting schemes to fund start ups in general, and in IT in particular.

Value Addition

The venture funds can have a totally "hands on" approach towards their investment like Draper or "hands off" like Chase. ICICI Ventures falls in the limited exposure category. In general, venture funds who fund seed or start ups have a closer interaction with the companies and advice on strategy, etc while the private equity funds treat their exposure like any other listed investment. This is partially justified, as they tend to invest in more mature stories.

**Venture capital in India: A Prognostic View**

Technology and knowledge based enterprises properly supported by venture capital can be propelled into a powerful engine of economic growth and wealth creation on a sustainable basis. According to Venture Economics Inc., a leading research organization and industry observer of venture capital industry, much of American innovation and economic development in the past three decades has come from venture capital-backed companies. In fact, many companies, which are now considered as global giants like Microsoft, Intel, and Sun among many others, are venture backed companies.

In the global venture capital industry, investor and invitee firms work together closely in an enabling environment that allows entrepreneurs to focus on value creation.

This paper argues that sometimes significant changes are needed to institutionalized venture capital in India. Some of the basic problem faced by industry can be categorized as 1) need of improvement in venture capital practice and 2) improving exit mechanism.

Improving Practice

Indian venture capital Association (IVCA) was formed as a pressure group to impress upon the government the need for a favorable policy regime. It is molded as the leading public policy advocate for the Venture Capital Industry and is represented by almost all the Venture Capital Companies in India. The members of the association were working with all branches of the government and the media for a better understanding of Venture Capital in Indian economy. The association is largely successful in meeting the objectives it has set out but could not extend the horizon of its operations and could not emerge as an independent knowledge institution.

High-end Services

In order to meet the new economy's requirements, where knowledge plays a crucial role, a different kind of institutional set up is required. IVCA should promote research in Venture Activity in India. It should also encourage all knowledge endeavors in related areas such as technology management and innovation. It should be an academic power house which offers training in areas such as setting Venture Capital funds, to name a few. These programs can be aimed at catering to the needs of young Venture Capitalists, entrepreneurs and investors in Venture Funds. It should employ knowledge workers in various technological spheres and form related areas of social science like entrepreneurship, who will be contributing to the cause of educational and professional development of the individual in the industry.

It should offer performance testing services which will provide crucial information about aspect if interests such as how well Venture funded Initial Public Offerings have performed or gains made by Venture funds through Mergers and Acquisition. Also, it should assess the industry in the wider economic sphere, i.e., by providing information about the number of jobs generated each year by funded companies of this industry and contribution to GDP. Some of the benchmarking services may include offering cost of capital benchmark that aid the industry in valuation and develop broad stock market returns information that aids the Venture Capital funds to assess their performance against market returns. In doing so, care should be taken to include only representative listed companies that broadly represent Venture Capitalist's client companies.

Widening Exit Route

According to Asian Venture Capital Journal, the number of exits (venture capitalists divesting their stakes) in the year 2000 improved from $2.5 bn in 1999 to $3.93 bn, largely because of a successful series of IPOs in the US and regional markets and several successful trade sales. In the year 2001, there seemed to be a general slowdown in venture activity all over the world, especially in the US. From given table it is evident that the scale of venture capital exists in India was very small in compared to Japan, Korea, Hong and Australia.

Number of Disinvestment in South Asia

| Country | 1999 | 2000 | % change |
|---|---|---|---|
| Australia | 236 | 258 | 9.3 |
| Hong Kong/China | 375 | 755 | 101.3 |
| India | 6 | 28 | 366.7 |
| Indonesia | 21 | 29 | 38.1 |
| Japan | 876 | 1156 | 32.0 |
| Korea | 660 | 969 | 46.8 |
| Malaysia | 3 | 6 | 100.0 |
| Philippines | 6 | 39 | 550.0 |
| Singapore | 147 | 377 | 156.5 |
| Sri Lanka | 1 | 1 | 0 |
| Taiwan | 195 | 148 | -24.1 |
| Thailand | 14 | 10 | -28.6 |
| Vietnam | - | 158 | - |

(Source: ICFAI Journal of Financial Economics. June 2005)

**Indian Scenario - A Statistical Snapshot**

Contributors of Funds

| Contributors | Rs mn | Per cent |
|---|---|---|
| Foreign Institutional Investors | 13,426.47 | 52.46% |
| All India Financial Institutions | 6,252.90 | 24.43% |
| Multilateral Development Agencies | 2,133.64 | 8.34% |
| Other Banks | 1,541.00 | 6.02% |
| Foreign Investors | 570 | 2.23% |
| Private Sector | 412.53 | 1.61% |
| Public Sector | 324.44 | 1.27% |
| Nationalized Banks | 278.67 | 1.09% |
| Non Resident Indians | 235.5 | 0.92% |
| State Financial Institutions | 215 | 0.84% |
| Other Public | 115.52 | 0.45% |
| Insurance Companies | 85 | 0.33% |
| Mutual Funds | 4.5 | 0.02% |
| Total | 25,595.17 | 100.00% |

Methods of Financing

| Instruments | Rs million | Per cent |
|---|---|---|
| Equity Shares | 6,318.12 | 63.18 |
| Redeemable Preference Shares | 2,154.46 | 21.54 |
| Non Convertible Debt | 873.01 | 8.73 |
| Convertible Instruments | 580.02 | 5.8 |
| Other Instruments | 75.85 | 0.75 |
| Total | 10,000.46 | 100 |

Financing By Investment Stage

| Investment Stages | Rs million | Number |
|---|---|---|
| Start-up | 3,813.00 | 297 |
| Later stage | 3,338.99 | 154 |
| Other early stage | 1,825.77 | 124 |
| Seed stage | 963.2 | 107 |
| Turnaround financing | 59.5 | 9 |
| Total | 10,000.46 | 691 |

Financing By Industry

| Industry | Rs million | Number |
|---|---|---|
| Industrial products, machinery | 2,599.32 | 208 |
| Computer Software | 1,832 | 87 |
| Consumer Related | 1,412.74 | 58 |
| Medical | 623.8 | 44 |
| Food, food processing | 500.06 | 50 |
| Other electronics | 436.54 | 41 |
| Tel & Data Communications | 385.09 | 16 |
| Biotechnology | 376.46 | 30 |
| Energy related | 249.56 | 19 |
| Computer Hardware | 203.36 | 25 |
| Miscellaneous | 1,380.85 | 113 |
| Total | 10,000.46 | 691 |

Financing By States

| Investment | Rs million | Number |
|---|---|---|
| Maharashtra | 2,566 | 161 |
| Tamil Nadu | 1531 | 119 |
| Andhra Pradesh | 1372 | 89 |
| Gujarat | 1102 | 49 |
| Karnataka | 1046 | 93 |
| West Bengal | 312 | 22 |
| Haryana | 300 | 22 |
| Delhi | 294 | 21 |
| Uttar Pradesh | 283 | 29 |
| Madhya Pradesh | 231 | 2 |
| Kerala | 135 | 15 |
| Goa | 105 | 16 |
| Rajasthan | 87 | 11 |
| Punjab | 84 | 6 |
| Orissa | 35 | 5 |
| Dadra & Nagar Haveli | 32 | 1 |
| Himachal Pradesh | 28 | 3 |
| Pondicherry | 22 | 2 |
| Bihar | 16 | 3 |
| Overseas | 413 | 12 |
| Total | 9994 | 691 |

**Problems with VCs in the Indian Context**

One can ask why venture funding is so successful in USA and faced a number of problems in India. The biggest problem was a mindset change from "collateral funding" to high risk high return funding. Most of the pioneers in the industry were people with credit background and exposure to manufacturing industries. Exposure to fast growing intellectual property business and services sector was almost zero. All these combined to a slow start to the industry. The other issues that led to such a situation include:

License Raj and the IPO Boom

Till early 90s, under the license Raj regime, only commodity centric businesses thrived in a deficit situation. To fund a cement plant, venture capital is not needed. What was needed was ability to get a license and then get the project funded by the banks and DFIs. In most cases, the promoters were well-established industrial houses, with no apparent need for funds. Most of these entities were capable of raising funds from conventional sources, including term loans from institutions and equity markets.

Scalability

The Indian software segment has recorded an impressive growth over the last few years and earns large revenues from its export earnings, yet our share in the global market is less than 1 per cent. Within the software industry, the value chain ranges from body shopping at the bottom to strategic consulting at the top. Higher value addition and profitability as well as significant market presence take place at the higher end of the value chain. If the industry has to grow further and survive the flux it would only be through innovation. For any venture idea to succeed there should be a product that has a growing market with a scalable business model. The IT industry (which is most suited for venture funding because of its "ideas" nature) in India till recently had a service centric business model. Products developed for Indian markets lack scale.

Mindsets

Venture capital as an activity was virtually non-existent in India. Most venture capital companies want to provide capital on a secured debt basis, to established businesses with profitable operating histories. Most of the venture capital units were offshoots of financial institutions and banks and the lending mindset continued. True venture capital is capital that is used to help launch products and ideas of tomorrow. Abroad, this problem is solved by the presence of `angel investors'. They are typically wealthy individuals who not only provide venture finance but also help entrepreneurs to shape their business and make their venture successful.

Returns, Taxes and Regulations

There is a multiplicity of regulators like SEBI and RBI. Domestic venture funds are set up under the Indian Trusts Act of 1882 as per SEBI guidelines, while offshore funds routed through Mauritius follow RBI guidelines. Abroad, such funds are made under the Limited Partnership Act, which brings advantages in terms of taxation. The government must allow pension funds and insurance companies to invest in venture capitals as in USA where corporate contributions to venture funds are large.

Exit

The exit routes available to the venture capitalists were restricted to the IPO route. Before deregulation, pricing was dependent on the erstwhile CCI regulations. In general, all issues were under priced. Even now SEBI guidelines make it difficult for pricing issues for an easy exit. Given the failure of the OTCEI and the revised guidelines, small companies could not hope for a BSE/ NSE listing. Given the dull market for mergers and acquisitions, strategic sale was also not available.

Valuation

The recent phenomenon is valuation mismatches. Thanks to the software boom, most promoters have sky high valuation expectations. Given this, it is difficult for deals to reach financial closure as promoters do not agree to a valuation. This coupled with the fancy for software stocks in the bourses means that most companies are proponing their IPOs. Consequently, the number and quality of deals available to the venture funds gets reduced.