Impact of Venture Capital on Indian Economy

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Abstract: **A number of technocrats are seeking to set up shop on their own and capitalize on opportunities. In the highly dynamic economic climate that surrounds us today, few 'traditional' business models may survive. Countries across the globe are realizing that it is not the conglomerates and the gigantic corporations that fuel economic growth any more. The essence of any economy, today is the small and medium enterprises. For example, in the US, 50% of the exports, are created by companies with less than 20 employees and only 7% are created by companies with 500 or more employees.**

I.INTRODUCTION

This growing trend can be attributed to rapid advances in technology in the last decade. Knowledge driven industries like infotech, health-care, entertainment and services have become the cynosure of bourses worldwide. In these sectors, it is innovation and technical capability that are big business-drivers. This is a paradigm shift from the earlier physical production and 'economies of scale' model.

However, starting an enterprise is never easy. There are a number of parameters that contribute to its success or downfall. Experience, integrity, prudence and a clear understanding of the market are among the sought after qualities of a promoter. However, there are other factors, which lie beyond the control of the entrepreneur. Prominent among these is the timely infusion of funds. This is where the venture capitalist comes in, with money, business sense and a lot more.

A. 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.

Professionally managed venture capital firms generally are private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves.

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

When considering an investment, venture capitalists carefully screen the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. They also actively work with the company's management, especially with contacts and strategy formulation.

Venture capitalists mitigate the risk of investing by developing a portfolio of young companies in a single venture fund. Many times they co-invest with other professional venture capital firms. In addition, many venture partnerships manage multiple funds simultaneously. For decades, venture capitalists have nurtured the growth of America's high technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness. Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft and Genentech are famous examples of companies that received venture capital early in their development.

In India, these funds are governed by the Securities and Exchange Board of India (SEBI) guidelines. According to this, venture capital fund means a fund established in the form of a company or trust, which raises monies through loans, donations, issue of securities or units as the case may be, and makes or proposes to make investments in accordance with these regulations.

II. FACTORS AFFECTING INVESTMENT DECISIONS

The venture capitalists usually take into account the following factors while making investments:

1. Strong Management Team. Venture capital firms ascertain the strength of the management team in terms of adequacy of level of skills,., commitment and motivation

that creates a balance between members in area such as marketing, finance and operations, research and development, general management, personal management and legal and tax issues. Track record of promoters is also taken into account.

2. A Viable Idea. Before taking investment decision, venture capital firms consider the viability of project or the idea. Because a viable idea establishes the market for the product or service. Why the customers will purchase the product, who the ultimate users are, who the competition is with and the projected growth of the industry?

3. Business Plan. The business plan should concisely describe the nature of the business, the qualifications of the members of the management team, how well; the business has performed, and business projections and forecasts. The promoters experience in the proposed or related businesses is an important consideration. The business plan should also meet the investment objective of the venture capitalist.

4. Project Cost and Returns A. VCI would like to undertake investment in a venture only if future cash inflows are likely to be more than the present cash outflows. While calculating the Internal Rate of Return (IRR) the risk associated with the business proposal, the length of time his money will be tied up are taken into consideration. Project cost, scheme of financing, sources of finance, cash inflows for next five years are closely studied.

5. Future Market Prospects. The marketing policies adopted, marketing strategies in relation to the competitors, market research undertaken, market size, share and future market prospects are some of the considerations that affect the Decision.

6. Existing Technology. Existing technology used and any technical collaboration agreements entered into by the promoters also to a large extent affect the investment decision. Miscellaneous Factors. Others factors which indirectly affect the investment decisions include availability of raw material and labor, pollution control measures undertaken, government policies, rules and regulations applicable to the business/industry, location of the industry etc.

Selection of Venture Capitalists

Venture capital industry has shown tremendous growth during the last ten years. Thus, it becomes necessary for the entrepreneurs to be careful while selecting the venture capitalists.

Following factors must be taken into consideration:

1. Approach adopted by VCs - Selection of VCs to a large extent depends upon the approach adopted by VCs.

a. Hands on approach of VCs aims at providing value added services in an advisory role or active involvement in marketing, recruitment and funding technical collaborators. VCs show keen interest in the management affairs and actively interact with the entrepreneurs on various issues.

b. Hands off approach refers to passive participation by the venture capitalists in management affairs. VCs just receive. periodic financial statements. VCs enjoy the right to appoint a director but this right is seldom exercised by them. In between the above two approaches lies an approach where VC' s approach is passive except in major decisions like change in top management, large expansion or major acquisition.

(2) Flexibility in deals - The entrepreneurs would like to strike a deal with such venture capitalists that are flexible and generous in their approach. They provide them a package which best meet the needs of the entrepreneurs. VC's having rigid attitude may not be preferred.

(3) Exit policy - The entrepreneurs should ask clearly the venture capitalists as to their exit policies whether it is buy back or quotation or trade sale. To avoid conflicts, clarifications should be sought in the beginning; the policy should not be against the interests of the business. Depending upon the exit policy of the VCs, selection would be made by the entrepreneurs.

(4) Fund viability and liquidity - The entrepreneurs must make sure that the VCs has adequate liquid resources and can provide later stage financing if the need arises, also, the VC has committed backers and is not just interested in making quick financial gains.

(5) Track record of the VC & its team - The scrutiny of the past performance, time since operational, list of successful projects financed earlier etc. should be made by the entrepreneur. The team of VCs, their experience, commitment, guidance during bad times is the .other consideration affecting the selection of VCs.

Procedure Followed by VCs

a. Receipt of proposal. A proposal is received by the venture capitalists in the form of a business plan. A detailed and well-organised business plan helps the entrepreneur in gaining the attention of the VCs and in obtaining funds. A well-prepared business proposal serves two functions.

1. It informs the venture capitalists about the entrepreneur's ideas.

2. It shows that the entrepreneur has detailed knowledge about the proposed business and is aware of the all Potential problems.

b. Appraisal of plan. VC appraises the business plan giving due regard to the creditworthiness of the promoters, the nature of the product or service to be developed, the markets to be served and financing required. VCs also conduct cost-benefit analysis by comparing future expected cash inflows with present investment.

c. Investment. If venture capital fund is satisfied with the future profitability of the company, it will take step to invest his own money in the equity shares of the new company known as the assisted company.

d. Provide value added services. Venture capitalists not only invest money but also provide managerial and marketing assistance and operational advice. They also make efforts to accomplish the set targets which consequently results in appreciation of their capital.

e. Exit. After some years, when the assisted company has reached a certain stage of profitability the VC sells his shares in the stock market at high premium, thus earning profits as well as releasing locked up funds for redeployment in some other venture and this cycle continues.

III. VENTURE CAPITAL IN INDIA

Most of the success stories of the popular Indian entrepreneurs like the Ambanis and Tatas had little to do with a professionally backed up investment at an early stage. In fact, till very recently, for an entrepreneur starting off on his own personal savings or loans raised through personal contacts/financial institutions.

Traditionally, the role of venture capital was an extension of the developmental financial institutions like IDBI, ICICI, SIDBI and State Finance Corporations (SFCs). The first origins of modern Venture Capital in India can be traced to the setting up of a Technology Development Fund (TDF) in the year 1987-88, through the levy of a cess on all technology import payments. TDF was meant to provide financial assistance– to innovative and high-risk technological programs through the Industrial Development Bank of India. This measure was followed up in November 1988, by the issue of guidelines by the (then) Controller of Capital Issues (CCI). These stipulated the framework for the establishment and operation of funds/companies that could avail of the fiscal benefits extended to them. However, another form of (ad?)Venture capital which was unique to Indian conditions also existed. That was funding of green-field projects by the small investor by subscribing to the Initial Public Offering (IPO) of the companies. Companies like Jindal Vijaynagar Steel, which raised money even before they started constructing their plants, were established through this route.

The industry's growth in India can be considered in two phases. The first phase was spurred on soon after the liberalization process began in 1991. According to former finance minister and harbinger of economic reform in the country, Manmohan Singh, the government had recognized the need for venture capital as early as 1988. That was the year in which the Technical Development and Information Corporation of India (TDICI, now ICICI ventures) was set up, soon followed by Gujarat Venture Finance Limited (GVFL). Both these organizations were promoted by financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high net-worth individuals. Though an attempt was also made to raise funds from the public and fund new ventures, the venture capitalists had hardly any impact on the economic scenario for the next eight years.

However, it was realized that the concept of venture capital funding needed to be institutionalized and regulated. This funding requires different skills in assessing the proposal and monitoring the progress of the fledging enterprise. In 1996, the Securities and Exchange Board of India (SEBI) came out with guidelines for venture capital funds has to adhere to, in order to carry out activities in India. This was the beginning of the second phase in the growth of venture capital in India. The move liberated the industry from a number of bureaucratic hassles and paved the path for the entry of a number of foreign funds into India. Increased competition brought with it greater access to capital and professional business practices from the most mature markets.

There are a number of funds, which are currently operational in India and involved in funding start-up ventures. Most of them are not true venture funds, as they do not fund start-ups. What they do is provide mezzanine or bridge funding and is better known as private equity players. However, there is a strong optimistic undertone in the air. With the Indian knowledge industry finally showing signs of readiness towards competing globally and awareness of venture capitalists among entrepreneurs higher than ever before, the stage seems all set for an overdrive.

The Indian Venture Capital Association (IVCA) is the nodal center for all venture activity in the country. The association was set up in 1992 and over the last few years, has built up an impressive database. According to the IVCA, the pool of

funds available for investment to its 20 members in 1997 was Rs25.6bn. Out of this, Rs10 bn had been invested in 691 projects. Certain venture capital funds are Industry specific (i.e. they fund enterprises only in certain industries such as pharmaceuticals, InfoTech or food processing) whereas others may have a much wider spectrum. Again, certain funds may have a geographic focus – like Uttar Pradesh, Maharashtra, Kerala, etc whereas others may fund across different territories.
The funds may be either close-ended schemes (with a fixed period of maturity) or open-ended.

IV. CLASSIFICATION

Venture funds in India can be classified on the basis of Genesis
Financial Institutions Led By ICICI Ventures, RCTC, ILFS, etc.

- Private venture funds like Indus, etc.
- Regional funds like Warburg Pincus, JF Electra (mostly operating out of Hong Kong).
- Regional funds dedicated to India like Draper, Walden, etc.
- Offshore funds like Barings, TCW, HSBC, etc.
- Corporate ventures like Intel.

To this list we can add Angels like Sivan Securities, Atul Choksey (ex Asian Paints) and others. Merchant bankers and NBFCs who specialized in "bought out" deals also fund companies. Most merchant bankers led by Enam Securities now invest in IT companies.

A. 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.

B. 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.

C. 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.

A list of the members registered with the IVCA as of June 1999, has been provided in the Annexure. However, in addition to the organized sector, there are a number of players operating in India whose activity is not monitored by the association. Add together the infusion of funds by overseas funds, private individuals, 'angel' investors and a host of financial intermediaries and the total pool of Indian Venture Capital today, stands at Rs50bn, according to industry estimates!

The primary markets in the country have remained depressed for quite some time now. In the last two years, there have been just 74 initial public offerings (IPO's) at the stock exchanges, leading to an investment of just Rs14.24bn. That's less than 12% of the money raised in the previous two years. That makes the conservative estimate of Rs36bn invested in companies through the Venture Capital/Private Equity route all the more significant.
Some of the companies that have received funding through this route include:

- Mastek, one of the oldest software houses in India
- Geometric Software, a producer of software solutions for the CAD/CAM market
- Ruksun Software, Pune-based software consultancy
- SQL Star, Hyderabad based training and software development company
- Micro land, networking hardware and services company based in Bangalore
- Satyam Infoway, the first private ISP in India
- Hinditron, makers of embedded software
- PowerTel Boca, distributor of telecomputing products for the Indian market
- Rediff on the Net, Indian website featuring electronic shopping, news, chat, etc
- Entevo, security and enterprise resource management software products
- Planetasia.com, Microland's subsidiary, one of India's leading portals
- Torrent Networking, pioneer of Gigabit-scaled IP routers for inter/intra nets
- Selectica, provider of interactive software selection
- Yantra, ITLInfosys' US subsidiary, solutions for supply chain management

Though the infotech companies are among the most favored by venture capitalists, companies from other sectors also feature equally in their portfolios. The healthcare sector with pharmaceutical, medical appliances and biotechnology industries also get much attention in India. With the

deregulation of the telecom sector, telecommunications industries like Zip Telecom and media companies like UTV and Television Eighteen have joined the list of favorites. So far, these trends have been in keeping with the global course.
However, recent developments have shown that India is maturing into a more developed marketplace, unconventional investments in a gamut of industries have sprung up all over the country. This includes:

Indus League Clothing, a company set up by eight former employees of readymade garments giant Madura, who set up shop on their own to develop a unique virtual organization that will license global apparel brands and sell them, without owning any manufacturing units. They dream to build a network of 2,500 outlets in three years and to be among the top three readymade brands.

V. THE VENTURE CAPITAL PROCESS

Venture capitalists are a busy lot. This chapter aims to highlight the approach to an investor and the entire process that goes into the wooing the venture capital with your plan.

First, you need to work out a business plan. The business plan is a document that outlines the management team, product, marketing plan, capital costs and means of financing and profitability statements.

The venture capital investment process has variances/features that are context specific and vary from industry, timing and region. However, activities in a venture capital fund follow a typical sequence. The typical stages in an investment cycle are as below:

- Generating a deal flow
- Due diligence
- Investment valuation
- Pricing and structuring the deal
- Value Addition and monitoring
- Exit

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