

Venture Capital Financing and its scope in India

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Abstract

Venture capital (VC) is a type of private equity, a form of financing that is provided by firms or funds to small, early-stage, emerging firms that are deemed to have high growth potential, or which have demonstrated high growth (in terms of number of employees, annual revenue, or both). Venture capital firms or funds invest in these early-stage companies in exchange for equity, or an ownership stake, in the companies they invest in. Venture capitalists take on the risk of financing risky start-ups in the hopes that some of the firms they support will become successful. The start-ups are usually based on an innovative technology or business model and they are usually from the high technology industries, such as information technology (IT), clean technology or biotechnology. The typical venture capital investment occurs after an initial "seed funding" round. The first round of institutional venture capital to fund growth is called the Series A round. Venture capitalists provide this financing in the interest of generating a return through an eventual "exit" event, such as the company selling shares to the public for the first time in an initial public offering (IPO) or doing a merger and acquisition (also known as a "trade sale") of the company.

Keywords: *Venture capital, IPO, Financial Stake.*

Introduction

The term 'Venture Capital' is understood in many ways. In a narrow sense it refers to, investment in new and tried enterprises that are lacking a stable record of growth. In a broader sense, venture capital refers to the commitment of capital as shareholding for the formulation and setting up of small firms specializing in new ideas or new technologies. 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. 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 Financing new and rapidly growing companies, purchasing equity securities, taking higher risk in expectation of higher reward,

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 Hong Kong, www.ijesonline.com (ISSN: 2319-6564)

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 sometimes as subordinated debt which is a semi secured investment in the company (through debenture) ranking below the secured lenders that often requires periodic repayment. 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 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.

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:

- (i) Requirement of an experienced management team.
- (ii) Requirement of an above average rate of return on investment.
- (iii) Longer payback period.
- (iv) Uncertainty regarding the success of the product in the market.
- (v) Questions regarding the infrastructure details of production like plant location, accessibility, relationship with the suppliers and creditors, transportation facilities, labor availability etc.
- (vi) The category of potential customers and hence the packaging and pricing details of the product.
- (vii) The size of the market.
- (viii) 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.

THE Indian venture capital (VC) industry has witnessed considerable turmoil in the last two

years. Consider this: At least seven VC funds (VCFs) shut shop. Many others simply ran out of funds. A few set up high-cost Indian operations, with no funds raised or allocated for investment. The rest of the industry appears to be busy, 'restructuring' their investment focus, making very few new investments.

After a period of hectic investing, from 1998 to 2000, the Indian VC industry appears to be going through difficult times. This is a time for the industry to engage in some serious reflection. Managers in the industry may possibly disagree with me. They might argue that the developments in the Indian industry are a mere reflection of a larger global phenomenon. After all, have the American and European VC industries not slowed down? That comparison though, is inappropriate. The slow down and the poor performance of many funds in the Western world are part of a cyclical phenomenon. The Indian industry, on the contrary, faces issues of a fundamental nature. Let us examine four issues of concern.

First, there is a serious mismatch between the kind of venture capital available in India and what the market demands. Almost all VCFs in India have been targeting their capital at companies in the information technology, pharmaceuticals and some services industries, looking for expansion financing of Rs 15 crores or more. Now, this is a limited market segment. Most of the industries mentioned above are relatively young. There are very few firms in these sectors, seeking large amounts of capital for expansion financing. At the same time, a large number of aspiring entrepreneurs, start-ups, early-stage companies and Old Economy firms, which are fundamentally sound businesses, are unable to attract the VC financing that they badly need in order to grow. Apart from the relatively smaller amounts of funding that they seek, on average start-ups require considerable post-funding support from the investor to grow their businesses. That is painstaking work, for

which Indian VCF managers have demonstrated neither experience nor training nor temperament. Old Economy firms do not provide the quick or glamorous exits that VCFs often desire.

Second, most VCFs in India are an extended arm or a division of global investment institutions. International funds represent more than 95 per cent of the VC invested in India. Two consequences follow from this near-total dependence on foreign capital. One, the investment mandates of these VCFs are often driven by the parent institutions' global world view, which often ignores local market needs. The homogenous investment preferences of VCFs outlined earlier follow from the parent institutions' global investment strategies. Two, at a portfolio level, every international VC investor in India has been a victim of the depreciation of the rupee against the dollar. The returns produced by Indian VCFs, measured in US dollars or other Western currencies, turn out to be considerably less attractive than that measured in Indian currency. Many nations such as the Netherlands, Portugal, Finland, Norway and Israel recognized the limitations of depending on foreign funds at the time of evolving a policy for developing a local VC industry. Their first step was to kick start VCFs in the private sector with funds from domestic institutions. Over a decade, or even less, they succeeded in creating a local VC industry that depended less and less on government support and international investors.

The third issue is the poor quality of corporate governance and lack of sensitivity among entrepreneurs and investors, to each other's legitimate business aspirations. This is a universal problem and not unique to India. What is however unique to India is the hopeless system of legal redress of grievances when partners renege on contractual obligations. Often, aggrieved parties in India agree to settlements that are unfair to them, apprehending that litigation in Indian courts

could be dysfunctional. This situation may not change in the foreseeable future. The alternative to litigation and unfair bad investments would be to invest more effort in better identification and selection of investments and supervision of the portfolio. Indian VCF managers need to ask themselves if they are prepared to put in that extra effort to minimize prospects for litigation in the first place.

Last, but not the least, the industry lacks a broad-based and effective trade association. The Indian Venture Capital Association (IVCA) does not represent a large proportion of the VCFs who are active in India. I am not sure of the IVCA's contributions to the VC industry either, in the ten years since it was formed. For some years initially, the IVCA used to produce a delightfully uninformative annual report, many months after the end of the year. For the past four years even those reports do not appear to have been published! Venture capital has been a remarkable catalyst of entrepreneurial activity, after the Second World War, in many developed countries. It has led to significant growth in industry and innovation. The prospects for the Indian VC industry are no less humongous. It is up to the industry to reflect on its current predicament and evolve a strategy to seize the opportunity.

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 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 and 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 \$ 1.7 mn. 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:-

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 254.36 mn.

Whopping investments of over USD 8.5 billion is expected in Indian from Venture Capitalists (VCs) and Private Equities (PEs) in next five years in at least five identified areas such as Biotechnology and Life Sciences, Logistics, Clean technology, Film Production and Education,

Quoting the findings of the ASSOCHAM & Deloitte paper, president ASSOCHAM, Sajjan Jindal said that India has large opportunities in Biotechnology and Life Sciences on lines of retail and Real Estate. The Life Sciences sector in India has been attracting specialists Venture

Capitalists from global and local funds. According to information received by the ASSOCHAM, US based Life Sciences Fund has recently invested approximately USD 20 million in a Hyderabad based pharmaceutical company. Devices and diagnostics are other areas where investors are active. It is anticipated that the Biotechnology and Life Sciences will alone attract about USD 1.5 billion investments from VCs and PEs by 2012.

Jindal said that logistics is another area in which VCs are expected to invest in excess of USD 2 billion in India's maritime infrastructure and logistics as it strengthens cargo handling facilities to meet rising demand for exports and imports. The paper mentions that National Maritime Development Programme envisages huge investment to upgrade India's maritime sector of which 64% is expected to come from VCs and PEs firms. These funds are also looking at possibilities in ancillary business that supports maritime trade such as warehousing and container freight stations.

Clean technology is still another area where VCs and PEs would grow more and more active. In 2007, investors committed USD 290 million in 11 cleantech investment deals compared to USD 140 million in 9 deals in 2006. The momentum is expected to continue over the coming years given the government initiatives and policy focus on cleantech. It is expected that PEs and VCs would be able to jointly garner an investment of USD 3.5 billion in cleantech areas in next few years, pointed out Jindal.

The other prospective areas in which VCs and PEs would make huge investments include Indian film production and education. The Indian film industry currently is worth 1.8 billion and is expected to grow @of over 25% and would reach a level of USD over 5 billion by 2011. With the newly accorded status of industry and professionalism on film industry, it will emerge as new venue for VCs. The

ASSOCHAM expects USD 0.25 billion VCs investments in this industry in next five years.

With a booming economy and concurrent talent shortage, denying for services from the domestic education sector is slated to create a lucrative opportunities for VCs. A global private equity firm with USD 36 billion in assets is planning approximately

USD 200 million investments in the Indian education sector by taking up strategic positions in companies offering e-learning, distant learning, vocational training and the like.

The paper further points out that venture capital investment is undergoing some interesting transitions. Developing economies like India and China continue to attract investments; early stage finance is becoming increasingly globalize. Investors are backing consumer and retail firms that benefit from the rise of the Indian middle class, as well as business services that cater to the nation's growing economic sector. The other transition is that the capital flowing to India is designed to expand existing companies. By contrast, venture capital in the United States, Europe and Israel is usually dedicated to backing new technologies or services.

In Asia, venture capitalists are still in the process of developing common evaluation criteria for investment, unlike in mature markets, where a common criterion is the level of attention paid to the entrepreneur's personality and experience. In Asia, different classes of stocks with different voting rights are relatively uncommon. Asian investors thus have to rely mostly on common stocks and other means to manage their portfolio risk. Traditional venture capitalists are expected to actively assist their portfolio companies in what are termed value-added activities. Most of the Asian venture capitalists' assistance remains restricted to providing advice on financial matters.

The dynamics in emerging venture capital markets differ from those in developed venture capital markets. The emerging private equity markets focus primarily on growth capital investments through minority equity participation. Emerging venture capital markets, although not without challenges, present a host of opportunities

India story still attracts venture capital funds

Venture capitalists raising new funds dedicated to the Indian market are not finding the going tough despite a global slowdown impacting availability of capital.

For instance, Clearstone Venture Advisors, a global venture capital fund with over \$650 million of committed capital for investment globally, plans to close its fourth fund soon. The fund, which could be over \$200 million, will also have a larger share of investments in India. The company had raised \$210 million for its third fund, of which 20 to 25 per cent was dedicated for investments in India.

Similarly, Seed Fund, which invests in early start-ups, is in the process of raising its second fund. The fund, which will be in the range of \$50-60 million, will be closed by the end of this year. It all depends on who is raising the funds. Firms like us who invest in early-stage companies will be least impacted as we are not looking at immediate gains," said Pravin Gandhi, Partner, Seed Fund.

The strong India story is probably the reason why several funds are strengthening their India focus. These include names such as Walden International and Accel India Venture Fund. Walden International recently announced its plans to raise a \$500 million global fund early next year to step up its investment in China and India. Over the next 12-18 months, the global VC fund will invest close to \$150 million (around Rs 650 crore) in India.

Mohit Bhatnagar, operating partner at Sequoia Capital, said the firm has not seen any major drop in either the investments or the pipeline of deals they examine. A lot of good companies get started globally during economic downturns and India should be no different. Of course, deals might take longer to close accounting for valuation corrections, different exit strategies, etc., says Bhatnagar. Not everyone is bullish on the future as some VCs said the subsequent rounds of funding will get impacted.

VCs raising follow-on funds are not facing the problem as much as those raising funds for the first time, points out Arun Natarajan, founder and CEO, Venture Intelligence. According to Venture Intelligence data, during the first six months of 2008, VCs invested \$380 million across 60 deals. This compares with \$379 million spread across 59 investments during corresponding period in 2007. VCs invested \$760 million across 125 investments during whole of 2007. Seed Fund's Gandhi said most investors are cautious, hence the appetite for investment will slow down. Many also feel that India as a market was too hyped-up for investment and many went overboard with regard to valuations. Avnish Bajaj co-founder and MD, Matrix India, said some of the global funds coming to India will be impacted, especially where the fund did not have an India-dedicated team who could bring in local expertise

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, liberalizing 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, Pharmacy, 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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