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- Bowersox, Donald J., Closs, David J., (1996), "Logistical Management." Tata McGraw, Hill, New Delhi.
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# VENTURE CAPITAL IN INDIA: TRENDS & CHALLENGES

*SAUMYA JAIN*
*ASST. PROFESSOR*
*SHAHEED SUKHDEV COLLEGE OF BUSINESS STUDIES*
*UNIVERSITY OF DELHI*
*DELHI*

*NARANDER KUMAR NIGAM*
*ASST. PROFESSOR*
*SHAHEED SUKHDEV COLLEGE OF BUSINESS STUDIES*
*UNIVERSITY OF DELHI*
*DELHI*

**ABSTRACT**

*The Indian startup environment is a buzzword since last year when the Venture Capital investments hit an all-time high of more than 9$ billion. The year 2016 started with the launch of ambitious Start Up India Campaign. With a 10,000 crore corpus, tax exemption and self-compliance procedure, the Indian Startup ecosystem has never been more conducive. The current government policies are favouring business environment and with the number of mobile phone and internet users increasingly exponentially in India, sectors like e-commerce are attracting unprecedented investment. There are a lot of mergers and acquisitions in the start up industry and the government support is supporting this consolidation. With all the initiatives, Indian start up scene is on a never before growth trajectory that is bound to sustain for a long time. The present paper examines the conceptual framework of Venture Capital, the evolution of Venture Capital in India and the Regulatory framework for Venture Capital Funds. The paper analyses the current trends and challenges in the Venture Capital Industry and the way ahead for India.*

**KEYWORDS**

history, SEBI regulations, startup, trends, venture capital.

## I. INTRODUCTION

A new business requires capital for establishment and expansion. There are a number of ways to fund growth of a business: proprietor's own capital, arranging loan from financial institutions and seeking equity investment as happens in Venture capital. Venture Capital is a source of funding for small companies which have limited or no operation history and are not strong enough to access the capital market or acquire institutional finance. Venture Capital is basically investment in newly formed companies which have a strong potential for growth with a goal of earning long term capital gains at the time of exit. Venture capital investment promotes the growth of entrepreneurs with promising ideas and thereby act as medium for fulfilling the lacuna in financing options for risky, growth oriented firms

**Jane Koloski Morris**, editor of the well-known industry publication, Venture Economics, defines venture capital as **'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**

Venture capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms known as VENTURE CAPITAL FUNDS. The individuals who invest in this funds are known as Venture Capitalists and the firms in which they invest in are known as Venture Capital undertakings. Angel Investors are private individuals with huge net worth which directly invest in growth oriented firms.

WHAT DO VCs LOOK FOR?

Venture capitalists look for businesses that have the potential to grow quickly to a significant size, yielding a significant return on the VC's investment in a relatively short period of time.

The company's current size is less important than its future aspirations and growth potential. A target company for a VC is one that may be capable of becoming a large market leader in its industry due to some new industry opportunity and competitive advantage.

1. ***Commercially viable.*** *Does the company have a product or service that can be* reproduced efficiently to generate revenue?
2. ***Identifiable market****. Is there a clearly defined market for the company's product* or service? Does the company's product or service meet an identifiable need in that industry? Does the company have a reasonable plan to meet the identified need in an efficient, revenue-generating manner?
3. ***Strong management****. Does the company's leadership inspire confidence? Do* they have the vision, expertise, and the ability to propel a business to a significant level of growth?
4. ***Sustainable competitive advantage.*** *Has the company hit upon an idea that's truly* unique to the industry, one that has significant barriers to entry that will inhibit others from encroaching upon its market? Has the company considered economic and technological change that may affect the business model?
5. ***Exit Opportunity:*** Lastly, venture capitalists look for the clear exit opportunity for their investment such as public listing or a third party acquisition of the investee company

## II. VENTURE CAPITAL INVESTMENT PROCESS

**STAGES OF FINANCING**

Venture Capital typically refers to risk capital as they invest in risky projects at a stage when the idea of the business is still shaping up and as the company progresses they may fund additional rounds for expansion and growth of the company. The various rounds of financing may be divided as:

**Early stage Financing**

1. Seed Money: This is the funding required to test and research on a new idea before commercial production starts. At this stage, the risk of losing the investment is tremendously high, because there are so many uncertain factors.
2. Start-up: This is the funding required by firms that have conducted successful feasibility studies and are now looking at product development and marketing.
3. Second-Round: Firms at this stage require funding for promoting sales as they are selling the product but not yet turning profit. They are trying to compete and carve out a market for themselves.

**Later stage Financing**

4. Mezzanine/Development financing: This is expansion money for a newly profitable company to acquire new assets and foray into different markets.
5. Bridge Financing: This is the final stage funding required for financing the cost of public issue so that Venture Capitalist is able to liquidate his investment.

**VC investment process**

There are various stages in Venture Capital Investment Process.

1. Business Plan Submission: In the first stage, the venture capital undertaking submits a Business Plan outlining the Background of the Company, Product or service, Market Analysis, Marketing, qualifications of the Management Team and in depth financial analysis of the future revenues and costs.
2. Introductory Conversation/Meeting: If the business plan meets the initial investment criteria of the Venture Capital Fund, a personal meeting is arranged.
3. Due Diligence: The due diligence phase lasts for weeks and involves analysis of the Company's current & Projected Valuation, Risk, Projected ROI, Liquidity of Investment, security interests and exit strategies in the event of distress, Ability to fund future rounds and extent of Influence over decision making in the VCU.
4. Term Sheets and Funding: On the completion of due diligence phase, the two parties prepare a term sheet which is a non-binding document that spells out the basic terms and conditions of the investment agreement. The Term Sheet contains details pertaining to type of shares that will be offered to the financier, Dividend rights, Liquidation Preference, Redemption, Conversion rights, Representation & warranties, Voting rights, Consent rights, Information rights, Planned Exit scenario.
5. Methods of Venture Financing: The financing pattern of the deal is the most important element. The various methods of venture financing are Equity Instruments, Debt Instruments such as Conditional loan**,** Income notes. Conditional Loans and Income Notes are innovative debt instruments that carry low interest rate plus royalty as a certain percentage of sales.
6. Exit strategy: VCs would be more interested in listening to entrepreneurs who have a perfect exit strategy planned for investors. There is various exit option for VC to cash out their investment:

- Initial Public Offering (IPO): IPO is about offering company shares in the market for public to buy. IPO constitutes the most preferred route for VC exit as it offers flexibility to investors in terms of time, price and quantity. IPO gives a perfect opportunity to reap benefits for their investment, liquidity and quick exit
- Mergers & Acquisition: M&A offers an opportunity to investors to sell company shares to another company. Most mergers or acquisitions of VC-funded companies consist of a smaller, VC-funded company merging or being acquired by public or private company. The acquisition/merger is also a efficient way for the acquirer of a VC-funded company to enlarge its business by adding product lines or services already developed by the VC-funded company.
- Shares buyback**:** Company promoters or entrepreneur can buy back the company's shares from Investors on a fixed price after negotiation. However, investors would like to go for this VC exit option only when IPO & M&A route is not available to them and company is not doing well in terms of meeting expectations of investors.
- Sale to Other Strategic Investor/Venture Capital Fund**:** It is quite possible that VC prefer to offload their shares to other strategic investors which could be either bigger angel investors or venture capital funds who are ready to put more money into the business.

For instance, in the year 2005, Crossover Advisors, a private equity firm invested in an automobile component manufacturer, Indo Schottle Auto Components. Once their market demand increased after procuring orders from Volkswagen and General Motors, a decision was taken to co-opt a large partner such as ICICI Ventures. Crossover Advisors exited through a sale to ICICI in 2007.

## III. VENTURE CAPITAL FUNDS IN INDIA

VCFs in India can be categorized into following five groups:

1) Those promoted by the Central Government controlled development finance institution. For eg: IFCI Venture Capital Funds Ltd (IVCF) & SIDBI Venture Capital Ltd (SVCL)
2) Those promoted by State Government controlled development finance institutions. For eg: Punjab Infotech Venture Fund, Gujarat Venture Finance Ltd (GVFL), Kerala Venture Capital Fund Pvt Ltd.
3) Those promoted by public banks. For example: Canbank Venture Capital Fund, SBI Capital Market Ltd.
4) These promoted by private sector companies. For example: IL&FS Trust Company Ltd, Infinity Venture India Fund
5) Those established as foreign venture capital fund. For ex: Walden Investment, Citi group Venture Capital Investment

## IV. THE ORIGIN OF VENTURE CAPITAL IN U.S.

In the U.S., in first half of 20th century, wealthy families funded private companies which had potential for success. Georges Doriot, a professor at Harvard Business School, now known as father of Venture Capital in 1946 founded the American Research and Development Corporation (ARDC), the first private institutional firm which went on to invest in many successful firms, most notably, Digital Equipment Corporation (DEC) which was valued at over 1200 times at the time of listing and became a watershed in the history of venture Capital funding.

J.H. Whitney & Company was the second private equity investment firm that invested in Minute Maid juice which later was sold to Coca Cola Company.

In its early years, Venture Capital primarily invested in technology startups in the U.S but now the terms refer to investment in any unlisted private company.

## V. EVOLUTION OF VENTURE CAPITAL IN INDIA

The concept of venture capital came to India after decades of being introduced in the U.S and U.K. The advent of organised venture capital in India has been slow and funding was available from only banks and government, that too secured. Most of the entrepreneurs had to rely on their own family resources for setting up businesses.

**EARLY BEGINNINGS**

In 1972, a committee on Development of Small and Medium Enterprises stressed the importance of venture capital in promoting the growth of technology start ups and innovative entrepreneurs. This resulted in a series of fragmented steps such as setting up of Risk Capital Foundation, sponsored by IFCI in 1975 to promote and support new technologies and businesses. It is now known as IFCI Venture Capital Funds Ltd. Seed Capital scheme was set up by IDBI in 1976. Programme for Advancement of Commercial Technology (PACT) Scheme introduced by ICICI in 1985. These schemes were marginally successful as they were largely collateral and project based.

**1987-1994**

This was a period of setting up of organised venture capital funds in the country. The budget of 1986-87 introduced the idea of venture capital funding by levying a cess on technology imports to create a pool of funds. Venture Capital guidelines were announced in 1988.

The following VC funds laid the foundations of India's VC industry:

1. Venture Capital Fund Scheme (IDBI, 1987)
2. Venture Capital Unit Scheme I (TDICI, 1989)
3. Canbank Venture Capital Fund (Canbank Financial Services Ltd. 1989)
4. Venture Capital Unit Scheme II (TDICI,1990)
5. Gujarat Venture Capital Fund (Gujarat Venture Finance Ltd. 1990)

**1995-1998: ENTRY OF FOREIGN VENTURE CAPITAL FUNDS**

The Government of India issued guidelines in September 1995 for overseas investment in venture capital in India. The Securities and Exchange Board of India (SEBI) framed the SEBI (Venture Capital Funds) Regulations, 1996. These guidelines were further amended in April 2000 with the objective of fuelling the growth of venture capital activities in India.

The Government constituted a SEBI committee headed by K. B. Chandrasekhar to make recommendations to facilitate the growth of VC industry in India. The committee recommended, inter alia, that SEBI should be the single point contact for all regulations and clearances pertaining to flow of VC in India.

**2000 ONWARDS**

VCF industry has been in upswing touching $1.4 billion in 2015. The government revised the regulatory framework by covering Venture Capitalists and Angel Investors under the ambit of SEBI (Alternative Investment Fund) Regulation, 2012.

## VI. REGULATORY FRAMEWORK PERTAINING TO VENTURE CAPITAL FUNDS IN INDIA

**BACKGROUND**

SEBI notified the Alternative Investment Fund Regulations on 21st May, 2012 taking note of the rapidly growing private funding industry so as to to regulate them and ensure that they work in the interest of the entrepreneurs according to a well-defined investment criteria. A summary of these guidelines is produced below:

Definition of Alternative Investment Fund: AIF means a privately pooled investment vehicle structured as trust, company or limited liability partnership which collects funds from investors and invests them as per a well-defined investment policy.

Classification of AIFs.: SEBI has categorised Alternative Investment Funds into 3 categories

**TABLE 1: CATEGORIES OF ALTERNATIVE INVESTMENT FUNDS**

| Category I | Category II | Category III |
|---|---|---|
| Start Up Ventures<br>Social Venture Funds<br>SME Fund<br>Infrastructure Funds | Private equity Funds<br>Debt Funds | Funds which employ complex trading strategies. Eg: Hedge Funds. |

Corpus: Each scheme of an AIF is to have a corpus of atleast 20 crores. Manager or sponsor of the fund should have continuing interest in the form of investment of not less than: 2.50% of corpus or Rs. 5 crores, whichever is less.

Private Placement: AIFs will collect funds by private placement and issuing units of the funds of the investors. Funds are to be raised by issue of Placement Memorandum containing material information about the AIF, Investment Strategy, targeted investors etc. This PM is to be filed with SEBI atleast 30 days before the launch of the scheme.

Tenure: Category I and Category II funds must be close ended with predefined tenure subject to minimum of 3 years. Category III funds may be close ended or open ended.

Investment Conditions: Category I AIFs cannot borrow funds except for meeting temporary funding requirement. Atleast $2/3^{rd}$ of the corpus of VCF s should be invested in unlisted equity shares or equity linked instruments of VCUs. SME funds should invest atleast 75% of corpus in unlisted or proposed to be listed Small and Medium Enterprises. Social Venture Funds should invest atleast 75% of corpus in unlisted securities of social ventures. Infrastructure Funds should invest atleast 75 % corpus in VCUs involved in operating, developing infrastructure project. Category II AIFs should invest primarily in unlisted investee companies or in units of other AIFs. Category III AIFs may invest in listed or unlisted investee companies or derivatives or complex products.

Valuation: Category I and III AIFs should undertake valuation of their investments every 6 months by an independent value and disclose to the investors.

Transparency: all AIFs should ensure transparency and disclose information to investors relating to risk management, fees of the manager, material liabilities, financial information of the investee companies within 180 days from year end.

**Angel Funds**

"Angel Fund" means a sub-category of Venture Capital Fund under Category I- Alternative Investment Fund that raises funds from angel investors.

**Angel Investor**

"Angel Investor" means any person who proposes to invest in an angel fund and satisfies one of the following conditions, namely,

(a) an individual investor who has net tangible assets of at least two crore rupees has early stage investment experience, or has experience as a serial entrepreneur, or is a senior management professional with at least ten years of experience

(b) a body corporate with a net worth of at least ten crore rupees.

Investment in angel funds: Angel funds shall only raise funds by way of issue of units to angel investors. An angel fund shall have a corpus of at least ten crore rupees. Angel funds shall accept an investment of not less than twenty-five lakh rupees from an angel investor.

Investment by Angel Funds: Angel funds shall invest only in venture capital undertakings which have been incorporated during the preceding three years from the date of such investment; have a turnover of less than twenty-five crore rupees; Investment by an angel fund in any venture capital undertaking shall not be less than fifty lakh rupees and shall not exceed five crore rupees. Investment by an angel fund in the venture capital undertaking shall be locked-in for a period of three years. Angel funds shall not invest more than twenty-five per cent of the total investments under all its schemes in one venture capital undertaking.

## VII. VENTURE CAPITAL INVESTMENTS IN INDIA: CURRENT TRENDS

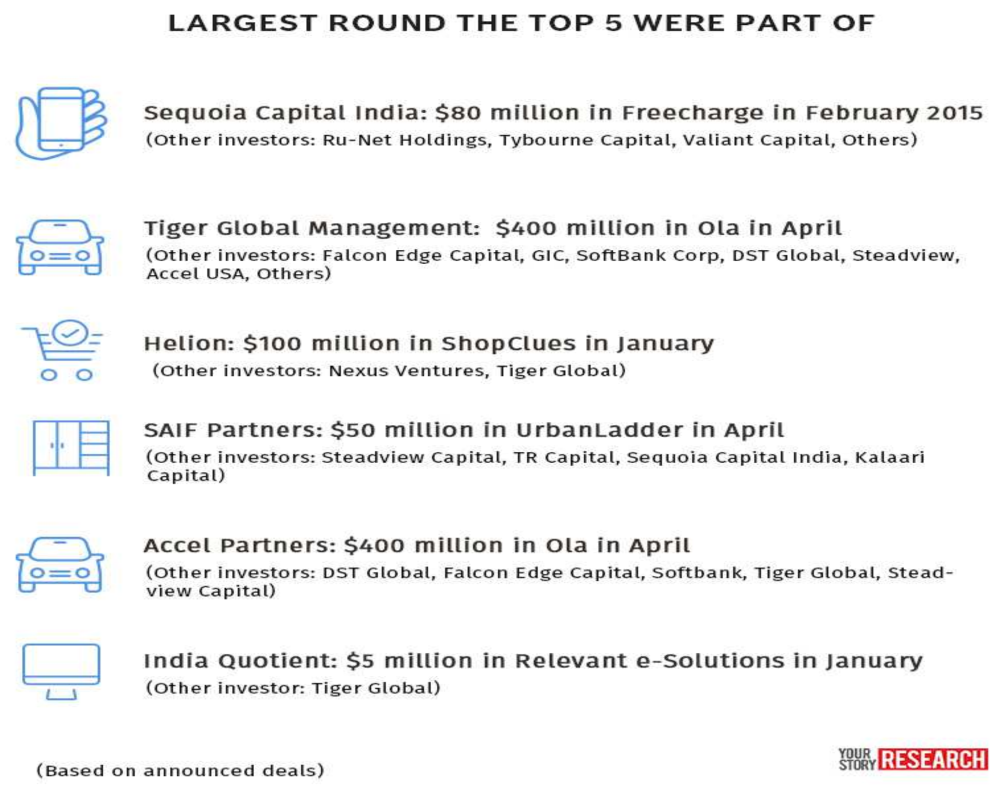
Venture capitalism in India began in 1986 with the start of the economic liberalisation. In 1988, the organised venture capital industry came into being with the setting up of funds by IFCI, ICICI & UTI. Over the years, more and more investors from India and abroad, have started investing in Indian startups.

In the early stages, venture capital investments were mainly in the technology sector. However, with changing trends and advent of smartphones, companies in consumer services and consumer retail space emerged as top contenders for VC funding, attracting almost 50% of total VC investments. Other key industries included IT and IT-related services, software development, telecommunications, electronics, biotechnology and pharmaceuticals, banking and finance/insurance, public sector disinvestment, media and entertainment, and education.

2015 was year of all time high in Venture Capital Investments in India. Between January and December 2015, risk capital worth $9 billion was invested in Indian startups across 1,005 plus deals where deal value was announced. Between 2010 and 2015, Indian startups raised $18 billion. In contrast in 2014, total deal value stood at about $5 billion and volumes at over 300 deals. Majority of the deals were in online and mobile categories. Firms like Flipkart, Snapdeal, Ola, Paytm, Quikr, Zomato raised about $3billion in 2015. The top sectors are ecommerce, Food and beverages, app based cab services, mobile advertising and online classifieds.

The top investors between January and June 2015 are:

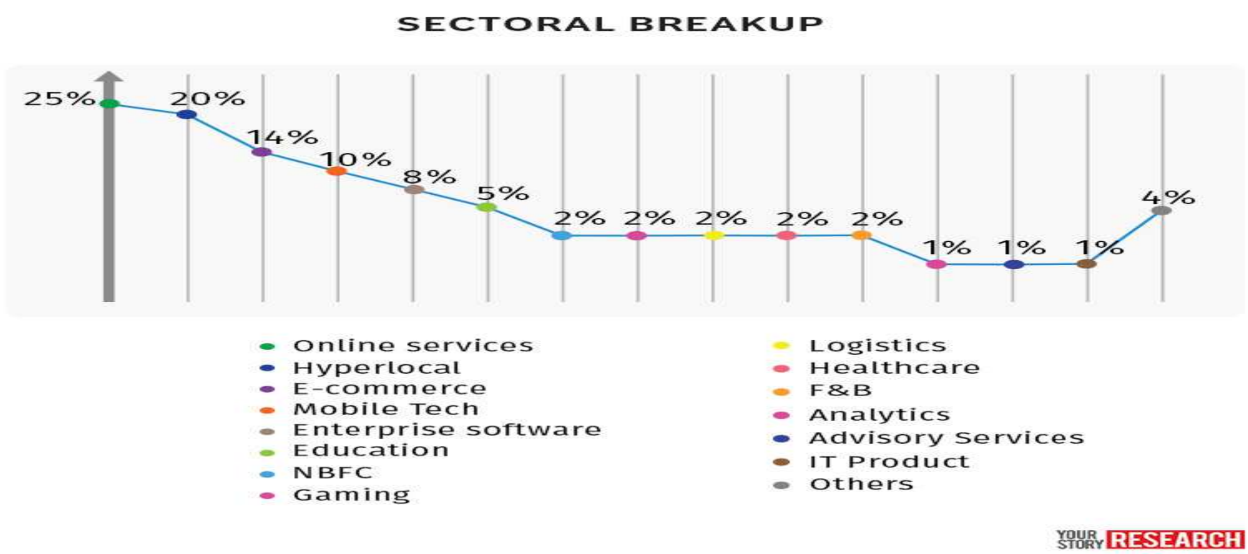
**FIGURE 1: TOP 5 INVESTORS OF 2015**




Source: yourstory/research

The sectoral composition is as follows:

**FIGURE 2: SECTORAL BREAKUP OF INVESTMENTS IN 2015**




Source: yourstory/research

**India Shining**

The rise in the deals can be contributed to strong economic fundamentals, business friendly policy regime and hard working Indian founders having strong technical capabilities. The increased availability of Angel Investors who were earlier entrepreneurs themselves are also contributing to the growth of entrepreneurial talent. Moreover, increased disposable incomes of the youth are driving up consumer demand. Mobile sector continues to be the most attractive segment for investment has an ever expanding base of mobile phone users.

**Startup Trends -2016**

Venture Capital Investments have dropped sharply in the first quarter of 2016 to 90 as compared to 138 in the same period in 2015 according to data from risk capital data monitoring service VCCEdge. This is due to the fact that 2015 was a year of all time high with bonanza deals and huge rounds of financing. The deal surge for Indian startups began inhuge 2014, after e-commerce firm Flipkart raised a mammoth $1 billion in July 2014.

Investors such as Japan's Soft Bank which benefited handsomely from the Alibaba IPO, targeted Indian for spending on promising young entrepreneurs. With the valuation of Flipkart being brought down by Moody's many investors have turned cautious.

## VIII. CHALLENGES FACED BY VENTURE CAPITALISTS IN INDIA

The biggest challenge facing Venture Capitalists in India is exit. The exits have been slow and return percentages have been lower as per the data from India venture Capital and Private Equity Report 2015. Data from Venture Intelligence on exits shows Deal value in the manufacturing sector slipped 28 per cent y-o-y in 2015, compared with the average growth rate of 10 per cent in the last decade. There were 229 exits in 2015, with manufacturing and BFSI topping the list with

34 exits each. One reason for poor exit performance is lack of secondary funds that buy out private investors. Also exit through IPOs have been poor. Listing requirements such as profitable track record, desired valuation and corporate governance norms make it difficult for start ups to go public and for venture capitalists to cash out their investments. There are also valuation concerns and those who are able to exit have to do so on lower valuations. Also as per the VCI, good deal flow is also a challenge. For every one deal, investors have to go through close to 300-400 deals.

## IX. CONCLUSION: THE WAY AHEAD

India has one of the most attractive ecosystems in the world. The internet sector, for example, has seen large number of exits rewarding investors, albeit lingering concerns over lack of profits. Also, late-stage investors such as PE funds have averaged returns of 6 per cent (2002 to 2015). The number of mobile phone users in India is increasing exponentially which is a viable opportunity for Venture Capital Investors. However, viable exit options and valuation concerns are dampening new investors. Unless the Venture Capitalists are ready to stay for a long time and nurture the undertakings, they may have to deal with lower returns in the short run. Regulatory regime for the start ups has been relaxed with the Start Up India Campaign launched by Prime Minister Modi. Compliance based on self-certification, patent protection, tax holiday and single point start up ecosystem are the key features of this scheme. As the policy regime simplifies, the Venture Capital Industry in India has become more lucrative. Though in the first quarter of 2016, deals have slowed down as compared to last year, industry experts have categorised it as the new normal. With a consistent growth in GDP and strong economic fundamentals, India remains one of the most attractive destinations for Venture Capitals, both domestic and Foreign.

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