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VENTURE CAPITAL & ITS IMPORTANCE IN INDIAN CONTEXT

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ABSTRACT

Venture Capital has emerged as a new financial method of financing during the 20th century. Venture capital is the capital provided by firms of professionals who invest alongside management in young, rapidly growing or changing companies that have the potential for high growth. Venture capital is a form of equity financing especially designed for funding high risk and high reward projects. Venture capital can be visualized as “your ideas and our money” concept of developing business. The venture capital industry in India has really taken off in. Venture capitalists not only provide monetary resources but also help the entrepreneur with guidance in formalizing his ideas into a viable business venture. In order to promote innovation, enterprise and conversion of scientific technology and knowledge based ideas into commercial production, it is very important to promote venture capital activity in India. India’s success story in the area of information technology has shown that there is a tremendous potential for growth of knowledge based industries. The recent economic slowdown of IT Sector is provided a chance to Venture capitalist to consider investment opportunities in other sectors such as Manufacturing and Service Industry which will be necessary to have overall economic development and to reduce the economic dependency on a single sector.

Keywords – Venture capital , Finance, Investment , Business .

Venture capital can be visualized as ‘your ideas and our money’ concept of developing business. Venture capitalists are people who pool financial resources from high net worth individuals, corporate, pension funds, insurance companies, etc. to invest in high risk- high return ventures that are unable to mobilize funds from regular channels like banks and capital markets. The Venture capital industry in India has really taken off recently. Venture capitalists not only provide monetary resources but also help the entrepreneur with guidance in formalizing his ideas into a viable business venture. With technology and knowledge based ideas set to drive the global economy in the coming millennium, and given the inherent strength by way of its human capital, technical skills, cost competitive workforce, research and entrepreneurship, India can unleash a revolution of wealth creation and rapid economic growth in a sustainable manner, However, this to happen, there is a need for risk finance and Venture capital environment which can leverage innovation, promote technology and harness knowledge based ideas.

The venture capital industry in India is still at a nascent stage. With a view to promote innovation, enterprise and conversion of scientific technology and knowledge –based ideas into commercial production, it is very important to promote venture capital activity in India. India’s recent success story in the area of information technology has shown that there is a tremendous potential for growth of knowledge-based industries. This potential is not only confined to information technology but is equally relevant in several areas such as bio-technology, pharmaceuticals and drugs, agriculture, food processing, telecommunication, services and the like.

Given the inherent strength by way of its skilled and cost competitive manpower, technology, research and entrepreneurship, with proper environment and policy support, India can achieve rapid economic growth and competitive global strength in a sustainable manner. A flourishing venture capital industry in India will fill the gap between the capital requirements of technology and knowledge-based startup enterprises, and funding available from traditional institutional lenders such as banks. The gap exists because such startups are necessarily based on intangible assets such as human capital and on a technology-enabled mission, often with the hope of changing the world.



The Indian Government's objective to encourage the commercialization of new technologies, the backward integration of existing technologies, and the domestic production of foreign technologies called for thinking in terms of financing a company's growth, rather than a particular project. In many technology-intensive sectors, capital is required to pay for the development of the product, to study the market and establish distribution networks. These frontended working capital requirements cannot be readily accommodated by the development banks or the commercial banks, but are critical to the growth of the companies involved. Thus the importance of venture capital as a means of financing technology related risk has been recognized in India only recently.

Recommendations made by K B Chandrasekhar Committee:

- (1) Multiplicity of regulations – need for harmonization and nodal Regulator
- (2) Double taxation for Venture Capital Funds need to be avoided
- (3) Mobilization of Global and Domestic resources
- (4) Flexibility in Investment and Exit of Venture Capitalists:
- (5) Flexibility in the matter of investment ceiling and sectoral restrictions:
- (6) Relaxation in IPO norms:
- (7) Issue of Shares with Differential Right with regard to voting and dividend:
- (8) Global integration and opportunities:
 - (A) Incentives for Employees:
 - (B) Incentives for Shareholders
- (C) Global investment opportunity for Domestic Venture Capital Funds (DVCF):
- (9) Development in Infrastructure and R&D
- (10) Self Regulatory Organization (SRO)

Implementation of these recommendations would lead to creation of an enabling regulatory and institutional environment to facilitate faster growth of venture capital industry in the country. Apart from increasing the domestic pool of venture capital, around US\$ 10 billion are expected to be brought in by offshore investors over 3/5 years on conservative estimates. This would in turn lead to increase in the value of products and services adding up to US\$100 billion to GDP by 2005. Venture supported enterprises would convert into

quality IPOs providing over all benefit and protection to the investors. Additionally, judging from the global experience, this will result into substantial and sustainable employment generation of around 3 million jobs in skilled sector alone over next five years. Spin off effect of such activity would create other support services and further employment. This can put India on a path of rapid economic growth and a position of strength in global economy.

In 2010, venture capitalists invested approximately \$22 billion into nearly 2,749 companies. Of these, 1,001 companies received funding for the first time. The average venture fund size was \$149 million. Venture capitalists have been instrumental in developing sectors such as the computer, biotechnology and the communications industries. Today, the majority of venture capital is invested in high technology companies including software, biotechnology, medical devices, media and entertainment, wireless communications, Internet, and networking. In the last five years, the venture industry has also committed itself to investing in the clean technology sectors which include renewable energy, environmental and sustainability technologies and power management. However, venture capitalists also invest in innovative companies within more traditional industries such as consumer products, manufacturing, financial services, and healthcare services and business products and services. Venture capital activity has a significant impact on the U.S and global economies.

Venture capital is a catalyst for job creation, innovation, technology advancement, international competitiveness and increased tax revenues. According to the 2011 Venture Impact study, produced by IHS Global Insight, originally venture-backed companies accounted for 11.87 million jobs and over \$3.1 trillion in revenue in the United States (based on 2010 data). Those totals compare to 21% of GDP and 11% of private sector employment. Venture capitalists are long-term investors who take a very active role in their portfolio companies and it does not yield return on their investment for 7-10 years, on average. The initial investment is just the beginning of a long relationship between the venture capitalist and entrepreneur. Venture capitalists provide great value by providing capital and management expertise. Venture capitalists often are invaluable in building strong management teams, managing rapid growth and facilitating strategic partnerships. Typically, the venture capitalist realizes a return on their investment when the company goes public (IPO) or is merged or purchased by another company (M&A).

The **Indian Private Equity and Venture Capital Association** was established in 1993 and is based in New Delhi, the capital of India. IVCA is a member based national organization that represents Venture capital and Private equity firms, promotes the industry within India and throughout the world and encourages investment in high growth companies. It enables the development of venture capital and private equity industry in India and to support entrepreneurial activity and innovation. The IVCA also serves as a powerful platform for investment funds to interact with each other. In 2006, the total amount of private equity and venture capital in India reached US\$7.5 billion across 299 deals. IVCA members comprise Venture capital firms, Institutional investors, Banks, Business incubators, Angel investor groups, Financial advisers, Accountants, Lawyers, Government bodies, Academic institutions and other service providers to the venture capital and private equity industry. Members represent most of the active venture capital and private equity firms in India. These firms provide capital for seed ventures, early stage companies, later stage expansion, and growth finance for management buy-ins/buy-outs of established companies. So far, the biggest member firm of IVCA is ICICI Ventures which currently has a \$750 million fund, and has \$450 million under management.

Five critical success factors have been identified for the growth of venture capital in India, namely:

- The regulatory, tax and legal environment should play an enabling role as internationally venture funds have evolved in an atmosphere of structural flexibility, fiscal neutrality and operational adaptability.
- Resource raising, investment, management and exit should be as simple and flexible as needed and driven by global trends.
- Venture capital should become an institutionalized industry that protects investors and invitee firms, operating in an environment suitable for raising the large amounts of risk capital needed and for spurring innovation through start-up firms in a wide range of high growth areas.
- In view of increasing global integration and mobility of capital it is important that Indian venture capital funds as well as venture finance enterprises are able to have global exposure and investment opportunities
- Infrastructure in the form of incubators and R&D need to be promoted using government support and private management as has successfully been done by countries such as the US, Israel and Taiwan. This is necessary for faster conversion of R&D and technological innovation into commercial products.

The hassle free entry of such Foreign Venture Capitalists in the pattern of FIIs is even more necessary because of the following factors:

- (i) Venture capital is a high risk area. In out of 10 projects, 8 either fail or yield negligible returns. It is therefore in the interest of the country that FVCIs bear such a risk.
- (ii) For venture capital activity, high capitalization of venture capital companies is essential to withstand the losses in 80% of the projects. In India, we do not have such strong companies.
- (iii) The FVCIs are also more experienced in providing the needed managerial expertise and other supports.

Venture capital at a take-off stage in India

The venture capital industry in India is still at a growing stage today and there are tremendous changes seen since 1993 when VCAI formulated. With a view to promote innovation, enterprise and conversion of scientific technology and knowledge based ideas into commercial production, it is very important to promote venture capital activity in India. India's recent success story in the area of information technology has shown that there is a tremendous potential for growth of knowledge based industries. This potential is not only confined to information technology but is equally relevant in several areas such as other sectors eg. Bio-technology, pharmaceuticals and drugs, agriculture, food processing, telecommunications, service industry, Information Technology etc. Given the inherent strength by way of its skilled and cost competitive manpower, technology, research and entrepreneurship, with proper environment and policy support, India can achieve rapid economic growth and competitive global strength in a sustainable manner.

A flourishing venture capital industry in India will fill the gap between the capital requirements of Manufacture and Service based startup enterprises and funding available from traditional institutional lenders such as banks. The gap exists because such startups are necessarily based on intangible assets such as human capital and on a technology-enabled mission, often with the hope of changing the world. Very often, they use technology developed in university and government research laboratories that would otherwise not be converted to commercial use. However, from the viewpoint of a traditional banker, they have neither physical assets nor a low-risk business plan. Not surprisingly, companies such as Apple, Hotmail and Yahoo, to mention a few of the many successful multinational venture-capital funded companies, initially failed to get capital as startups when they approached traditional lenders. However, they were able to obtain finance from independently managed venture capital funds that focus on equity or equity-linked investments in privately held, high-growth companies. Along with this finance came smart advice, hand-on management support and other skills that helped the entrepreneurial vision to be converted to marketable products.

A similar investor preference for start-up companies eg. IT companies is being seen, though not of the same magnitude. Yet, it is apparent that investors are willing to take higher risks for a potentially higher reward by investing in start-up companies.

Finally, exit options were considered to be few, with the general feeling that entrepreneurs were unwilling to sell their start-ups even if it was feasible. As a result, much of the risk capital available was not quickly deployed. However, since March 1999, things have been changing dramatically for the better in this concern.

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:

- (i) Requirement of an experienced management team.
- (ii) Requirement of an above average rate of return on investment.
- (iii) Longer payback period.
- (iv) Uncertainty regarding the success of the product in the market.

- (v) Questions regarding the infrastructure details of production like plant location, accessibility, relationship with the suppliers and creditors, transportation facilities, labour availability etc.
- (vi) The category of potential customers and hence the packaging and pricing details of the product.
- (vii) The size of the market.
- (viii) Major competitors and their market share.

The Indian venture capital (VC) industry has witnessed considerable turmoil in the last two years. Consider this: At least seven VC funds (VCFs) shut shop. Many others simply ran out of funds. A few set up high-cost Indian operations, with no funds raised or allocated for investment. The rest of the industry appears to be busy, 'restructuring' their investment focus, making very few new investments.

After a period of hectic investing, from 1998 to 2000, the Indian VC industry appears to be going through difficult times. This is a time for the industry to engage in some serious reflection. Managers in the industry may possibly disagree with me. They might argue that the developments in the Indian industry are a mere reflection of a larger global phenomenon. After all, have the American and European VC industries not slowed down? That comparison though, is inappropriate. The slow down and the poor performance of many funds in the Western world are part of a cyclical phenomenon. The Indian industry, on the contrary, faces issues of a fundamental nature. Let us examine three issues of concern.

First, there is a serious mismatch between the kind of venture capital available in India and what the market demands. Almost all venture capital funds in India have been targeting their capital at companies in the information technology, pharmaceuticals and some services industries, looking for expansion financing of Rs 15 crores or more. Now, this is a limited market segment. Most of the industries mentioned above are relatively young. There are very few firms in these sectors, seeking large amounts of capital for expansion financing. At the same time, a large number of aspiring entrepreneurs, start-ups, early-stage companies and Old Economy firms, which are fundamentally sound businesses, are unable to attract the venture capital financing that they badly need in order to grow. Apart from the relatively smaller amounts of funding that they seek, on average start-ups require considerable post-funding support from the investor to grow their businesses. That is painstaking work, for which Indian venture capital fund managers have demonstrated neither experience nor training nor temperament. Old Economy firms do not provide the quick or glamorous exits that venture capital funds often desire.

Second, most venture capital funds in India are an extended arm or a division of global investment institutions. International funds represent more than 95 per cent of the venture capital invested in India. Two consequences follow from this near-total dependence on foreign capital. One, the investment mandates of these venture capital funds are often driven by the parent institutions' global world view, which often ignores local market needs. The homogenous investment preferences of venture capital funds outlined earlier follow from the parent institutions' global investment strategies. Two, at a portfolio level, every international venture capital investor in India has been a victim of the depreciation of the rupee against the dollar. The returns produced by Indian VCFs, measured in US dollars or other Western currencies, turn out to be considerably less attractive than that measured in Indian currency. Many nations such as the Netherlands, Portugal, Finland, Norway and Israel recognized the limitations of depending on foreign funds at the time of evolving a policy for developing a local VC industry. Their first step was to kick start VCFs in the private sector with funds from domestic institutions. Over a decade, or even less, they succeeded in creating a local VC industry that depended less and less on government support and international investors.

The third issue is the poor quality of corporate governance and lack of sensitivity among entrepreneurs and investors, to each other's legitimate business aspirations. This is a universal problem and not unique to India. What is however unique to India is the hopeless system of legal redress of grievances when partners renege on contractual obligations. Often, aggrieved parties in India agree to settlements that are unfair to them, apprehending that litigation in Indian courts could be dysfunctional. This situation may not change in the foreseeable future. The alternative to litigation and unfair bad investments would be to invest more effort in better identification and selection of investments and supervision of the portfolio. Indian VCF managers need to ask themselves if they are prepared to put in that extra effort to minimize prospects for litigation in the first place.

Conclusion

The world is becoming increasingly competitive. Companies are required to be super efficient with respect to cost, productivity, labour efficiency, technical back up, flexibility to consumer demand, adaptability and foresightedness. As in India, small and medium-sized enterprises with active support from large industries (their customers) and government have turned manufacturing into an art form. To achieve this, these enterprises poured money into R&D and cut other expenses. The government supported them by loosening up the tightly regulated labor market. Large and small manufacturers found unique ways to cut labor costs by sometimes providing an employment guarantee for a fixed period as a quid-pro-quo for less pay. Instead of laying-off workers, managements deployed idled workers to new assignments. The result of such strategies is evident.

India has emerged as the most competitive industrial economy across the developing world through the last decade. Unemployment in India has declined during the global economic crisis. Identifying a valuable market position ahead of competitors is a necessary first step to high performance. We propose four key actions toward this goal: building brand image for India, opportunities in Indian operating environment, using sustainability to build competitiveness and developing Indian economy in overall sector. The challenge of building India's strong economy must be a shared responsibility.

The size and scale of investments make it imperative for industry, government and other stakeholders to collectively find solutions to macro problems. This report emphasizes the need for advertising the different opportunities in all sectors and providing employment opportunities for Indian talent pool. It also highlights the need to canalize an Investor Services Organization to achieve more policy and regulatory coordination across authorities at the central, state and local levels. The software sector development has marked India as an emerging opportunity for the venture capital and by using the same repo can be utilized for attracting the domestic and global venture capital towards Indian economy.

FDI Inflows to India will lead to a phenomenal growth in the economic life of the country. India has become one of the most prime destinations for investments. Though the opportunities arising from the global industry for the Indian industries are huge, but so are the challenges. The global economic slowdown and cost pressures have made the Global industry outsource elements of technology, design and sub-assembly Manufacture. The industries who achieve success are the ones who can innovate, adapt cutting edge technologies, deliver customized solutions, develop and maintain a global standard in Manufacturing qualities and specifications while maintaining their cost advantages. The Challenge, therefore, for the India is to proactively respond to changing customer Expectations. This could require a lot of effort and investment by the government as well as the entrepreneurs in the Indian context.

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