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Venture Capital: A Next Generation Financing in India

VAISHALI PAGARIA

RESEARCH SCHOLAR (HEMCHANDRACHARYA NORTH GUJARAT UNIVERSITY, PATAN, GUJARAT)LIG/B-130, DR. A.S. RAO NAGAR, SECUNDERABAD, HYDERABAD – 500062

ABSTRACT

This paper has attempted to understand the venture capital financing as a new generation funding option in fast growing businesses in India. The intension is to get through all the aspects related to the topic and to become able to make some suggestion at the industry. Venture Capital is a type of private equity financing basically for technologically innovative projects typically provided financial support for early-stage, high-potential, and growth companies in the interest of generating a return. Venture capital has developed as a result of the need to provide non-conventional, risky finance to new ventures based on innovative entrepreneurship. The instruments used in venture capital investment are in the form of equity, quasi-equity and sometimes debt - straight or conditional/normal. Government policy has a significant impact on the growth and development of the VC industry and as far as regulation is concerned the Company's Act, 1956 and SEBI guideline has drawn set rules for venture capitals funds in India. The VC investments and deals in various industry sectors are nearly correlated and it is observed that next generation trend of entrepreneurship i.e. small companies; emerging start-ups are attracting more early stage of VC funding the developing economy like India. This gives a big opportunity for the venture capital and immense scope of growth.

KEYWORDS venture capital, equity investment, risky finance, innovative entrepreneurship

Concept and Feature of Venture Capital

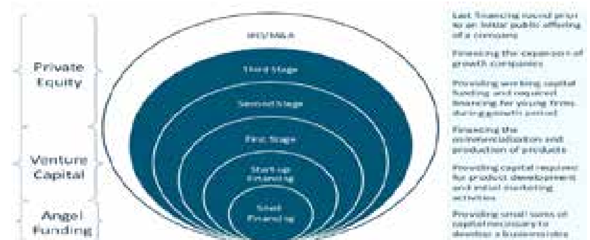
Venture capital (VC) is a process of providing seed, start-up and first stage financing and also funding the expansion of companies that have already demonstrated their business potential but do not yet have access to the public securities market or to credit oriented institutional funding sources. In India, where the industry is still nascent, the Securities and Exchange Board of India (SEBI) has laid down those activities that would constitute eligible business activities qualifying for the concessions available to a recognized venture capital fund . Initially, SEBI defined venture capital as an equity support for projects launched by first generation entrepreneurs using commercially untested but sophisticated technologies. However, this definition has been subsequently relaxed and the restrictive features concerning 'technology financing' were dispensed with. Venture capital is now seen as encompassing all kinds of funding of a high risk technology intensive undertaking at any stage of its life. It would appear from the foregoing that venture capital investments would have one or more of the following ***characteristics***:

- Equity or equity-featured instrument of investment.
- Young companies that do not have access to public sources of equity or other forms of capital.
- Industry, products or services that hold potential of better than normal or average revenue growth rates.
- Companies with better than normal or average profitability.
- Products/services in the early stages of their life cycle.
- Higher than average risk levels that do not lend themselves to systematic quantification through conventional techniques and tools.
- Turnaround companies.
- Long-term (more than three years) and active involvement with investee.

One of the important characteristic of venture capital from conventional loan is the participation of Venture Capital Company/ Venture Capital Firm (VCC/VCF) in the management of the Venture Capital Unit (VCU). VCF/VCC intends to increase the value of the VCU by helping the company in its marketing and financial aspects, thereby increasing the profitability of the company. VCF/VCC provides highly professionalized and competent advice on the technical aspects of the functioning of the company.

Stages in Venture Capital Financing

There are typically six stages of financing offered in Venture Capital that correspond to following stages of a company's development.



Indian Venture Capital Industry

History

In India, the VC plays a vital role in the development and growth of innovative entrepreneurships. VC 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 VC. 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. The need for VC in India was recognized 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 Devel-

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opment 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. At present, 180 VCFs are registered with SEBI.

Role of VC in the Economy
Future of any economy depends on the success of the new technologies and industries and services supporting these technologies. In India, where human, particularly technical and entrepreneurial are abundant and there is shortfall of capital, venture capital has a greater significance. It is observed that new companies, particularly the smaller ones, create more jobs. The financing of domestically developed technologies in general and those developed by the new generation of entrepreneur has always been a problem in both developed and developing countries. This is because domestically developed technologies, either by organized sector or the unorganized sector, are usually perceived to be uncertain by the conventional financial system. Since independence, a number of financial institutions have emerged to cater to the needs of the industrial entrepreneurs and these have mainly remained as debt providing organizations but risk finance has always been in short supply. The initial equity for any venture has to be raised by the promoters from their own sources and public financial institutions are not of much help. To overcome this problem, venture capital financing made a small beginning since 1988. Like in the USA, where venture capitalists have been catalytic in bringing forth technological innovation, a similar act can also be performed in India.

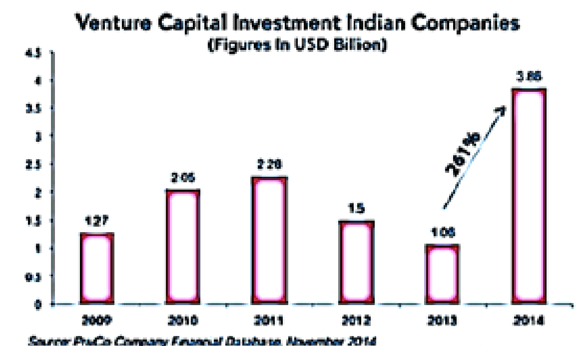
Investment objective of VCF/VCC
Broadly, there are three categories of VC funds/companies promoted in India. They are the (i) funds promoted by all India DFIs/State level DFIs, (ii) funds promoted by commercial banks, and (iii) funds promoted by private sector financial services companies.

Where is VCs Investing in India?

- IT and IT-enabled services
- Software Products (Mainly Enterprise-focused)
- Wireless/Telecom/Semiconductor
- Banking
- PSU Disinvestments
- Media/Entertainment
- Bio Technology/Bio Informatics
- Electronic Manufacturing
- Retail
- Pharmaceutical

Recent Investment Trends of VCF/VCC
VC companies in India have tried to carve out specific niches for themselves by defining their investment objectives in an appropriately distinctive manner. It would appear that at least among the public sector VC investors there is a tendency to identify VC quite closely with high/new technology development. It could also be observed from these statements that most VC investors in India do not seem to have any stated sectorial preferences. Investment preferences are more distinct in terms of the size of the business, technological novelty of the proposal or the promoters of the project. However in the recent past (*Figure 2*), technological expertise shown by Indian software professionals has encouraged many venture capital funds to devote most of their energy towards the software sector.

Months	No. of Deals	Amount(US$M)
Jul-15	51	273.02
Aug-15	43	160.15
Sep-15	36	158.78
Oct-15	37	164.41
Nov-15	34	117.54
Dec-15	29	116.58
Jan-16	34	130.85
Feb-16	24	55.06
Mar-16	28	91.82
Apr-16	18	67.09
May-16	28	85.47
Jun-16	19	75.43
Total	381	1496.2



VC investments has also grown in the last couple of years. *Figure 3* highlights volume of VC investments from year 2009 to 2014 with a stiff increase in 2014. *In Figure 4*, one can observe trends of VC investment and the no. of deals from year 2011 to 2015 which has an initially low volume of investments as well as less no. of deals. From 2014, both volume of investment and corresponding deals have picked up but by 2015 the volume per deal has increased. That means, large fund were invested in single treaty. The table below shows the approximate VC investments materialized in various sector of business in India from July 2015 to June 2016.

VC deals in past one year shows that there is a nearly correlation (0.933) between the number of deals and the amount of deals. With the increase in no. of deals, in the year 2015, the amount of VC investments are increasing whereas in the first half of the year 2016, the no. of deal have decreased and so as to the amount of VC investments. This can also be seen in the above figure 3 covering details of VC investments and no. of deals from year 2011 to 2014.

Financing Instruments of VCFs/VCCs
The Indian VC industry has attempted to maintain the risk-reward sharing nature of the relationship through a variety of innovative instruments for structuring the investment. These have been in response to the:

- Constraints on pricing imposed by the securities pricing regulations;
- Indian entrepreneurial ethos which lays considerable emphasis on ownership and control of the company; and
- Company law regulations under Section 43(A), Section 370, etc.

While the various VCF/VCC have tried to nomenclature instruments differently, essentially these could be classified into three broad categories with individual tweaks and twists to the basic forms. These are:

Equity Investments:
Almost all VCF/VCC appear to prefer a minority position in the investee company. Subscription has almost always been at par so far since the investees have been start-ups or early stage companies and a premium would have been difficult to justify under the guidelines issued by the Controller of Capital Issues (CCI). When its risked the equity investment usually carries with it a number of protective covenants (especially in situations where the VC investor is a significant stockholder) including several standard ones such as the right to appoint nominee(s) on the Board of Directors, authority to examine books of accounts, carry out concurrent audit and sometimes even power to veto decisions on a set of issues that may be agreed upon with the company's management/ promoters[1]. The timing of the disinvestment, though, will be at the VC investors' option. The VC investor also requires the investee, through the agreement, to have the company's stock listed on one or more stock exchange(s) as desired by the VC investor. The pricing of the sale-back of the equity to the promoters/ management is often linked either to the market price upon listing of the scrip or some formula. The equity investments also carry 'a first right of refusal in favor of the promoter'. What needs to be noted is that most VC funds/investors provide the buyback 'comfort'.[2] It may not be inaccurate to conclude that this provision is also in response to the Indian entrepreneur's tendency to maximize his share-holding in the company over a period of time.[3]

Quasi Equity Investments:
Most quasi equity investments, as mentioned earlier, have evolved in response to the regulatory framework as also to the reluctance of the average Indian entrepreneur to permit external participation in 'his' company's equity. The quasi equity loans come in two broad types:

1. A loan whose servicing is linked entirely to the company's/project's performance and thus participate totally in the downside and significantly in the upside in a manner agreed upon upfront. In the former type, the servicing is through a percentage charge on sales that is contracted upfront taking into account the future sales and profitability of the project/company and the servicing capacity available in the company's cash flow.
2. A loan on which there is a minimum obligation (be it of interest or principal) contracted at reasonably low levels irrespective of performance and an upside sharing component. In this type, again two models obtain. The VC investor either stipulates a fixed repayment schedule for the loan and a variable rate of charge in lieu of interest; or a fixed repayment schedule, a fixed floor rate of interest and a variable premium to share the upsides. This type of quasi equity loans also carry collateral.

The quasi-equity loan has not found much favor or fancy in Western Europe or North America. However, in some of the newly industrialized countries such as Korea and emerging Asian economies, the conditional loan has been widely applied in structuring VC investments.

Normal Loans:
Of all the financial instruments mentioned above, it may be safely stated that the normal (term) loan is the least preferred alternative. The reason, presumably and understandably, is that it is not ideally suited for VC situations where the cash flows of the firm cannot be predicted with even a reasonable degree of certainty to be able to contract fixed repayment and interest obligations. The limited normal loans that VCs provide appear to be to meet short-term/medium-term requirements of portfolio companies to help them tide over temporary cash shortages. These are short-term maturities (ranging from six to eighteen months) and carry interest at a rate equal to (or slightly higher) then the lending rate of commercial banks.

Regulatory Issues Impacting The VC Industry in India
It has been mentioned earlier that government policy has a significant impact on the growth and development of the VC industry. VC industry was sought to be developed by the government by giving tax breaks and concessions on the income of VCC/VCF. In the SEBI regulations, VCF/VCC were allowed to function irrespective of whether they want to claim the concession under tax laws or not. Under Section 10(23FA&FB) of the Income Tax Act, the income of VCF/VCC is totally exempt from income tax by way of dividend and long-term capital gain from equity investment provided they satisfy the specified criteria.

Other regulations concerning the venture capital industry are:

- Section 372 of the Indian Companies Act, 1956 (Companies. Act, hereafter) precludes all corporates, other than the recognized VC funds approved under the Government Guidelines from making significant VC investments.
- Section 43(A) of the Companies Act acts as a deterrent. Consequently, investment by a public company VC investor beyond 25% of paid-up capital would entail loss of the legal status and accompanying privileges of a private company to the investee.[4]
- The Government Guidelines on VC companies is in itself a source of several restraints to even an approved VC investor. These include:

1. Regulation of portfolio composition.
2. Technology/innovativeness requirement in qualifying projects.
3. Volume of capital (minimum) to be raised, sources from which the capital may be raised, and capital structure of the VC company
4. Composition of non VC assets in the VC fund portfolio.

The issue of capital, until the recent rescindment of the Control of Capital Issues Act, was a serious limitation on the ability of the VC investor to structure deals that would be reflective of the risk and rewards inherent in a project or provide for financial rewards/ incentives to the participants in the venture for contributing to its success through providing technology or managerial inputs. The selective removal of restrictions on premia and several other restrictions such as capitalization of reserves (by way of bonus issues) have added infinitely to the freedom in structuring deals.

Income from dividends and capital gains from equity investments is exempted for the VC companies, where as it is taxable in the case of shareholders.

As mentioned above, venture capital may be provided by the VCFs established as Trusts or VC companies established under the Companies Act. SEBI rules permit establishment of venture capital institutions under either of the methods provided:

VCFs set-up Asset Management Companies (AMC) that 'screens, makes and manages individual investments'.

VC company established as a company satisfies the eligibility criteria drafted by SEBI for the purpose of registration, namely:

1. memorandum of association has its main activity of carrying out the business of venture capital fund.[5]
2. memorandum and articles of association explicitly prohibits invitation to the public to subscribe to its securities.

VCF established as a trust satisfies the eligibility criteria drafted by SEBI for the purpose of registration, namely:

1. the instrument of trust is in the form of a deed and has been duly registered under the provisions of the Indian Registration Act, 1908.
2. the main objective of the trust is to carry on the activity of a venture capital fund.

Venture Investment Valuation in India

There appears to be no standard approach to investment valuation in India. Some of the funds/companies appear to follow the traditional development banking approach with a high degree of emphasis on the project appraisal format and methodology adopted by credit oriented development banks. Different approaches followed include investment appraisal, equity investors with emphasis on the earnings potential, broad financial attractiveness of the industry and the promoter's track record. While some of the investors have been making a conscious attempt to move towards the American/UK paradigms of investment valuation, there still exists a strong local flavor to the valuation process. Some of the VC investors that invest in relatively large enterprises promoted by entrepreneurs from an industrial family or possessing well established credentials tend to prefer a 'hands-off' approach to value addition and be contented monitoring their investment. Some of the others who have been investing in small/medium entrepreneurial start-ups with considerable management gaps have been trying to add value to their portfolio companies, apart from just monitoring. Similarly, there are no known instances of VC taking over operating managements of portfolio companies in India. Given that most investments are in the early stages still, it may be premature to draw any firm conclusions on the effectiveness of those VC professionals in complementing/ supplementing operating managements.

The Indian approach no doubt will have to take into cognizance the differences in operating ambience prevalent in India. Notable among these are the non-availability of an established market mechanism and related norms, reliable and contemporary information and above everything else pricing regulations on securities offerings. Notwithstanding such differences, the Indian industry will have to evolve a new set of investment valuation techniques and standards in order to be able to handle true VC situations as opposed to the traditional credit appraisal approach.

Conclusion

The study provides that the maturity if the still nascent Indian VC market is imminent. Venture capitalists in India have notice of newer avenues and regions to expand. VCs have moved beyond IT service but are cautious in exploring the right business model, for finding opportunities that generate better returns for their investors. It is also been observed that there is nearly a direct correlation between the volume of VC investments and the no. of deals taking place in recent past. Venture capitalists are nowadays taking risk of investing high volume of fund in single deal. In terms of impediments to expansion, few concerning factors to VCs include; unfavorable political and regulatory environment compared to other countries, difficulty in achieving successful exists and administrative delays in documentation and approval. In spite of few non-attracting factors, Indian opportunities are no doubt promising which is evident by the large number of new entrants in past years as well in coming days. Nonetheless the market is challenging for successful investment. Therefore, venture capitalists responses are upbeat about the attractiveness of the India as a place to do the business, and VC has emerged as a next generation financing option for the intellectual and innovative entrepreneurs.

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