



## Venture capital financing in India: Yet to achieve its desired status

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### Abstract

There seems to be no dearth of business ideas/proposals, but what poses a challenge for the fast growing companies is their ability to tap appropriate finance for giving a concrete shape to their ideas. So, there emerges an enormous opportunity for organizations offering financial support. Probably triggered by the financial needs of young entrepreneurs, venture capital firms came into existence. They catered the financial demands of the newly set-up organizations to a great extent and still they continue to do so. A major development in venture capital was noticed during late 1990s. The development was the spurt in formal venture capital markets which not only resulted in emergence of dynamic new industries but also gave birth to excessive behaviour and costly mistakes. Venture capital markets around the globe have kept maturing and deepening in varying degrees. Similarly, the venture capitalists vary strongly in features and performance between countries.

**Keywords:** Corporate deals, investor education, seed capital, start up, venture capital

### Introduction

The term 'venture capital' comprises of two words *viz.*, 'venture' and 'capital'. The dictionary meaning of 'venture' is a course of proceeding associated with risk, the outcome of which is uncertain and 'capital' means resources to start the enterprise. In a narrower sense venture capital is understood as the capital which is available for financing new venture. Broadly, it can be interpreted as the investment of long-term equity finance where the venture capitalist earns his return from capital gain. The nature of financing i.e. long-term equity, implies that the investor bears the risk of venture, but would earn a return commensurate with its success. Thus, the return for the investor is not through a steady dividend or interest yield but through capital gain. This definition incorporates the three main features that distinguish venture capital investment from other forms of capital investment. They are:

- Supporting entrepreneurial talent by providing finance
- Providing business management skills
- A return in the form of capital gains,

Venture capital (VC) is generally regarded as a risk capital. The venture capital investor thus looks for markets with tremendous growth potential to be exploited with entrepreneur towards a highly rewarding relationship. To foster the growth of better technology new risky lines of business need support in the form of venture capital. The venture capital investment is a medium term high risk investment. The concept of venture capital has gained momentum in high risk oriented industrial wheel of the world economy during last five decades and it is of recent take off in the horizon of Indian financial systems. The practice of venture capital as an effective financing organ is yet to operate in full swing in our country. The venture capital scheme is designed to promote technological advancement and innovation through introduction of new products, process and ideas. But, venture capital does not finance to enterprises which are engaged in trading, investment brokerage or financial services, agency or liaison work. The schemes offered by most of the venture capital

institutions focus on projects with technological risk and provide support to indigenous efforts in technology development. Basically, professionally and/or technically qualified entrepreneurs venturing into high-tech areas are eligible for venture capital support.

Sabrinathan (2017) concluded that the venture capital has given a boost to the industry, the breadth, depth as well as sophistication in fund management practices. VC has the capacity to support enterprises across a range of sectors that have the potential and promise by providing funding across their various stages of development. Venture capital industry has evolved into being a source of growth financing for innovative and technology led businesses. The analysis also revealed that the market for managing VC funds is highly competitive with fairly high rates of entry and exit of fund management entities.

Shetty (2017) stated that when compared to venture financing in USA and China, Indian venture capital sector performance is relatively less but taking the Indian economy as whole there is substantial growth and rapid investment momentum mainly in the consumer technology sector and converted the same into the most promising avenue of all the industries. Effective research and development, better fiscal initiatives, adequate training and motivation are some major elements supporting might become more successful and flourish in India.

Komala (2016) <sup>[3]</sup> opine that the performance of private equity funds as reported by venture intelligence and prior research is overstated. The two reasons behind the development of the new startups in the country can be stated as the high input of private capital in the country and high need of risk capital. Then the other reasons include change in organizational innovation, aided by regulatory and tax framework and Second, adoption of limited partnership and general partnership.

Rani and Katyal (2015) found that Venture Capitalists in India are biased toward technology companies with 68% of investments made in this sector. Other sectors include healthcare and education accounting for 9% and 7% of total investments respectively. Industry has had a somewhat

frustrating run. With too much money chasing too few deals, Indian venture capital is struggling.

Chavda (2014) <sup>[1]</sup>, in the paper "An Overview of Venture Capital Financing in India" stated that the economy is in the high need of private equity which will widen up the industrial base of high tech industries and promote the growth of technology.

**Activities Eligible for Support**

In general the under mentioned activities are eligible for venture capital support:

- Evaluation of new process or product on a commercial scale.
- Technological up gradation leading to lesser material consumption, cost reduction, improved international competitiveness, energy conservation and innovative indigenous technology.
- Adoption of imported technology appropriate to Indian conditions with indigenous efforts.
- Commercial exploitation of laboratory proven technology at recognized research laboratory and university subsequent to successful implementation of venture on pilot scale.
- Risky ventures in technology development and long gestation technology development projects.

**Stages in Venture Capital Financing**

The object of venture capital is to generate substantial capital appreciation through investment in early stage companies capable of achieving rapid growth. Venture capital supports the early stage of a company's life cycle. However, the timing of investment may be at seed stage,

early development stage or turnaround stage. Thus, the investment may be during:

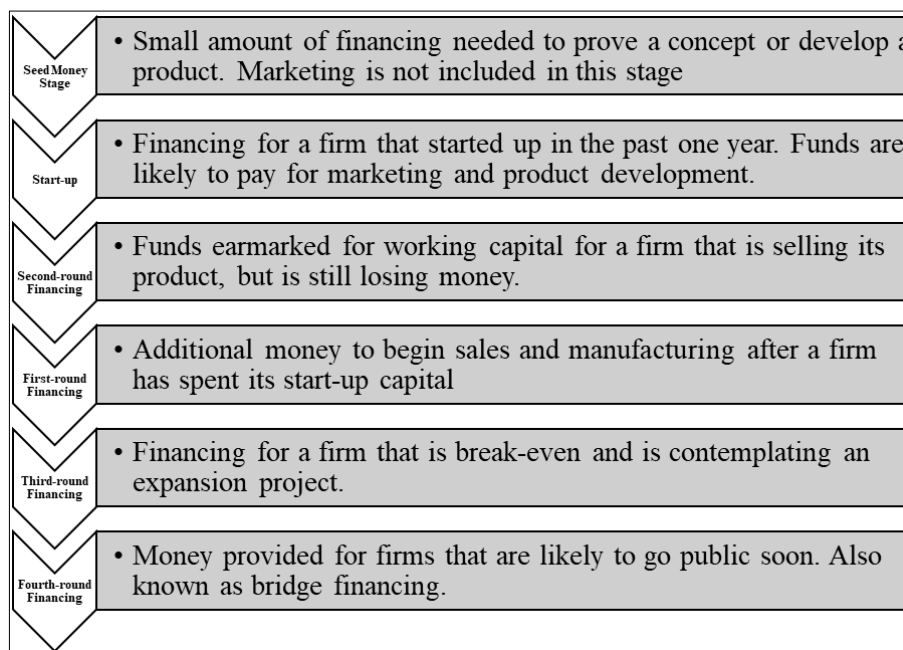
- Product concept to product development stage,
- Commercial scale implementation and
- Post commercialization stage.

There are the stages during which the enterprise's risks are very high due to technology and market uncertainties. During these periods venture capital support is sought for as it is long-term, patient and risk reward sharing in nature. However, the stages of financing can broadly be classified as early stage and expansion stage. Under each of the above, there are different stages of entry for different venture capital companies.

**Early Stage Financing:** Seed capital financing or start-up capital is relatively small amount of capital provided to an investor or entrepreneur to prove concept and to qualify for start-up capital. Start-up financing is provided to a company at the completion of product development stage and before the commercial exploitation.

**Expansion Financing:** Second stage financing is providing working capital support. At this stage, the company has good growth potential but needs additional working capital besides the bank's fund, to achieve the growth.

**Third Stage or Mezzanine Financing:** It is providing for major expansion of a company. Turnaround Financing- It is provided to persons for acquiring a viable non-performing company and strengthening its operation.



**Fig 1:** Stages in Venture Capital Financing

**Forms of Financing Assistance from VC Funds**

The venture capital institutions provide finance in the following forms:

- Seed capital for industrial setups and support a concept or idea.
- Additional capital to new businesses at various stages of their growth.

- Bridge finance/project financing.
- Equity financing to management groups for taking over other companies.
- Capital to new entrepreneurs in foreign operations.
- Research and development financing for product development.
- Start-up capital for initial production and marketing.

- Development financing for facilitating public issue.
- Acquisition or buy-out financing for acquiring another firm for further growth.
- Turnaround financing for turning around a sick unit.

### Types of Venture Capital Financing

Form of Investment- Venture capital companies invest their corpus in the form of equity purchase, conditional loans, income notes and participating debentures.

**Equity Participation:** It is the basic avenue of investment in the assisted firms. Equity holding does not generally exceed 49% of the total equity of the assisted firms. As a result, overall control over the venture remains in the hands of the entrepreneurs. Equity investment is a long-term investment philosophy - that helps the venture capitalists earn capital gains when the shares in the assisted firms are ultimately disposed of say, after 5 to 8 years since the venture was launched in the market.

**On Conditional Loan:** If loan is another form of investment, it is repayable by the assisted firms in the form of royalty after the venture is able to generate sales. Royalty charges normally range between 2 to 15 per cent as the cost of financing. Some venture capital funds offer a choice to the ventures of paying a high rate of interest say 20 to 25 per cent instead of royalty on sales, once the firm secure its commercial confidence, strength and viability in the market.

**Income Notes:** It is as a form of investment, it is a compromise between conventional loans and conditional loans. The assisted firms are to pay both interest and royalty on sales but at substantially low rate.

**Participating Debentures:** It is another form of investment. Venture capitalists charge interest in three phases under the scheme of investment through participating debentures. No interest is charged before the assisted firms attain operations on a minimum level, a low rate of interest is charged after the firms attain operations up to a particular level and a high rate of interest is charged once the ventures operate commercially in full swing. The terms and conditions of financing are decided by mutual agreement between the entrepreneurs launching the ventures and the venture capital funds.

### Advantages of VC Finance

The advantages of venture finance over other forms of finance are as follows:

- VC provides a solid capital base for future growth because it injects long-term equity finance.
- VCs are capable of providing additional rounds of funding required for financial growth.
- The venture capitalists act like business partners who share the rewards as well as the risks. They are rewarded by capital gain and business success.
- The venture capitalists provide strategic, operational, tactical and financial advice to the company based on past experience with other companies in similar situations.
- The venture capitalists have a network of contacts which helps them increase the value to the company.
- The venture capitalists help in recruitment of the key personnel, improving relationships with international

markets, co-investment with other VC firms and in decision making and facilitate additional financing.

- In case of IPO and book building, the venture capitalists not only facilitate the company in trade sales but also play an important role in the facilitation of various trades.

### Venture Capital: Indian Scenario

As the historical facts suggests, venture capital came into existence since post World War II, but this was not considered in the main line business arena. They use to invest in the ventures with minimum risk and may be some return is resulted. As the name suggests, the term includes to two words, viz., "venture" and "capital". Venture means "chance" or "trial" hinting at speculation, to try one's luck, i.e. good or bad involving risk or hazard or exposure to insecurity or danger. The term capital denotes the resources needed to start the enterprise. So we can interpret that VC is the particular type of money, which is being provided by the experienced and already in business type of firms in different startups and alike companies. This type of capital is private in all respects and specifically aligned for the new and nurturing companies which are in the expansion phase. As a matter of fact this type of financing use to give support to the growing concerns and also helps to achieve differentiated business goals. Now the question arises that why any off the venture capitalist will be interested in investing in new firms, the answer is, the new start ups are initiated by highly educated and trained persons and even they are making the use of latest technologies which is having the capability to change the face of business and gain an advantageous position in the market. The promoter's own inputs are his idea and determination. The venture capitalist provide equity or equity related finance and management support. After the enterprises settle down to a profitable working and investors, backers and bankers are ready to finance it further, the venture capitalist sells out his shareholding and recovers his investment.

Venture capital is not a new phenomenon in the world; it is growing with a great pace. Venture capital industry growth rate holds steady in India. This industry is still at a nascent stage in India.

Three decades ago, Indian companies were receiving low amount of venture capital. The scenario changed in late 1990s with the growth of India's IT sector companies. During five year period from 2000 to 2005, the industry growth rate in India was the fastest globally and it rose to occupy the number three slot worldwide in terms of quantum of investments. Venture capital has played a major role in developing entrepreneurship in India by building up professional companies which compete globally. It has made smart money available for projects which cannot be funded by conventional methods like IPOs (Initial Public Offer). The quality of entrepreneurs has improved considerably in the last decade. Entrepreneurs have the motivation to compete globally and the necessary attributes to build successful companies. Still Indian venture capital industry is far from reaching its full potential and growth is low in comparison to the other countries.

As far as India is concerned, since the starting of 21<sup>st</sup> century the country has taken a high pace on the path of technology and specially information technology and such initiatives have given boost to the industries based on the same, and why only information technology, there are other

industries as well where the country has shown a high advancements like, bio-technology, agriculture, food processing, services, and many others. On the other hand India is never in the dearth of skilled employees which are even cost effective, then technology is already there, other avenues can be named as research and entrepreneurship, development practices and that too supported by the relevant policies of the government. Major developments in the field of venture capital can be witnessed from the year 2012, where the aggregated amount of investment in new companies was recorded as 13% high than the aggregate of last 10 years. Then in the next year the same investment was doubled in terms of figures, this was because of the reason that new start-ups have increased the scale of their operations and more scope can be seen in the same.

### Venture Capital Players in India

The important players in venture capital financing in India are broadly categorized into the following:

#### a. Venture Capital Funds promoted by All India Development Financial Institutions: For example

- ICICI Ventures (promoted by ICICI)
- Risk Capital Fund (promoted by IDBI)
- Risk Capital and Technology Finance Corporation Ltd. (promoted by IFCI)
- Technology Development and Information Company of India (promoted by ICICI and UTI)

#### b. Venture Capital Funds promoted by State Level Development Financial Institutions: For example

- APIDC Venture Capital Ltd. (promoted by Andhra Pradesh Industrial Development Corporation Ltd.)
- Gujarat Venture Finance Ltd. (promoted by Gujarat Industrial Investment Corporation, IDBI, World Bank, SFLS and Private bodies).
- Karnataka Information Technology Venture Capital Fund (promoted by KSIIDC, KSFC and SIDBI).

#### c. Venture Capital Funds promoted by Public Sector Banks or their subsidiaries: For example

- State Bank Venture Capital Fund (promoted by SBI Merchant Banking and SBI Capital Market).
- Can Bank Venture Capital Fund (promoted by Canara Bank).

#### d. Venture Capital Funds set up by Indian or foreign private sector institutions: For example

- Indus Venture Capital Fund (private venture capital fund)
- Credit Capital Venture Fund (promoted by International Financial Agencies)
- Grindlays Bank Venture Capital Fund (promoted by Grindlays Bank)

### Trends of Venture Capital in India

#### 1. Upsurge in Corporate Deals

To inspire their innovation process, numerous corporations are opting to invest their money in small companies, not only for the pure financial returns, but also to get rewarded in many other ways. For example creating stronger suppliers, putting control levers in their industry, testing products, de-risking innovation, and engineering less expensive acquisitions.

#### 2. Increasing Incubators and Accelerators

Popularly one among the many updrafts, corporate sponsorship has been held responsible for the rise in incubators and accelerators. According to a recent MIT study of accelerators, initial stage dollars flow more aggressively, and indirectly lift their regions economically. There are an estimated 2,000 incubators across the U.S., with more opening almost weekly.

#### 3. Initial Heated Competition will Rise for VCs

The best among the investors, like Andreessen Horowitz and Google Ventures are denying indulging in any early stage deals because "small investments do not move the needle for their huge funds." This would further force smaller, relatively unknown funds work harder to make recognition for themselves in 2016 and onwards.

#### 4. A Steady Rise of Funds

The year 2015 saw a steady rise in funds, which still continues to increase. With so many new funds reporting friction raising money, there is a possibility of new funds launched in 2016 to sit a smidge above those rose in 2015.

#### 5. Increasing Focus on Investor Education

Even if venture is performing well for many investors, a few of them might not be educated on the asset class, and look at it with a wary eye. The old-school passive methodology "set-it and forget-it" days of investing in the major venture funds are practically over. In order to help their clients benefit more in 2016, family offices and wealth managers will step up to navigate the changing capital currents. Also, considering the fast evolving venture landscape-various investors will lean into their regional or local economy and find fantastic fits in their own backyards.

### Conclusion

The venture capital industry can play an important role in any country's economic as well as social development as the innovation and the technology are ruling the world. Hence, encouraging the venture capital industry is very much essential and the Government also should focus more than today's. It may be concluded that venture capital has a greater role to play in the post liberalization era of economic activities. Accordingly, an ideal environment should be created and administered in an effectively efficient manner. Investors, VCCs/VCFs, Regulators and Assisted units should play their roles properly keeping the interests of the national economy in view. Sincerity of purpose, Integrity in attitude, Responsibility for actions and Accountability for results should be their guiding principles in achieving their objectives.

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