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Venture Capital in India Today: An Ideal Overture for a Novel Capitalist

RAJESH KUMAR NIGAH
Faculty: Accountancy and Finance
Academy of Commerce
Satyaniketan, Dhoulakuan,
New Delhi (India)

Abstract:
Invariably any project or product that is technically convincing, globally competitive with a promising future needs sumptuous funds to take off the ground. These funds get deployed as equity capital and debt through debentures. Often such funds flow from venture capitalists who draw these investments from a pool of money raised from public and private stakeholders. The mechanism of Venture Capital funding varies across different stages of growth of a project and helps the enterprise in the long-run. The magnificent growth of South East Asian economies especially Hongkong, Singapore, South Korea, Malaysia along with India has been due to the large pool of Venture Capital funds from domestic / offshore arenas during the past two decades. Venture capital is an investment in the form of shares or a later stock option in potentially high-risk businesses. The beneficiary companies are usually small or medium-sized firms, requiring seed or early-stage funding for innovation and development of technology or products with high growth potential. High annual returns ranging from 25-75% are expected on such investments. The paper attempts to throw few insights on the positive side of the coin to venture out an investment in this era of growth and prosperity.

Keywords: *Equity Shares, Long-term Debt, Risk-return offset, Venture Capital*

1. Premise: The Changing Landscape

Promises and challenges galore for the Investors in India both from within and outside the country during the first quarter of Modi Era: The Indian government aims to target its budget for 2014-15 on the budding NRIs and HNIs other than FDI and FIIs. This gives a clear indication on the investor-friendly approach with a slew of provisions and funds earmarked for start-ups in India. Also, a start-up fund worth Rs 10,000 crore is being mulled by the government. According to the official sources it will be "equity, quasi-equity, soft loan and other risk capital for start-ups." This is encouraging news although angel investors and venture capitalists (VCs) have kept the start-up ecosystem thriving in India till date.

Venture capital can be injected in different stages of a business lifecycle:

- Incubation stage as 'seed capital' to convert an idea into a commercially viable venture
- 'Start-up capital' to take off the venture based on feasibility studies and DTP report to commence operations and production
- Additional capital to meet the long-term asset formation
- Boost-up capital to facilitate rapid expansion of an established company

Venture capital gives both short-term as well as a long-term investment options based on the project need and allows the investors to be flexible on their options. Usually the effective utilization of venture capital in one or other stages of a project could trigger market growth and also help attract more investors.

2. Venture capital in India: scope and significance

Ever since the introduction of 'venture capitalism' in India during the early '80s, signaled for a startup of the economic liberalization soon. Initially it was being restricted to IDBI, ICICI and IFC subsidiaries to get accepted and in the later part of the decade a special set of guidelines got issued to make it versatile in other sectors. But the turning point came when the well-established start-ups by Indians in the Silicon Valley convinced foreign investors that India had the talent and the scope for economic development and growth. Over the years, more and more private investors from India and abroad have entered the Indian venture capital market.

Conventionally the investments were mostly into manufacturing sector leaving little space for the service industry. As a breakthrough phenomenon, LPG shifted the focus to services sector and more towards growth oriented retail space as one of the top beneficiaries of 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. In the post liberalization era, some of the untouched segments started getting the attention of venture capitalists such as Agriculture, Fishing, Poultry farming etc., and perhaps they stand out to be better options in the near future to safeguard the interests of changing global scenario. This has been fuelled by the realization that food security is a vital, long-term necessity. Studies suggest that in future, for every Rs 100 increase in GDP, Rs 41 will be spent on food. At the recently held Global AgInvesting Conference, data released indicated that agro businesses would provide better returns of about 11%, compared to 3-5% yield from bonds and equities. Agriculture could well become the new Mecca for venture capital investments. Leading VC firms such as Venture Dairy, Anterra Capital (a spin-off of Rabobank's proprietary venture capital investment team), SAEF (Small Assistance Enterprise Funds) and Rabo Equity Advisors' India Agribusiness Fund have already entered this market.

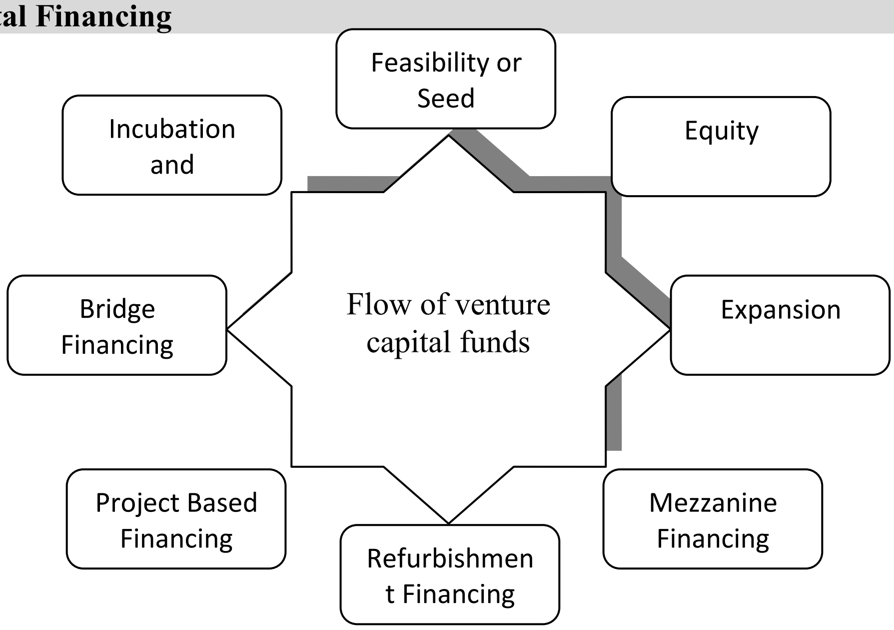
3. Promoting VC funding in India

Since 1988, ICICI has played a prominent role in promoting venture capital investments in India and currently manages funds over $2 billion. In fact, India recorded a 13% increase in the amount invested against the global rise of 2%. At $45.8 million, India posted an all-time-high median value at the profitable stage in 2013, the highest value ever seen in any market across all of the development stages since 2007. Early-stage funding has gone down and more funds have been diverted to later, more profitable stages or spread out in multilevel funding, indicating that investors are cautious about high risks. However, top players such as Sequoia Capital, Rabobank, Google Venture, Seed Venture Fund and World Bank's IFC are investing in India. IFC is the leading investor here, with $1.4 billion. Most VC investors, both local and global, have leveraged the Mauritius Treaty route to invest in India because tax is only payable in the country of the investor's residence. The SEBI (Securities and Exchange Board of India) can work towards further simplifying the investment procedures and offer attractive IPO and M&A exit ratios. However, the crucial challenge will be the development of responsible financial and management skills in the invested companies, and understanding the local conditions by foreign investors. A positive factor is that India has a large pool of English-speaking, trained and skilled manpower. Another trigger to invest in India is that both China and India are the top two growing global economies. The new pro-business Indian government has also inspired confidence and foreign investment worth Rs 17,000 crore has already been made. Thus the prospects are quite promising and rosy for the growth of venture capital in the next decade to come i.e. by 2050. Venture Capital is money provided by professionals who invest and manage rapidly growing companies that have the potential to contribute significantly to an economy. 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 could be an individual or a group of individuals or a company that provides investments in the form of capital, renders expertise, helps build network and marketing support while funding and operating innovative as well as prospective domains of goods and services.

Thus, the investments made by Venture Capitalists generally involves..

- Innovative project financing, rapidly growing companies;
- Investing in long-term equities;
- High risk-return tradeoffs;
- Moves along with core management team in drawing strategies
- Networking and marketing of the product /service being offered.

4. Venture Capital Financing



Indeed feasibility studies need small amount of capital to comprehend the market potential of an idea to get turned into prospective business. This is usually a kind of testing capital and invested during the initial phase of market research. Even when the company grows big, some funds get catered towards such R and D activities, and thus always there making it realize an entrepreneur about seed financing. Other most notable facets where finances are tapped would include product development, market penetration, advertising, warehousing inventory, working capital, and other short term commitments. Increase in scale would result into economies as well as diseconomies. To derive the benefits of economies and discount the diseconomies of expanding scale, optimum funds are to be parked in each segment of the scale so changed. Other intermittent financial needs may be to ensure the flow of market demand and cope with the competition, bridge financing or mezzanine financing may be ideally opted.

5. Management

Experienced and exposed management team with good credentials only would indisputably invite handsome investments for their forthcoming projects and expansion plans. Senior management team with proven capabilities can without wonder shoulder high-risk ventures and found dependable on the part of investors.

6. Potential for Capital Gain

An ROI above normal range (30 - 40%) is required to attract investments from the venture capitalists. However, the ROI depends on the stage of the business cycle where funds are being deployed. Usually if the funds are invited between growth and maturity stage, it will be idealistic from both the perspectives, and rarely the investors will be flinging towards post-maturity stage of a product life-cycle.

7. Realistic Financial Requirement and Projections

Always the prospective investors will eye for a good forecast based on the present financial and performance inklings that will draw in to pump required funds for the projected portfolios. This puts the board members on their toes to reveal realistic and more pragmatic future of the business avoiding cosmetic surgery over the financial snap of a company.

8. Owner's Financial Stake

The higher the stake of the owner in his own business the higher he could call for the investments from outside as he will have a better say. Secondly, the investors will always cast and relate the owners' interest in the business vis-à-vis the owner's equity and thus proportionately support the company in any of his capital decisions. It would be a rare commodity to get venture capitalists attracted having least equity from the owner's coffers.

8. Problems of Venture Capital Financing

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:

- Requirement of an experienced management team.
- Requirement of an above average rate of return on investment.
- Longer payback period.
- Uncertainty regarding the success of the product in the market.
- Questions regarding the infrastructure details of production like plant location, accessibility, relationship with the suppliers and creditors, transportation facilities, labour availability etc.
- The category of potential customers and hence the packaging and pricing details of the product.
- The size of the market.
- Major competitors and their market share.
- Skills and Training required and the cost of training.
- 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.

9. Prospects of Venture Capital Financing

With the advent of liberalization, India has been showing remarkable growth in the economy in the past two and half decades. The government is promoting growth in capacity utilization of available and acquired resources and hence entrepreneurship development, by liberalizing norms regarding venture 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 Paradesh, 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 & 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 million. The company would be creating and marketing branded web based consumer products in the near future.

The following points can be considered as the forerunner of VC financing in India:-

- Existence of a globally competitive high technology.
- Globally competitive human resource capital.
- Second Largest English speaking, scientific & technical manpower in the world.
- Vast pool of existing and ongoing scientific and technical research carried by large number of research laboratories.
- Initiatives taken by the Government in formulating policies to encourage investors and entrepreneurs.
- Initiatives of the SEBI to develop a strong and vibrant capital market giving the adequate liquidity and flexibility for investors for entry and exit.

10. The Final Outlook

A war against ‘quality and cost’ got triggered globally. Companies are required to be highly efficient vis-à-vis cost, productivity, labour, technology, etc., and meeting the consumer needs with an 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 has been constantly attempting to promote venture capital financing to new, innovative concepts and ideas, by providing incentives and subsidies viz., tax holidays, cost subsidies, etc., thereby giving a boost to create an encouraging environment for the emerging VC investors. There are large sectors of the economy that are ripe for VC investors, viz., I.T., Pharmaceuticals, Manufacturing. Telecom, Retail franchises, food processing. The India Inc is moving beyond this burgeoning VC business in the wake of transforming young India with awesome infrastructure growth.

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