ISSN 2319-7080
International Journal of Computer Science and Communication Engineering
IJCSCE Special issue on "Emerging Trends in Engineering & Management" ICETE 2013

Venture Capital: Growth and Obstacles in India

Pallvi Rani [1], Harpreet Kaur[2], Kanwaldeep Singh[3]
[1] Assistant Professor, DAV College , Hoshiarpur, Punjab, India
[2] HR Manager, BITS, Pilani
[3] Registrar, Singhania University
[1]pallvidhingra06@gmail.com, [2]preetsaran29@gmail.com, [3]kanwaldeepsaran@gmail.com

Abstract--Worldwide venture capital is not a new phenomenon. It is growing at a great pace. But it is a new concept in India. Two decades ago, Indian companies were receiving low amount of venture capital. The scenario changed in late 1900s with the growth of India's Economy. During last, 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. Still there are many problems in India. This paper would focus on that growth and obstacles.

Keywords: Venture Capital, Private Equity, Obstacles and Growth

I. CONCEPTION OF VENTURE CAPITAL

The dictionary meaning of Venture is adventure or speculation. Speculation is always risky. Capital is the money invested in a business. So venture capital is the source of finance where collected funds are invested in the risky projects and always high return is expected. Usually venture capital funds are invested in new enterprise. Major conventional sources of funds are Debts and Equity. But debts are provided to those who have sufficient resources to get things launched. They will cover living costs, office space rental. Venture Capital, defined as independently managed, dedicated pools of capital that focus on equity, or equity-linked investments in privately held, high-growth companies (Lerner 2009), plays a role in translating R&D activities into commercial outcomes and is therefore credited with a catalytic role in innovation (Christofidis and Debande 2001).Venture capitalists provide funds at uncertain event like Research and development, Development of new process, technology, new product, improving the existing products. Venture capitalists also provide managerial assistance. The underlying assumption is that the entrepreneur and the venture capitalist would act together in the interest of the enterprise as "partners". Venture capitalists invest money from funds of capital provided by third-party investors. These third party investors can be individuals, or organizations (usually pension funds, university endowments and other similar investors who can make long term investments), that agree to invest a certain amount of capital into a fund for a set period of time (typically ten years).

Investment cycle between investors, venture capital funds.

Source: EVCA

II. RESEARCH METHODOLOGY:

A. Objective of Study

1. To examine the process of venture capital and its typ\
2. To study the present status of Venture Capital industry in India.
3. To find the problems and obstacles associated with Venture Capital Financing in India and to explore views and measures required for the growth of Venture Capital Financing in India.

B. Research design

The research is an exploratory research. The major purpose of this research is description of the state of affairs as it exists at present.

C. Data collection

Secondary data is used for the study. The main sources are websites, press releases in venture capital, newspaper and journal.

III. INVESTMENT PROCESS OF VENTURE CAPITAL

Venture capital activities are guided by the venture capital cycle (Gompers and Lerner 2004). The venture capital cycle has five phases – fundraising, screening, negotiating, monitoring and exiting. Each of these phases is briefly discussed in further detail.

A. Fund Raising

This phase of activity is concerned with the processes of raising funds. Activities include deciding on management fees and negotiation of contracts between investors and the fund managers, concerning the timings of investment disbursements and distribution of profits over the course of the fund management period (Gompers and Lerner 2004). Government sponsored funds can negotiate a longer time period for the operation of the fund, so fund managers have a longer time period to realize their investments. Public funding into both publicly and privately managed funds targeting the early stage has increased in the past decade. This policy activity is in response to two supply issues; lack of early stage VC for NTBFs due to what is variously described as the 'equity gap' and a focus on increasing the supply of NTBFs to stimulate economic development.

B. Deal flow and screening

The second aspect of the venture capital cycle is generating deal flow and screening investment opportunities. The screening activities need to highlight good investment opportunities that have the potential for excellent returns within the lifespan of the fund and to meet any other conditions when public funding is involved. Cultivating good deal flow is an essential activity for the venture capital firm, but is largely completed through informal channels and principally through referral (Langeland 2007). There is an extensive literature assessing the screening and selection techniques of venture capital fund managers (Macmillan, Zemann et al. 1987; Hisrich and Jankowicz 1990; Diaz de Leon and Guild 2003; Lange, Mollov et al. 2007). This literature emphasises the importance three groups of information. Firstly information from intermediaries, such as bankers, accountants and lawyers, other venture capital funds and investors and university contact are all relied upon for providing investment opportunities (Shane and Cable 2002). Secondly, venture fund managers consider the network status and position of the potential portfolio firms within a wider community of firms, and the entrepreneur and /or management team's position within an entrepreneurial community. Thirdly fund managers consider the past experience of the entrepreneur and/or entrepreneurial team. From these sources of information fund managers develop 'rules of thumb' that shape their assessment behaviour (Hisrich and Jankowicz 1990).

C. Negotiating investments

The negotiation process involves the venture capital manager valuing the firm. This is done with regard to market conditions and future prospects. The fund manager will also complete a number of background checks on the entrepreneur and management and analysis of the firm's proposition and technology base. This is referred to as the due diligence period (De Clercq, Fried et al. 2006). The negotiation process is reliant on information gathered through personal and professional networks of the fund manager. Aspects of the literature point to similar uses of informal and intangible methods of firm evaluation that were used in screening investments (Macmillan, Zemann et al. 1987; Hisrich and Jankowicz 1990). We can also make similar comments on the 'rules of thumb' methods used by venture capitalists to make firm valuations. The due diligence process is time-consuming and costly. Due diligence costs are also relatively fixed and not related to the size of the investment in the firm, therefore larger investments in portfolio companies are more cost effective in relation to their due diligence costs. When negotiations are complete a written document, a 'term sheet' is produced, it summarises the main terms and conditions.

D. Monitoring

Once an investment is made then the monitoring phase begins. This is the stage at which non-capital value is added to the portfolio firms through the monitoring, advice and guidance of the fund managers. In the classic venture capital model strategic business support was part of the package. Venture capital investment was considered 'more than money '(Bygrave and Timmons 1992, Lange, Mollov et al. 2007). Support extended to portfolio firms includes fund managers occupying board positions within new firms, providing advice on strategic direction, assisting in recruiting management executives and providing introductions to customers and other key contacts. Research has also shown that venture capitalists play a role in highlighting unconscious and ill-considered behaviour in their portfolio firms by questioning assumptions that the firm may make (Berglund, Hellstrom et al. 2007). Some commentators claim that this provision of non-capital value is overstated. Fund managers will still take positions on the boards of these companies but, as research from Norway (Berg-Utby, Sorheim et al. 2007) suggests, many portfolio firms' expectations about even modest levels of involvement of the VC fund manager in the business, are unmet. The most potent form of control that venture capitalists have over their investments is in the staging mechanism for capital investments (Gompers and Lerner 2004). Contracts and staged investments highlight the trade-off between agency and monitoring costs that fund managers must decide between. Stipulating controls within a contract requires the VC to ensure that these controls are being adhered to and this raises monitoring costs. Staging investments over shorter periods of time can reduce monitoring costs, with evaluation taking place at the completion of each stage, but agency costs are higher as contracts must be re-negotiated frequently.

E. Exit

Exit is the final stage of the VC cycle and is an obligation taken on when the limited partnership was formed, but may not always

be taken at a time that is in the best interests of the firm, the economy, or even the investors. There are five different types of exit; exiting through an IPO, trade sale, secondary sale to another financial institution or fund, buy back by the entrepreneur or write off. The first of these exit methods, the IPO is perhaps the most celebrated and prominent in the literature, yet the second method, the trade sale is the most common successful exit method for both VC funds and business angels (Soderblom 2006). The secondary sale exit, where an investment in a portfolio firm is sold to another financial entity, usually another equity firm is also increasing in regularity, no doubt alongside the increasing levels of investment syndication. This form of exit is suitable for smaller, early stage investors who do not (or cannot) follow a successful growing firm through to another form of market sale (Soderblom 2004) or require longer time period for the successful realisation of the investment than the current fund allows. The entire length of the investment process for early stage ventures is estimated to be on average about 6-7 years, from the first capital investment to the final exit (Manigart, Desbrieres et al. 2002), although this can vary significantly by industry. Research also shows that early stage specialist funds generate lower rates of return (Gottschalg, Phalippou et al. 2004). This demonstrates the inability of early stage funds to realise successfully their investments over a 6-7 year period.

IV. CATEGORISATION

In an uncertain global environment, LPs would resist the idea of their fund committing to a narrow strategy upfront and strictly adhering to it over a period of eight to 10 years. The PEVC industry heavily depends upon various risk mitigation strategies which comprise of investing across different sectors, various stages of companies' evolution, diverse business houses, geographies, stages of capital markets preparedness, et cetera. It is by adopting this portfolio approach that PEVC funds attempt to provide higher risk-adjusted returns. Sebi's proposal of categorizing various PEVC funds to govern them better will have an adverse impact on the performance of these funds. Any regulation that tries to restrict the flexibility of investment across various risk dimensions hurts funds' ability to generate good returns. It should be the prerogative of LPs to devise strategies for the fund and change them based on global market conditions when they deem fit. LPs have steadfastly preserved their right to change the strategy of their funds given the economic environment, government and tax policies are dynamic and subject to change over a fund's life of eight-10 years. If the purpose of categorization is to channelize incentives effectively, the same can be administered on a deal to deal basis rather than by categorizing the entire fund. PEVC funds could be asked to disclose the category of each of their transactions at the time of investment and the regulator would decide whether to provide incentives or disincentives depending on the category of the deal (e.g. VC or real estate deals). If India domiciled PEVC funds have to adjust their strategies to changing market conditions, it is natural for LPs to choose PEVC funds which have more flexibility. However, at the macro level a regulator could still achieve developmental objectives of encouraging early stage investments and social enterprise by ensuring safer access to PEVC funds. If categorization is retained at a broader level with the following categories without outlining any micro-management of investment strategies:

4.1 Venture capital fund

4.2 Private equity fund

4.3 Fund of funds

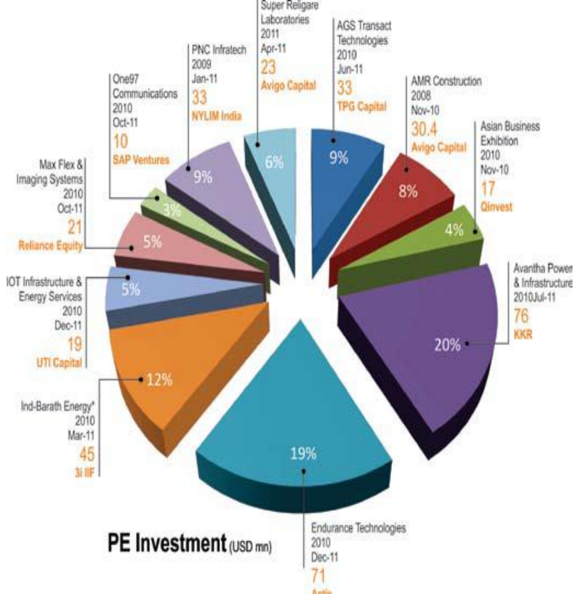
4.4 Social venture fund

To enable these AIFs to achieve superior returns through risk mitigation strategies of investing across different stages of investment and sectors, and capital market preparedness, they should be allowed to retain the flexibility to invest 40% of a fund's corpus across strategies. An LP (with the backing of at least 75% the other investors in the fund) should be able to change an investment strategy at any point of a fund's life, and intimating Sebi about it. In the above categorization, the venture fund category could cover investments in SMEs, all sector themes and PIPEs could be a single PE fund structure. PE funds effectively use the structure of their instruments to mitigate risk, ranging from pure equity to various forms of optionally or compulsorily convertible instruments. These are critical as it allows funds to assess and manage risk on an investment-to-investment basis, in line with the risk as well as the promoters' needs. Hence, debt investments, which are a strategic structuring need, could be used by all classes of AIFs as and when needed. The hedge fund category with leverage abilities, and regular redemption obligations is a very different asset class and requires a separate set of regulations. Such regulations may be more appropriate for mutual funds and may be examined as part of that sector, as they are like public equity funds designed for institutional investors.

V. VENTURE CAPITAL INDUSTRY IN INDIA

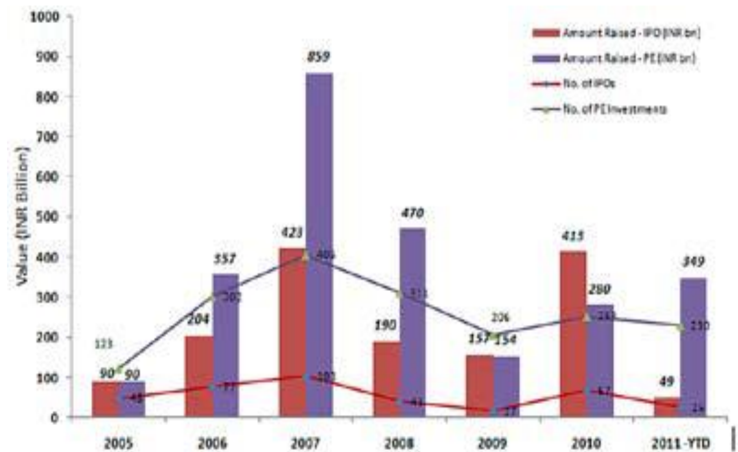
India today is vibrant and fast growing market for private equity in general and venture capital in particular. The number of deals and their aggregate value has been steadily increasing post-liberalization at a phenomenal rate. As a result of the global financial meltdown the deal value of the private equity and venture capital industry had experienced a considerable dip of 62% in 2009. However India was one country that emerged relatively untouched by the crisis, and by the first quarter of 2010 the GDP growth rate has returned to pre-crisis levels of 8% which by most conservative market estimates is expected to grow over the next few years. Market sources estimate that there are approximately 375 private equity firms currently operating in India and at least another 50 have raised or are in the process of

raising funds and are planning to start their operations in the near future. The aggregate amount of funds raised by the private equity firms for investment in India is estimated to be approximately US$50 billion. Thus the prospects of the private equity and venture capital industry continue to be robust.



Companies that dropped IPO plans and raised PE.

Prior to the advent of the PEVC industry in India, entrepreneurs largely depended upon private placements, public offerings and lending by financial institutions for raising capital. Many companies listed prematurely in the public markets for lack of alternative sources of funding. This legacy can be seen in the current composition of the capital markets with more than 6,000 listed companies – about 73% of BSE listed stocks–with less than `100 crores of market capitalization and which contribute less than 2% of daily trading volumes. While lenient listing norms have enabled small Indian companies to access capital through initial public offerings (IPOs), the smallest companies have languished, unable to raise follow-on capital to fund their growth due to the absence of research coverage, low liquidity, lack of interest from institutional investors and poor corporate governance standards. Other than in the capital markets, the funding available to them was mostly from traditional sources such as banks. Although, Sebi’s venture capital funds (VCF) regulations were framed in 1996, PEVC activity in India was subdued until 1999-2000 – the era of the dotcom bubble. After this lull, investments picked up again in 2004 onwards and since 2005, India has received close to $55 billion (2,55,000 crores) of PEVC investments. During this period more than 1,800 Indian companies have been funded and the flourishing PEVC industry has fulfilled a major need for capital by fast-growing companies. The robust flow of PEVC capital into Indian companies since 2005 and its predominance as an alternative source of capital for Indian businesses can be seen in the fundraising figures – IPOs versus PE – through 2005 until recently (see chart).



Source: www.icva.com

VI. OBSTACLES FOR VENTURE CAPITAL FUNDING:

The PEVC industry is at a critical juncture today and facing significant challenges on multiple fronts. While phenomenal investments have happened over the past few years, overcoming these challenges will be crucial to the sustainability of this industry. Some of the typical challenges are:

A. Exits

Realizing the value of investments has been hampered by over-dependence on IPOs for exits, very short IPO windows, and underdeveloped M&A exit mechanisms which need active cooperation of entrepreneurs and company promoters.

B. Valuation

In other comparable markets, such as China, there is an arbitrage in valuations between private markets and public markets. In India private valuations are on par or higher than their public peers. The primary reason is the paucity of good quality private companies of investible size. A majority of the 6,000 or so listed companies in India have the characteristics of private companies, are capital starved and available at lower valuations than their private peers. Unfortunately, they cannot be tapped by PEVC funds because of regulatory restrictions.

C. Scalability

Indian companies are finding it hard to scale beyond a certain critical size on account of infrastructure bottlenecks, regulatory delays and growing red tape.

D. Illiquidity

SMEs listed on the public markets are highly illiquid - companies with market cap less than 1,000 crores ($225 million) account for 11% of the total average daily traded value in public markets, while companies with market cap less than 500 crores

($113 million) account for 4%. PEVC investors who own significant stakes i.e. more than 10%) in portfolio companies have trouble exiting these companies on account of illiquidity in their scrips. Although the idea of a separate stock market for SMEs has been under discussion for some time, no significant progress has been made.

E. Returns

For various reasons, Indian PEVC has not been able to generate returns or exit multiples on par with competing markets, such as China. If this continues then the allocation of new capital by investors (or limited partners, LPs) to India will recede.

VII. FINDINGS

Venture capital investment process based agreements are legal contracts that essentially allocate risk, return, and ownership rights between the entrepreneur and the investing venture capital fund. Venture capital contracting, due to its very nature, faces the problems of uncertainty, information asymmetry and agency costs in a magnified form. The venture capitalist is also subject to strict obligations to their limited partners under the terms of the partnership agreement of the fund, which itself is designed to control similar problems of agency and informational asymmetry. Thus the challenge of venture capital contracting is managing the inherent problems in light of the eventual goal. Venture capitalists have developed various tools to help optimise their financing arrangements. Venture capital contract in India uses the strongest available tools to deal with these issues of uncertainty and agency.

VIII. SUGGESTIONS

The following elements are needed for the more success of venture capital in India:

A. R & D Activities

Public and private ltd. Venture capitalist companies should focus on the new technology.

B. Fiscal Incentive

Government should give fiscal incentives to the entrepreneur as well as venture capitalist in form of tax cuts.

C. Promotion Efforts

Promotional efforts, venture fairs, venture clubs and venture networks should be formed for the growth.

D. Better education and Training to the venture capital managers

To prepare the manager competent and trained, they should be giving training with using new technology.

E. Industry–institute linkage

Universities should be linked with universities so that new useful ideas can be transformed into realistic shape.

F. Motivation to the entrepreneurs

Entrepreneur should be motivated so that they could become for the risk taker and Indian economy could flourish.

REFERENCES

[1] Berglund, H., T. Hellstrom and S. Sjolander (2007), "Entrepreneurial Learning and the Role of Venture Capitalists." Venture Capital 9(3): 165-181.

[2] Berg-Utby, T., R. Sorheim and L. O. Widding (2007), "Venture Capital Funds: Do They Meet the Expectations of Portfolio Firms?" Venture Capital 9(1): 23-41.

[3] Bygrave, W. D. and J. A. Timmons (1992), Venture Capital at the Crossroads. Boston, MA, Harvard Business School Press.

[4] De Clercq, D., V. H. Fried, O. Lehtonen and H. J. Sapienza (2006), "An Entrepreneur's Guide to the Venture Capital Galaxy." Academy of Management Perspectives: 90-112.

[5] Gompers, P. and J. Lerner (2004), The Venture Capital Cycle. Cambridge MA, MIT Press.

[6] Hisrich, R. D. and A. D. Jankowicz (1990), "Intuition in Venture Capital Decsisions: An Exploratory Study Using a New Technique." Journal of Business Venturing 5: 49-62.

[7] Langeland, O. (2007), "Financing Innovation: The Role of Norwegian Venture Capitalists in Financing Knowledge-Intensive Enterprises." European Planning Studies 15(9): 1143-1161.

[8] Macmillan, I. C., L. Zemann and P. N. Subbanarasimha (1987), "Criteria Distinguishing Successful from Unsuccessful Ventures in the Venture Screening Process" Journal of Business Venturing 2: 123-137.

[9] Manigart, S., P. Desbrieres, K. De Waele, M. Wright, K. Robbie, H. J. Sapienza and A. Beekman (2002), "Determinants of Required Return in Venture Capital Investments: A Fie Country Study." Journal of Business Venturing 17(4): 291-312

[10] Shane, S. and D. Cable (2002), "Network Ties, Reputation and the Financing of New Ventures." Management Science 48(3): 364-381.

[11]Soderblom, A. (2006), Factors Determining the Performance of Early Stage High-Technology Venture Capital Funds - a Review of the Academic Literature. Small Business Services Research, Department of Trade and Industry.www.icva.com

[12] Pandey, I.M., Venture Capital Development Process in India, Technovation, Vol. 18, No. 4, 1998.

[13] SEBI, Report of Committee on Venture Capital, 2000 (K.B. Chandrasekhar Committee)

[14] Government of India, Report of committee on Technology Innovation and Venture Capital, 2006 set up by Planning Commission.