An analysis on strategic opportunities and critical challenges of venture capital in India

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Abstract

Giving a kick start to start-ups . that's what a venture capital company dose. Venture capital is a method of financing that investors provide to start up companies and small businesses that are believed to have long-term growth potential. In india icici started venture capital in the year 1988 with UTI

The venture capital industry formally started in the mid-80s but did not really take off till the mid-90s. The industry witnessed a peak during 2000 when the IT industry was booming and the economy looked stable. Year 2017 so far has seen 435 angel and seed transactions, translating to about $244.6 million (Rs 1,627.26 crore) .Despite this growth venture capital funding face lot of challenges . In this paper researcher attempts to analyse challenges and opportunities of venture capital in India.

Key words: *Venture capital,venture capilist,seed capital*

Introduction

Start up companies with a potential to grow need a certain amount of investment. Wealthy investors like to invest their capital in such businesses with a long-term growth perspective. This capital is known as venture capital and the investors are called venture capitalists Such investments are risky as they are liquid, but are capable of giving impressive returns if invested in the right venture. The returns to the venture capitalists depend upon the growth of the company. Venture capitalists have the power to influence major decisions of the companies they are investing in as it is their money at stake.

Venture capital is a method of financing that investors provide to start up companies and small businesses that are believed to have long-term growth potential. A venture capitalist is a person who invests in a business venture, providing capital for start-up or expansion. However, individual venture capitalists are a rarity; the majority of venture capital (VC) comes from professionally-managed public or private firms. Their business is to pool investment funds and find and invest in businesses that are going to provide their investors high rates of return.

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Venture capital process

Venture capital (VC) firms invest in private companies in exchange for equity (or part ownership of the business), VC firms invest in a company if they see a convincing opportunity. Company will scrutinize and analyze factors including the strength of the company's management team, how large and how attractive the market size is, whether the company possesses a unique technical advantage, the financial health of the business.

The decision making process starts with deal origination where they will get into may deals from various sources. Next VC's will scrutinises all the projects in which he could invest. The projects are categorised under certain criterion such as market scope, technology or product, size of investment, geographical location, stage of financing etc. For the process of screening the entrepreneurs are asked to either provide a brief profile of their venture or invited for face-to-face discussion for seeking certain clarifications. The proposal is evaluated after the screening and a detailed study is done. After the venture capitalist finds the project beneficial he gets into deal negotiation. Deal negotiation is a process by which the terms and conditions of the deal are so formulated so as to make it mutually beneficial. The both the parties put forward their demands and a way in between is sought to settle the demands. Some of the factors which are negotiated are amount of investment, percentage of profit held by both the parties, rights of the venture capitalist and entrepreneur etc. Once the deal is finalised, the venture capitalist becomes a part of the venture and takes up certain rights and duties. The capitalist does not take part in the day to day procedures of the firm; it only becomes involved during the situation of financial risk. The venture capitalists participate in the enterprise by a representation in the Board of Directors and ensure that the enterprise is acting as per the plan. The last stage of venture capital investment is to make the exit plan based on the nature of investment, extent and type of financial stake etc. The exit plan is made to make minimal losses and maximum profits. The venture capitalist may exit through IPOs, acquisition by another company, purchase of the venture capitalists share by the promoter or an outsider.

Venture Capitilist Financing Methods

In indiaVenture capital financing takes place in three forms: equity, conditional loans and income notes.

Equity

Venture capital companies in India provide fund through equity which may not exceed 49 per cent of the total equity capital. Thus, the effective control and majority ownership of the firm may remain with the entrepreneur. VCFs buy shares of an enterprise with an intention to ultimately sell them off to make capital gains. The advantage of the equity financing for the company seeking venture finance is that it does not have the burden of serving the capital, as dividends will not be paid if the company has no cash flows. The advantage to the VCF is that it can share in the high value of the venture and makes capital gains if the venture succeeds. But the other side is that the VCF will lose if the venture is unsuccessful. Venture financing is a risky business.

Conditional loan

A conditional loan is lumpsum amount given to the company which is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans in India, VCFs charged royalty ranging between 2 and 15 per cent gestation period, cost-flow patterns, risk and other factors of the enterprise. Some VCFs gave a choice to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially sound. Some funds recovered only half of the loan if the venture failed.

Income note

A unique way of venture financing in India was income note. It was a hybrid security which combined the features of both conventional loan and conditional loan. The entrepreneur had to pay both interest on royalty on sales, but at substantially low rates. Some venture funds provided funding equal to about 80 percent of a project's cost for commercial application of indigenous technology adapting imported technology to wider domestic applications. Funds were made available in the form of unsecured loans at a lower rate of interest during development phase and at a higher rate after development. In addition to interest charges, royalty on sales could also be charged.

Other financing methods

A few venture capitalists, particularly in the private sector introduced innovative financial securities. The participating debenture; is an example of innovative venture financial. Such security carries charges in three phases: in the start-up phase, before the venture attains operations to a minimum level, no interest is charged. After this, a low rate of interest is charged up to a particular level of operation. Once the venture starts operating on full commercial basis, a high rate of interest is required to be paid. A variation could be in terms of paying a certain share of the post-tax profits of royalty.

VCFs in India provide venture finance through partially or fully convertible debentures and cumulative convertible preference share (CPP). CPP could be particularly attractive in the Indian context since CPP shareholders do not have a right to vote.

Benefits and ill effects of venture capital

The key factor for growth of venture capital is that its all about sharing the risk in starting the business. An entrepreneur who want to start a business will definitely opt for venture capital as a easy source of money

The autonomy and control of the founder is lost as the investor becomes a part owner.The process is lengthy and complex as it involves a lot of riskThe object and profit return capacity of the investment is uncertain.The investments made based on long term goals thus the profits are returned late. Although the investment is time taking and uncertain, the wealth and expertise it brings to the investor is huge.The sum of equity finance that can be provided is huge. The entrepreneur is at a safer position as the business does not run on the obligation to repay money as the investor is well aware of the uncertainty of the project

Venture capital fund managers, venture capitalists or VCs, for short, are financial intermediaries who use their reputation, knowledge capital and network to source and evaluate risky, yet attractive investment opportunities, fund them and turn them into great businesses.And are expected to have the ability to deal with the risk inherent in investing in Absent such professional fund managers, entrepreneurs with high potential would be starved of funds. Equally, investors would be denied the opportunity to participate in those high-risk, high-reward enterprises

Venture capital in India

The idea of venture capital financing was adopted at the initiation of central government and government – sponsored institutions. The need for venture capital financing was first highlighted in 1972 by the Committee on Development of small and medium entrepreneurs under the chairmanship of R.S. Bhatt (popularly known as the Bhatt Committee) which drew attention to the problems of new entrepreneurs and technologists in setting up industries. In 1975 venture capital financing was introduced in India by the all-India financial institutions with the inauguration of Risk Capital Foundation (RCF) sponsored by Industrial Finance Corporation of India (IFCI) to supplement 'promoters' equity with a view to encouraging technologists and professionals to promote new industries.81 In 1976 the seed capital scheme was introduced by Industrial Development Bank of India (IDBI).ICICI was 1st private institution who provided venture finance with UTI in the year 1988.

Growth of venture capital India

Year	Milestones
1973	Central government set up Committee on Development of small and medium entrepreneurs under the chairmanship of R.S. Bhatt
1975	IFCL sets up risk capital foundation to make capital available to enterprise for green field projects
1976	IDBI introduced seed capital scheme
1986	Union budget fiscal 1987 proposes creation of venture capital fund to promote indigenous technology
1988	Icici and uti launched first venture capital fund through joint venture called TDICI
1995	Government issued guidelines to enable foreign venture capital to invest ndia
1996	SEBI frames venture capital regulations
1999	Few Indian based venture capital companies started
2000	IT boom in the market. Sebi launches foreign venture capital regulations
2001	Recession in IT sector .. sif in investment in BPO's
2004	India starting emerging as destination of outsourcing noncore R&D work.

Source :Author

Over the last 10 years, venture capitalists have played a central role in shaping India's start-up ecosystem and ushering in a decade of innovation and disruption. Early 2006 was when it all came together in India for venture capital firms. The economy was on a roll (and would be for a few more years). Some of the early movers in the space had started prospecting the lay of the land in 2003. In 2006, almost every large venture capital firm active in India launched their operations in a serious way.

Today, Indian e-commerce firms, such as Flipkart Online Services Pvt. Ltd and Snapdeal, taxi services aggregator Ola and big data analytics company Mu Sigma Inc. rank among the world's most valuable start-ups.

Their journeys from garage start-ups to the mythical valuations they command now—each is valued at billions of dollars—wouldn't have been possible without the support of risk capital.

Snapshot of VC deals from 2006-2015

	No. of deals	Deals value ($mn)
2006	141	718
2007	178	933
2008	205	1,099
2009	161	880
2010	177	946
2011	261	1,425
2012	228	1,136
2013	251	1,531
2014	308	2,395
2015	368	4,415
TOTAL	2,278	15,478

Since 2006, venture capitalists have been involved in deals worth more than $15 billion across more than 2,000 start-ups, according to data compiled by VCC Edge, an online research platform.

A large chunk of this capital has come from later-stage investors such as hedge funds, strategic corporate investors and mutual funds, but venture capitalists have been the catalysts for bringing in this late-stage capital. India is now home to more than 3,000 technology start-ups, around 800 new ones are born every year, and eight of the world's 140-odd start-ups valued at over $1 billion are from here.

List of leading Venture capitalist in India

Venture capilist	Companies funded
helion venture partners	Yepme, MakemyTrip, NetAmbit, Komli, TAXI For Sure, PubMatic.
ACCEL PARTNERS	: Flipkart, BabyOye, Freshdesk, Book My Show, Zansaar,Probe, Myntra, CommonFloor

BLUME VENTURES	Carbon Clean Solutions, EKI Communications, Audio Compass, Exotel, Printo.
SEQUOIA	JustDial, Knowlarity, Practo, iYogi, bankbazaar.com
NEXUS VENTURE PARTNERS	Snapdeal, Housing, Komli, ScaleArc, PubMatic,Delhivery.
IDG Ventures India	UNBXD, Yatra.com, Myntra.com. FirstCry, Zivame,iProf, Ozone Media
FIDELITY GROWTH PARTNERS INDIA	Netmagic, Yebhi
SAIFPartners	Justdial.com, Paytm, Network18, HomeShop18, Book My Show.
ForumSynergies	Zomato, Ola, Quikr, TaxiForSure, Commonfloor, Freecharge, Housing
kalaari capital	Mettl, UrbanLadder, Snapdeal, Zivame
Venture East We differentiate	: Little Eye Labs, Goli Vada Pav, Portea, 24 Mantra, Seclore.
WARBURG PINCUS	Lemon Tree, Biba, Quikr

Source;Author

Current scenarios

Total funding in the year 2014 was approximately $5which had a steep growth to$ 7.5in 2015. But in drastically plugned to $4 in 2016. But 2017 began with a bang and have created new hopes for the Indian startup ecosystem.

According to Inc42 Datalabs, over $5.56 Bn was invested across 452 Indian tech startups during the period January-June 2017. While in Q1 2017 about $1.46 Bn was invested across 206 startups, Q2 witnessed 217 deals amounting to $4.1 Bn in funding. Interestingly, in Q2 2017, most of the amount was contributed by Flipkart's $1.4 Bn funding in the month of April and Paytm's $1.4 Bn round led by Softbank Group in May.

2017 has also been considered as the year of M&As. While the Flipkart-Snapdeal merger is yet to take place, about 71 other M&As took place this year during H1 2017. Headliners include eBay selling its India business to Flipkart, Housing getting acquired by PropTiger among others.

The year also witnessed the launch of several new funds, VCs raising India-specific funds, and the Department of Industrial Policy and Promotion (DIPP) asking the Finance Ministry to release an additional $247.7 Mn under the Fund of Funds for startups (FFS) in FY ‘17-18. All in all, with different firms, organisations, and individuals coming to support startups financially; startup funding activity in India is expected to witness a significant spike.

Critical Challenges

Lack of buyers

For the past several months, more than a few venture capital portfolios in India have been up for sale and at steep discounts.The problem is that there aren’t many buyers out there for those portfolios. Most of the portfolios on sale is imitator investments which lack innovation to penetrate in the market.

Change in Investor Mindset

Capital gains have become a primary goal instead of being considered as a reward for a constructive task well done.Manufacturing capital gains seems to be of more importance than manufacturing products.

Economic and political risks

Uncertainties in government after 2019, changes in regulation and tax structure bearish trend in global market, ,international cold war between nations

Strategic opportunities ahead

Indian government has unveiled a new consolidated foreign direct investment policy framework comprises provisions specific to startups for the first time, a sector that is top on the government's agenda. The 2017 FDI policy circular has a separate section on startups and spells out provisions that allow them to raise foreign money from venture capital funds and other investors through instruments such as convertible notes.

According to the document released by the Department of Industrial Policy and Promotion (DIPP), startups can raise up to 100% of funds from Foreign Venture Capital Investors (FVCIs). They can issue equity or equity-linked instruments or debt instruments to FVCIs against the receipt of foreign remittance.The Indian government had recently relaxed rules for VCs getting funds from fund of funds, allowing them to invest a part of the corpus in firms other than startups. The government hopes this will encourage more VC funds to invest in

Indian startups. Non-resident Indians can also acquire convertible notes on a non-repatriation basis. following sectors are going to emerge and capture the Indian market in coming year

Consumer tech will make a comeback

. Startups in entertainment, personal finance, consumer brands, and education especially will be favoured by investors. With increasing accessibility of the mobile internet, it has never been easier for companies to reach end customers. Though with the slowdown in the Indian economy, consumption sectors like e-commerce, travel will see limited growth. Startups focusing on engagement will see better adoption.

Possibility of early-stage VC activity in India

In 2017, there was a launch of more than 20 new VC funds in India, and many existing VC funds raised large new funds. Indian VC funds have raised in excess of $4 billionin the past two years, but new investments by these firms have decreased by more than 30 percent since 2016. Next year will see increased early-stage investing by these firms, with 2019 seeing a new peak in terms of deal activity. India has also seen an increase in micro VC funds, largely in line with global trend

Growth in **Enterprise tech (B2B) will**

Enterprise tech, which was in favour in 2017, will continue to receive investor interest in 2018. As per a recent Nasscom-Zinnov report, the average funding for B2B startups in 2017 saw an increase of five percent, while B2C average funding saw a decline of 10 percent. Enterprise tech also suits micro VC funds, given that it is more capital-efficient and exits are possible on a smaller scale.

Deep tech sector will see a leader emerge

There has been increased activity in deep tech investments in India recently. India's advantages of a large software workforce and availability of large data sets, 2018 will see a upward swing in the sectors of logistics, retail, marketing and fintech.

Healthtech will see turbulent investing activity

With the global population ageing rapidly, and with the promise of using artificial intelligence (AI) to reduce healthcare costs, there is a massive opportunity for startups to disrupt healthcare.

India is also uniquely placed given that it has a more readily available large labelled dataset that startups can use to train their algorithms.

AI going to take lead in market

Artificial Narrow Intelligence (ANI) has proven to be very effective in automating processes and creating real-world impact in 2017. In 2018, if a startup does not leverage AI in its products it will be tough for it to raise capital. Software as a Service (SaaS) companies are especially at risk if they don't adopt AI. AI also helps startups build significant sustainable moats and M&A activity by non-tech companies for AI talent will create a talent war. Indian government will allocate massive budgets to improve AI capability in the country.

Overall, 2018 promises to be the year that the VC industry finds its feet. The industry has a healthy mix of portfolio diversification with consumer, enterprise, deep tech startups finding favour. The rise of sector-specific micro VCs augers well for the industry and will bring in fresh ideas.

Findings and suggestions

Venture capital investment are basically a legal contracts that essentially allocate risk, return, and ownership rights between the entrepreneur and the investing venture capital fund. The venture capital financing is easy and quick method of finance for and entrepreneur but face lot of problems of uncertainty, information asymmetry and agency costs. Lack of innovation in the projects is major hindrance in growth of venture capital in india. Duplicate and copycat investments makes the market reductant

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

- Venture capitalist companies should focus on the new technology.
- Government can provide fiscal incentives to the entrepreneur as well as venture capitalist
- Promotional efforts, through exhibitions ,fairs , venture clubs and venture networks will also support the growthof venture capital.
- Training and development programs will help to groom to the venture capital
- Connecting the concepts to academics through will also help the starts up financing to Universities should be linked with universities so that new useful ideas can be transformed into realistic shape.

Conclusion

In India, the venture capital plays a vital role in the development and growth of innovative entrepreneurs. Venture capital activities were primarily done by only a few institutions to promote entities in the private sector with funding for their business. The need on venture capitals was recognised in the 7th five year plan and long term fiscal policy of the government of India. The venture capital industry formally started in the mid-80sin India but did not really take off till the mid-90s. The industry witnessed a peak during 2000 when the IT industry was booming and the economy looked stable. There are many challenges for the venture capital financing India. This year -2017 so far has seen 435 angel and seed transactions, translating to about $244.6 million (Rs 1,627.26 crore. Overall, 2018 promises to be the year that the VC industry finds its feet. The industry has a healthy mix of portfolio diversification with consumer, enterprise, deep tech startups finding favour. The rise of sector-specific micro VCs augers well for the industry and will bring in fresh ideas.

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