## CHAPTER 2

VENTURE CAPITAL INDUSTRY IN INDIA

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Title</th>
<th>Page No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1</td>
<td>A BRIEF OVERVIEW</td>
<td>37</td>
</tr>
<tr>
<td>2.2</td>
<td>STRUCTURE OF VENTURE CAPITAL INDUSTRY IN INDIA</td>
<td>37</td>
</tr>
<tr>
<td>2.3</td>
<td>OBJECTIVES OF VENTURE CAPITAL FUNDS IN INDIA</td>
<td>38</td>
</tr>
<tr>
<td>2.4</td>
<td>CATEGORISATION OF RISK INVOLVED IN A PROJECT</td>
<td>38</td>
</tr>
<tr>
<td>2.5</td>
<td>FINANCIAL INSTRUMENTS USED BY VENTURE CAPITALISTS</td>
<td>40</td>
</tr>
<tr>
<td>2.6</td>
<td>TYPES OF VENTURE CAPITAL FIRMS</td>
<td>43</td>
</tr>
<tr>
<td>2.7</td>
<td>PARTIES INVOLVED IN VENTURE CAPITAL FUNDING</td>
<td>44</td>
</tr>
<tr>
<td>2.8</td>
<td>TYPES OF VENTURE CAPITALISTS</td>
<td>45</td>
</tr>
<tr>
<td></td>
<td>SUMMARY</td>
<td>47</td>
</tr>
</tbody>
</table>
Chapter 2

VENTURE CAPITAL INDUSTRY IN INDIA

2.1 A BRIEF OVERVIEW:

The notion of venture capital is not very old in Indian Economy. It is catching up in India after it was introduced in the budget for the year 1986-87. The creation of a venture fund by IDBI (Industrial Development Bank of India). ICICI (Industrial Credit and Investment Corporation of India) also started venture capital activity in the same year. Many public and private sector firms have entered the venture capital industry now.

2.2 STRUCTURE OF VENTURE CAPITAL INDUSTRY IN INDIA

The venture capital firms in India can be categorised into the following four groups:

1. All-India DFIs (Development Financial Institutions)-sponsored Venture Capital Funds promoted by the all-India development financial institutions such as Technology Development and Information Company of India Limited (TDICI) by ICICI, Risk Capital and Technology Finance Corporation Limited (RCTFC) by IFCI and Risk Capital Fund by IDBI.

2. SFC's (State Finance Corporation)-sponsored Venture Capital Funds promoted by the state-level development financial institutions such as Gujarat Venture Finance Limited (GVFL) by GIIC and Andhra Pradesh Venture Capital Limited (APVCL) by APSFC.

3. Banks-sponsored Venture Capital Funds promoted by the public sector banks such as Canfina and SBI caps.

4. Private Venture Capital Funds promoted by the foreign banks / private sector companies and financial institutions such as Indus Venture Capital Fund, Credit Capital Venture Fund and Grindlay's India Development Fund. (Satyanarayan Chary, 2005:12-18)
2.3 OBJECTIVES OF VENTURE CAPITAL FUNDS IN INDIA

Venture Capital Funds in India have their stated objectives as the financing and development of high technology business. This is most significant, but the limited scope of venture capital has been influenced by the Government guidelines which makes tax concession available only for investment in high-technology businesses. The major players in the venture capital industry are public-owned development banks and commercial banks. Therefore, within high-technology ventures, their focus is more on development-oriented projects. Being public institutions, their concern in providing risk capital is employment, export, import substitution, energy saving, pollution control etc. India has a few private sector Venture Capital Funds. They have clearly stated their objectives in commercial terms. Venture Capital Funds in India do not so far seem favourably inclined to finance development of a new product/process from the laboratory stage. They are, however, ready to finance prototype projects or pilot plants which are ready for commercialization. (I.M. Pandey, 1996:10-12)

2.4 CATEGORISATION OF THE RISKS INVOLVED IN A PROJECT

The perceived risks in a project are categorised in the following way (Table 1):

<table>
<thead>
<tr>
<th>Category of risk factors</th>
<th>Component</th>
</tr>
</thead>
</table>
| Promoter Risk           | • Integrity / honesty of the entrepreneur / promoter  
                          | • First generation entrepreneur  
                          | • Lack of experience in related field  
                          | • Lack of contacts with resource persons  
                          | • Lack of experience about  
                          |   - market  
                          |   - technology |
| **Product Risk** | • Development stage of product  
• Product life cycle  
• Risk of reverse engineering  
• Manufacturing complexities  
• Number of constituent technologies |
| **Technological Risk** | • Availability of superior technology  
• Unpredictable technology development  
• Technology life cycle  
• Investment requirement for assimilation  
• Lack of organisational capability to assimilate  
• Source of technology / Goodwill of supplier  
• Level of technology (high or low) |
| **Market Risk** | • New users; uncertainty in market acceptance  
• Market growth rate  
• Competitors  
• Substitute products  
• Potential entrants  
• Huge marketing expenditure  
• Unorganised sector  
• No assured market |
| **Financial Risk** | • Capital market situation (e.g. lack of exit opportunities)  
• Current leverage ratio not in par with industry average  
• Growth prospect of the company  
• Foreign exchange risk  
• Problem with working capital; Liquidity problem  
• Expected rate of return  
• Lack of understanding of standard financial procedures |
| Implementation / Operational Risk | • Manufacturing complexities  
• Capability of producer / organisation  
• Manufacturing set up  
• Commitment from manufacturing  
• Unavailability of skilled work-force  
• Maintenance problem  
• Lack of contacts with resource persons  
• Problem in arranging additional fund |
|-----------------------------------|---------------------------------|
| Organisational Risk              | • Motivation of employees  
• Employee turnover  
• Dependence on few workers |
| Strategy Risk                    | • Loosing competitiveness  
• Unrelated diversification |
| Environmental Risk               | • Changes in Government policy  
• Lack of understanding about regulations  
• Pollution / hazard  
• Availability of raw material  
• Legal barriers - piracy / patent etc. |

2.5 FINANCIAL INSTRUMENTS USED BY VENTURE CAPITALISTS

All the Venture Capital firms invest in shares, either Equity or Preference and sometimes both of the Investee Companies.

The following methods of financing are being used by Venture Capital Funds

**Equity Shares**

When Venture Capitalists (VC’s), invest in Equity Shares of Investee Company, they expect that the sustained growth of the venture financed will lead to the growth of the value of the investee companies and its shares
Preference Shares

- Redeemable Preference Shares
  These shares are redeemed as Preference shares when the Venture has been established, providing an easy exit

- Convertible Preference Shares
  These are converted to common Equity on a later date enabling the Venture Capitalist to earn Capital Gain

Debt

- Convertible Debt
  1. Debenture
     This can be in the form of tradable debt that is later converted into Equity
  2. Convertible Loan
     This can be in the form of Non Tradable Debt that is later converted into Equity

- Non Convertible Debt
  1. Conventional Loan
     This is a loan that carries a fixed rate of Interest and a pre-determined payment schedule
  2. Conditional Loan
     It is a Quasi Equity Instrument, which does not carry a fixed rate of interest or a pre determined repayment schedule but is liquidated by payment of Royalty on sales. It is akin to Equity in the sense that the returns to the financier are performance based. The Royalty is payable only if the Venture succeeds and the investee company makes Sale(Subbulakshmi,2004:46-47)
  3. Income Notes
     This is a type of loan that carries a flexible nominal interest. The repayment of the principal is specified over a period besides there is a Royalty on Sales
4. **Non Convertible Debentures**
   These are pure Debt instruments with a Fixed Interest Rate and Repayment Schedule but are in the form of tradable security
   
   Off late, Venture Capitalist’s have started using a variety of innovative Quasi Equity Instruments. The important ones are as follows:

1. **Optionally Convertible Debentures**
   Based on the Performance around third year of operation, the Venture Capitalist can opt for conversion of the Debenture as Equity

2. **Partially Convertible Debentures**
   This is a convertible debt wherein a part is converted into Equity to enable the Venture Capitalist to gain from the success of the Venture and the balance remains as a Fixed Interest Debt

3. **Bridge Loans**
   These are Short Term Loans provided to a company contemplating a Public Issue to increase its Valuation

4. **Shares Warrants**
   This is a Right granted to the investor to purchase Equity Shares at a pre determined price on a later date. This normally provides for the expansion finance required by the investee company and ensures capital gains from successful Ventures
   
   In Accordance with the world wide practice the bulk of Venture Capitalist investment in India is in Equity shares. Initially there was a higher proportion of conventional loan but later it was reduced and its place is been taken by various innovative Quasi Equity Instruments. With VC financing getting mature, Preference Shares and Convertible Debts are becoming more popular. Today VC funds use more than one instrument for their investments
2.6 TYPES OF VENTURE CAPITAL FIRMS

There is quite a variety of types of venture capital firms. They include:

1. Traditional partnerships: which are often established by wealthy families to aggressively manage a portion of their funds by investing in small companies. These funds are typically established as partnerships that invest the money of their institutional limited partners. The partners typically include corporate pension funds, government pension funds, private individuals, foreign investors, corporations and insurance companies. These include venture capital funds that are focused on investing in minority businesses or minority markets.

2. Investment banking firms: which usually trade in more established securities, but occasionally form investor syndicates for venture proposals.

3. Manufacturing companies: which have sometimes looked upon investing in smaller companies as a means of supplementing their R & D programs (Some "Fortune 500" corporations have venture capital operations to help keep them abreast of technological innovations).

4. Small Business Investment Corporations (SBICs): which are licensed by the Small Business Administration (SBA) and which may provide management assistance as well as venture capital.

In addition to these venture capital firms there are individual private investors and finders. Finders, which can be firms or individuals, often know the capital industry and may be able to help the small company seeking capital to locate it, though they are generally not sources of capital themselves. Care should be exercised so that a small business owner deals with reputable, professional finders whose fees are in line with industry practice. Further, it should be noted that venture capitalists generally prefer working directly with principals in making investments, though finders may provide useful introductions.
2.7 PARTIES INVOLVED

1. Entrepreneurs
The word entrepreneur derived from the French verb enterprendre, which means “to undertake”. It is very difficult to define entrepreneur but Peter Drucker and Frances Walker explain their views on entrepreneur.
It is the qualities of the entrepreneur that define entrepreneur. Innovative, risk-taking ability, passionate, visionary, change agent and many more qualities that makes entrepreneur apart from others and define what he is.
Entrepreneurs has various types but broadly classified according to: the type of business, the use of technology, the motivation, the growth, the stages of development, area, gender and age, the sale of operation and others.
In the flow entrepreneur creates an idea which creates the entire flow. Entrepreneur has to sell its idea to the Venture Capitalist. In turn entrepreneur receives the fund (money) to implement his idea into reality.

2. Venture Capitalists
He is the one who supports the idea of the entrepreneur and in turn makes fund available to the entrepreneur. Venture capitalist posses a good experience of his area and provide expertise to the entrepreneur. Venture capitalist makes money for themselves by making market for entrepreneurs, investors and bankers.
Venture capitalist will raise money from the investors who expect high returns. Venture capitalist takes the help of bankers to issues IPOs and in turn received the initial outflow.

3. Investors
These are the private investors who expect high return as they invest in the business which is full of risk. They invest in from of money and received return in form of money as well. Venture capitalists raise money from these investors to invest in entrepreneur’s idea.
4. Bankers
An investment banker helps the venture capitalist to float the IPOs in the market. They are the one who help the venture capitalist to exit from the VC.

Diagram No. 1
Funds flow between the parties

2.8 TYPES OF VENTURE CAPITALISTS
Incubators
Incubator is a company or facility designed to foster entrepreneurship and help startup companies usually technology-related, to grow through the use of shared resources, management expertise and intellectual capital.
Kanwal Rekhi School of Information Technology (KReSIT) is a business incubators at IIT Mumbai, N.S.Raghavan Centre for Entrepreneurial Learning (NSRCEL) at IIM Bangalore are the best example of business incubators in India.
**Angel Investors**

An **angel investor** (known as a "business angel" in Europe, or simply an "angel") is an affluent individual who provides capital for a business start-up, usually in exchange for ownership equity. Angels typically invest their own funds, unlike venture capitalists, who manage the pooled money of others in a professionally-managed fund. However, a small but increasing number of angel investors are organizing themselves into **angel networks** or **angel groups** to share research and pool their investment capital.

Angel investments bear extremely high risk, and thus require a very high return on investment. Because a large percentage of angel investments are lost completely when early stage companies fail, professional angel investors seek investments that have the potential to return at least 10 or more times their original investment within 5 years, through a defined exit strategy, such as plans for an initial public offering or an acquisition.

Angel investors are often retired entrepreneurs or executives, who may be interested in angel investing for other reasons in addition to pure monetary return. These include wanting to keep abreast of current developments in a particular business arena, mentoring another generation of entrepreneurs, and making use of their experience and networks on a less-than-full-time basis. Thus, in addition to funds, angel investors can often provide valuable management advice and important contacts.

**Venture Capitalist**

Venture capitalists are organizations which pooled in money from various investors in a professionally managed fund. Venture Capitalists are inclined toward the turnaround ventures that entail some investment risk but offer the potential for above average future profits.

Sources of venture capital includes wealthy individual investors; subsidiaries of banks and other corporations organized as small business investment companies (SBICs); groups of investment banks and other financing sources who pool investments in venture capital funds or Venture Capital Limited Partnerships.
Private Equity players

Equity capital that is made available to companies or investors but not quoted on a stock market. The funds raised through private equity can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to strengthen a company's balance sheet. KKR (Kohlberg Kravis Roberts), Blackstone and Vestar Capital Venture and ICICI venture are examples of private equity players.

Private equity funds typically control management of the companies in which they invest, and often bring in new management teams that focus on making the company more valuable.

Summary:

In developing country like India still the major source of funding to entrepreneurs are conventional funding. There still exist a gap between what entrepreneurs look in the business plan / project report and what venture capital is look for before funding the projects. In order to fill this gap there is a need for research to identify the key parameters from venture capitalist point of view in a business proposal so that entrepreneurs can built on the key aspects in the project as well as scale the idea.