CHAPTER-FOUR

FACTORS INFLUENCING THE MANAGEMENT OF VENTURE CAPITAL FUNDS

• Pre Investment Strategies
• Post Investment Activity Profile
• Post Investment Monitoring of Investee Company Activities
• Investor Investee Relationships
• Strategic Choices In View of Challenges Posed by Venture Capital Funds
The present chapter focuses on the factors that are mainly considered by Venture Capital Funds in managing their business. These factors have been grouped into five major categories namely, pre-investment strategies, post-investment activity profile, post-investment monitoring of investee company activities, investor-investee relationships and strategic choices in view of challenges posed to VC industry in future. Each category covers various financial and non-financial aspects considered by the venture capitalists while managing their funds and further builds the ground for the subsequent analysis of the manner in which VCFs are managed. Factors considered have been drawn from various empirical studies undertaken on the subject.
PRE-INVESTMENT STRATEGIES

The financial and non-financial factors that affect the management of venture capital funds have been categorized into the five above mentioned groups and are discussed below: Pre-investment strategies refer to issues considered by the venture capitalists before putting their funds into any project/venture. Issues such as policy decisions regarding sources of deal origination, initial screening criteria, evaluation criteria, i.e., considerations regarding the entrepreneurs and their management team, market, product and financial results expected out of the venture, venture portfolio management strategy determining the size and status of venture portfolio, size of the investment made in an individual venture, stages and instruments of financing, venture syndication and its stages, venture culmination strategies, exit options, strategic choices for venture capitalists and use of specialists for evaluation of proposals coming across, have been discussed in this part.

To start with, an attempt has been made to find out the possible reasons behind entering venture capital business on part of any venture capitalist. Following reasons were identified and presented before the venture capitalists: Strategic and planned decision, as a part of a diversification strategy and at the suggestion of a friend. The endeavour is to gain familiarity with the individual venture capital units.

Tyebjee and Bruno\(^1\) (1984) were first to suggest a venture capital investment model comprising five sequential steps categorised as deal origination, screening, evaluation, deal structuring and post-investment activities. The investment model advocates the first step as deal origination. A continuous flow of deals forms an important activity of the venture capital investment process.
Deals can be originated from various sources such as arising out of referral system, unsolicited calls by business plans, deals within the venture capital communities and active search by venture capitalists themselves. An important source of deals in the USA has been the referral system. Deals may be referred to venture capitalists by their parent organization, trade partners or friends. Certain intermediaries may also play an important role in matching VCFs and potential entrepreneurs. On the other hand, an active search can be made through networks, trade shows, seminars and conferences. Venture capitalists are now-a-days paying attention to the sources that help in the origination of potential deals. Thus, this aspect has been covered in the questionnaire (Appendix B) that brings out the sources of deals for individual venture capitalists. Owing to the stiff competition among venture capital funds for good investments, sources of potential deal are a matter of concern for venture fund investment. Similar studies conducted in other countries (Asian, European and US) exhibit similar kind of behaviour. Fund managers prefer deals originating from associated financial institutions as they screen proposals themselves before referring the same to the venture capitalists. Thus referral system has played an important part in bringing deals. An effort has also been made to find out the stage of investment process that draws maximum attention of the venture capitalist as a prudent investor.

Deal origination is the initial phase of venture capital activity. Deals originated out of various sources have to pass through several other stages to be converted in to a venture capital backed venture/project. A venture capitalist comes across many proposals during investment process, so a broad initial screening criterion is likely to be used to weed out ventures that do not fall within investment policies. Generally, proposals are screened initially in terms of size of investment, technology, market, geographical location, stages of finance and quality of management. It thus
limits the number of proposal to be referred for detailed evaluation criteria employed by the Venture Capital Company. Macmillan, Siegal and Subba Narasimha² (1985), in their studies, have called this criterion as necessary conditions to weed out undesirable ventures at the initial stages only. Earlier studies conducted in Asian and the US economies show differences in initial screening criteria to be used by venture capitalists. Thus, knowledge of initial screening criteria employed by any venture capitalist would be of great help to any entrepreneur in approaching a right kind of venture capitalist for funding.

Next, comes the evaluation of proposals coming across the venture capital funds. As far as evaluation is concerned, in-house specialists can be used or the same can be entrusted to any outsider who possesses expertise in that particular field. Alternately, a combination of two has mostly been used. However, the use of internal and external specialists generally depends upon requirement in terms of technical, marketing, financial and general management skills; inherent capabilities of in-house team and availability of external expertise for the same. Ray and Turpin³ (1993) have made an attempt to cover this aspect of evaluation of proposals. They found that except for evaluation of the entrepreneurs, for the rest of the factors, most venture capitalists use technical, marketing, and legal specialists for the evaluation of a proposal. However, regarding the judgement of the capability of the entrepreneur, they go by their own judgement. Thus, earlier studies go in favour of use of combination of both internal and external expertise for the evaluation purposes and as such the said issue has also been incorporated in the questionnaire.

After deciding upon the team responsible for evaluation of proposal coming across, the next step is to decide upon evaluation criteria. Once a proposal passes through initial screening, it is
subjected to detailed evaluation. The evaluation of proposed venture is the most crucial aspect of the operation of venture capital funds. Most ventures for venture financing are new without any operating experiences and can not be formally evaluated. Thus, evaluation can only be based on rational judgement and intuition. These two factors can either have equal weightage in investment decisions or their relative importance can differ. Generally, all technical, financial and managerial aspects are evaluated on rational judgement basis, while for the evaluation of the personality and experience of the entrepreneur, the venture capitalist rests on intuition only. The venture capitalists in USA make an assessment of risk and return on the basis of quantitative analysis. In India, however, venture evaluation is not subjected to a very high degree of quantitative analysis since the investment is in small firms with a direct involvement of the venture capitalists. These factors have also been incorporated in the questionnaire (Appendix B).

Tyebjee and Bruno\(^4\) (1984) in their study made an attempt to ascertain the evaluation criteria used by venture capital funds in the US. Venture capital fund’s assessment of the probability of the failure of a venture was used as a measure of the venture’s perceived risk. Factors were divided into five categories namely, market attractiveness (market size, product need, market accessibility and potential market growth), product differentiation (unique product as a result of entrepreneur’s technical skills with patent protection and high profit margins), managerial capabilities (entrepreneur’s management, marketing & financial skills and personal influences), environmental threat resistance (venture’s capacity to resist obsolescence risk of product or technology, the economic changes and low barriers-induced competition) and cash-out potential (ease of liquidation of investment) and thus, these factors have also been examined for Indian venture capital industry in the present study.

4.5
In another study, Goslin and Barge⁵ (1986) concluded that in a venture capital firm’s assessment of a venture investment, the entrepreneurs and the quality of management were critical factors. Venture capital funds prefer entrepreneur who accepts a high degree of risk; has little or no experience with failure; is people oriented; highly concerned with costs and one who views money more as a performance measure than an end in itself.

In an another study, Macmillan, Siegal and Subba Narasimha⁶ (1985) identified the evaluation criteria comprising six groups: entrepreneur’s personality, entrepreneur’s experience, product characteristics, market characteristics, financial considerations and characteristics of its management team. In the present study, however, the entrepreneur's personality and his experience have been taken together. The authors concluded that, in general, personality and experience concerns dominate the financial criteria, which, in turn is regarded as more important than product or market criteria.

I.M. Pandey⁷ (1996) establishes that the investment decisions of venture capitalists in India are governed by quality of its entrepreneurs. It was revealed that if a proposed venture is attractive with regard to product, market and profitability, it might still be rejected if the entrepreneurs lack the most desired traits. On the other hand, a marginal venture may be accepted if it is supported by the entrepreneurs who have the desired personality. Desirable characteristics of the entrepreneurs may count for qualities like integrity, capability of sustained intense effort, competence, ability to evaluate and react to risk involved, vision, attentiveness, urge to grow, commercial orientation, amenability to suggestion and criticism, articulation in discussing

4.6
ventures, familiarity with target market, leadership qualities, track record, compatibility, in personality with the venture capitalists and reference of a trustworthy sources.

Next to characteristics of an entrepreneur stand desired characteristics of a product. Although relatively less importance has been given to the characteristics of the product as compared to the quality of the entrepreneur, it still tends to be an important aspect from the viewpoint of any venture capitalist. The product generally preferred by any venture capitalist is a high-tech product, patent protected, resistant to economic cycle, unique, with high profit margins and demonstrated market acceptance.

Market situation becomes an important matter of concern for the venture capitalist. Important issues regarding market aspect of evaluation can be size of the market, familiarity of the market with the venture capitalist, market accessibility, threat of competition, market growth rate and support of venture to the existing market. The venture capitalist may also consider whether the venture will be able to create a new market. Indian market, however, is considered to be an untapped market. So venture capital industry, which is still at infancy stage, can go a long way with Indian markets without much concern.

Financial considerations also stand next to entrepreneur’s personality and experience in the evaluation of a venture project. Financial aspect is one of the most important aspects of evaluation of proposals. A methodology has been given by Macmillan (1985) which consists of 27 criteria grouped into six categories as characteristics of the entrepreneurs, characteristics of the product, characteristics of the market, financial considerations and characteristics of the venture.
management team, for identification of evaluation criteria used by venture capitalists in various countries. Out of these, it is the financial considerations that are the most sought after by the venture capitalists. Major aspects covered under financial aspect are return from the investment, ease for liquidity, and opportunities for exit and tax benefits. Since venture capital financing is a high-risk proposition, expected returns become an important part of the financial criteria. Returns are evaluated by using various techniques of financial evaluation such as NPV (net present value), IRR (internal rate of return), payback period, sensitivity analysis and simulation techniques. Tax benefits can be considerable if special tax incentives are available for venture capitalists in any country. Ease with which investments can be made liquid along with the opportunities available to any venture capitalist for exiting out of the venture are also given due importance due to strategic reasons by venture capital funds. Last, but not the least, stands characteristics of venture management team. The management team of the entrepreneur is expected to be competent enough in terms of technical, managerial, financial and marketing skills and thus, making the team as a balanced one.

After screening various proposals against the evaluation criteria, the suitable ones are opted for and others are rejected. An important aspect in relation to venture fund management is portfolio management strategy. What contribution would any venture capital funds make in any individual venture investment depends directly upon the strategy adopted by the venture capitalist with regard to portfolio construction. In this regard two kinds of strategies are evident:

a) Make smaller individual investments and make a larger number of investments so as to be better positioned to capture a wider range of future technology opportunities or be less concerned about the possibility of loss-making investments.
b) Keep the size of portfolio relatively small by investing in two or three ventures with large individual investments. Since portfolio construction is directly related to the effective management of venture capital funds, individual venture capitalists have been on an average asked what percentage of total funds do they devote to individual venture investments with options as: 0-10 per cent, 10-20 per cent, 20-30 per cent and 30 and above per cent. It clearly spells out the strategy of a venture capitalist i.e. whether he wants to spread risk by investing in many ventures by making the size of investment relatively small or emerges as a major source of finance by investing in just 2-3 ventures. Thus, an attempt has been made to study venture capitalists' strategy regarding size of contribution to individual venture investment.

In a study conducted relating to venture portfolio sizes, Hurry, D., Miller, A. T. and Bowman (1992) have made a comparison among the US and the Japanese venture capital funds regarding sizes of their portfolios and found that investment portfolios of Japanese were larger than that of US funds. In modern times, this factor is of great importance as it determines the strategy of any venture capitalist regarding risk, diversification and size of individual investment as a percentage of total funds under management. Individual venture capitalists have been approached with options regarding the portfolio sizes to choose that which best describes their present portfolio size.

Exhibit 4.1

<table>
<thead>
<tr>
<th>Particulars of Portfolio</th>
<th>Portfolio Size</th>
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<tbody>
<tr>
<td>Status of Young</td>
<td>SY, LY</td>
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<tr>
<td>Status of Old</td>
<td>SO, LO</td>
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</tbody>
</table>

4.9
As evident from exhibit 4.1, these options are: Small/Young, Large/Young, Small/Old, Large/Old or any other as might be specified by the venture capitalist himself. Large portfolio size indicates greater number of investment with smaller investment in individual ventures. On the other hand, small portfolio size implies larger investment in individual ventures keeping number of investments relatively small. 'Young' means a new venture and 'old' is under the purview of an existing unit. Choice of venture portfolio depends upon the policy of individual venture capital funds. An effort has also been made to find out the preferences of these funds regarding portfolio size in future keeping in view the present scenario and challenges posed to venture capital funds in the coming future. It is expected that in future the strategies regarding portfolio management are getting inclined towards large portfolio size with smaller individual investment.

After deciding upon the percentage of individual investment and status of the venture for putting funds, another important issue arises before a venture capitalist regarding the industries in which investment would be made. With so much money poured into various ventures in form of risk capital, it becomes necessary to understand which key industries venture capitalists are longing for.

Pandey, I. M.\(^\text{10}\) (1996) has tried to relate India to other developing countries like Thailand, Korea, Sri Lanka and more. He has concluded that venture capital funds in developing countries, like India, do not consider high technology characteristics of the proposed ventures in their investment evaluation. A possible explanation, according to him, is lack of any technological breakthroughs in such countries and that is why a substantial part of the venture capital funds in developing
countries like India have been invested in high technology industries. This finding has been confirmed by other studies too. Developing countries are thus approaching technology sector. Although there is always a risk in focussing on a few industries, many venture capital funds are reluctant to diversify their investments into the industries with which they are not familiar. It speaks of their diversification strategy. In view of present technology era and future challenges posed to VC industry, similar attempt has been made; in this study, to reveal the preferences of the Indian Venture Funds regarding industrial sector. Most preferred industries for putting funds in the same are industrial products and machinery, computer hardware systems, food and food processing, telecommunications and data communications, biotechnology, other electronics and energy related products and others. Venture capitalists have also been requested to indicate the percentage of their total funds under management that they would like to put under one management or individual industry so as to draw a conclusion about the management and industries preferred by venture capitalists most.

A venture capitalist provides financial assistance to many entrepreneurs. Another issue of concern in this regard is the stage of financing. Money can be provided at various stages of the business as seed financing (for supporting concept or an idea), start-up capital (for initial production and marketing to initiate sales), expansion capital and for other purposes (management buyouts and turnaround etc.). It may be a strategic point for any venture capitalist to opt for specialization in a particular stage of financing say seed capital or expansion capital, or it can go for financing all stages as above stated. In earlier studies also, this aspect of financing has been studied depicting the strategies venture capitalists adopt for stages of financing. A very interesting fact has been brought to the notice that instead of investing in a particular stage of financing, most of the
venture capital funds go for diversification of portfolios as far as the stage of financing is concerned. Thus, to stay in the highly competitive environment, it is very difficult for venture capitalists to narrow down their investments in a few sectors as well as to any specific stage. Still some of them opt for 'niches'. In present study also, an effort has been made to find out staging strategies of Indian venture capital funds. Knowledge of financing strategies of venture capitalists can be of great help to the investor companies’ entrepreneurs as they can approach the right kind of venture capitalist for the right kind of stage.

It is evident that venture capital financing involves providing financial assistance to the entrepreneurs. This sort of financing arrangements can be made through various vehicle and thus, different innovative instruments have been devised by venture capital funds for the same. This has been done to provide various combinations of maintaining the risk-reward sharing nature of relationship for structuring the investment such as equity, debt and convertible instruments. These instruments are always subjected to various constraints on pricing as imposed by the securities pricing regulations, entrepreneurial ethos and various governing laws and regulations. A venture capitalist is required to make a choice among these instruments. As per the earlier studies conducted in other Asian countries like Thailand, Korea and Sri Lanka, most venture capitalists, in order to get their returns by way of capital gains, prefer to invest in companies through equity participation. Second preference has been given to the quasi-equity financing, i.e., financing through convertible instruments bearing characteristics of both equity and debt. So the vehicles for financing represent an important aspect of investment strategy. Venture capital funds can either opt for any of the above-stated instruments or go in for a combination of these.
Stage of financing can also be an area of specialisation for the venture capital fund on account of earlier experience with the same. However, BVCA directory considers that venture capitalists are generalists not specialists having expertise in providing equity based financing to the investee companies.

Location is an important criterion used by the venture capitalists for screening of undesirable ventures at initial stages only. However, locational preferences may exist affected by a number of factors such as stage of industrial development, rules and regulations by governing authorities, level of competition and accessibility to the phase. A venture capital fund, established in any country can also operate on international basis, subject to the rules and regulations made by governing authorities. Similarly, regarding the domestic part, these funds can have regional preferences regarding the investments like northern, southern, western or eastern part of any country. Mishra, A. K. (1993), however, in his study points out that though hardly any venture capitalist has any kind of locational preference, there is no uniformity among these institutions in their sanctions. According to him, generally, industrially developed states avail the highest number of sanctions. All these issues have been considered in the present study.

Another upcoming activity of venture capitalists is syndication of investments. Syndication is a mechanism through which venture capitalists resolve informational uncertainties about potential investments by investing jointly. Syndication is commonplace, even in first-round investments. Experienced venture capitalists primarily syndicate first-round investments to venture investors with similar levels of experience. In later rounds, established venture capitalists syndicate investment to both their peers and to less experienced capital providers. Syndication also often
ensures that the ownership stake of venture capitalist stays constant in later venture rounds. Despite its persistence, syndication has been little scrutinized in the corporate finance literature. The reason may lie in the difficulty of analyzing syndication patterns empirically and the complexity of motives behind syndication. Syndication may lead to a superior selection of investments. Sah and Stiglitz\textsuperscript{12} (1986) contrast decision-making in hierarchies and polyarchies, that is, settings in which projects are undertaken only if two reviewers agree that the project is worthy and the approval of either is sufficient. Venture capitalists prefer syndicating most deals for a simple reason that they have a chance to check out their own thinking against other knowledgeable sources. If two or three funds whose thinking they respect agree to go along, that acts as double check to their thinking.

Most financing involves a syndicate of two or more venture groups, providing more capital availability for current and follow-on cash needs. Syndication also spreads the risk and brings more expertise and support. These benefits pertain only to start-up-financing requiring the venture capitalist’s first investment decision. There are different strategies and motivations for syndication in follow-on financing.

Admati and Pfleiderer\textsuperscript{13} (1994) argue that syndication in later rounds should occur even when venture capitalists are risk-neutral and there are no capital constraints. In keeping with Brennan and Kraus\textsuperscript{14} (1987), entrepreneurs can communicate all their private information with a set of contingent claims. If an unforeseen state of the world can occur, however, the signaling equilibrium breaks down. As a result, the entrepreneur may be unable to raise the full amount
needed. A rationale for syndication in later rounds suggests that venture capitalists will hold a constant equity stake across rounds.

Lakonishok, Shleifer, Thaler, and Vishny's\textsuperscript{15} (1991) discussion of money manager "window dressing" suggests a third rationale for venture syndication. Pension funds, which typically evaluate money managers once a quarter, examine performance in several ways. Since market-adjusted performance is a noisy indicator of a money manager's skill, plan sponsors also examine the portfolios just before the quarter's end. They may buy firms that have performed particularly well in that quarter or sell "mistakes" that have incurred losses.

Venture capitalists generally prefer larger funds because of the substantial economies of scale in operating a large venture fund (or several large funds). The typical later-round syndication involves less-experienced venture capitalists investing in a deal begun by established organizations.

When established funds join as new investors in later rounds, the firm's valuation increases sharply prior to the investment. This pattern supports suggestions of "window dressing" in the syndication of later round investments. It also presents evidence consistent with Admati and Pfleiderer's\textsuperscript{16} (1994) constant equity share hypothesis.

Results of this syndication in one particular environment may be more broadly applicable. We see many of these behaviours in public security issues. Decisions regarding IPOs of firms specializing
in complex technologies are often taken in consultation with co-lead investment bankers. Decision-sharing is an important motivation in many offerings.

This analysis does not exhaust the important questions concerning syndication. One issue that has been acknowledged but not addressed is how reputation affects the risk aversion of venture capitalists and their consequent willingness to syndicate. For instance, more established venture organizations might be willing to accept lower returns, as the variance is lower. They may thus participate in many syndicated deals.

The endeavour of this study is to find out the syndication patterns and to bring out the complexity of motives behind syndication if opted for by Indian Venture Capitalists. Venture capitalists have been asked whether they have already opted for/would like to go in for syndication for their respective ventures and if yes, at what stage would they prefer. Respondents have been asked to specify their motive behind syndication out of the motives described as risk avoidance through risk sharing, financing of large size of investment, benefits for IPO (Initial Public Offering), window dressing, superior selection of investment and others. Thus, an attempt has been made to study the level of competence in evaluation by two or more venture capitalists jointly. Moreover, endeavour is also to find out the stages of syndication as preferred by the venture capitalists. Three stages have been identified under this aspect: Early stage, later stage and exit stage. The venture capital funds can opt for syndication in anyone or all of these stages.

Another important aspect concerning management of venture capital funds is venture culmination strategy. A new technology venture start-up is a risky proposition for most stock market investors.
and hence it is usually financed partly by the entrepreneur and largely by venture capital firms. The venture capital funds are willing to provide risk capital and can afford to wait for 5-7 years before earning returns. Once the venture has succeeded in introducing new products and earning revenues, it will make its initial public offering of stock. At this point of time, the venture capitalists are in a position to reap their rewards. However reaping rewards after 5-7 years is not the sole objective. A new high-technology venture also offers a potential source for a new technology for the investing firm. So a firm can have two strategic alternatives: a "project strategy" of seeking direct venture gains or an "option strategy" of seeking new technology. These two strategies are not mutually exclusive and they reflect different perceptions of the available opportunity set. Project strategy implies that the new technology opportunity was either not recognized or not positively evaluated, if recognized. On the other side, an option strategy or a combination of two suggests recognition and positive evaluation of this opportunity. Project strategy speaks of direct capital gains arising out the venture. On the other hand, option strategy gives way to acquiring new technology. A firm interested in explaining new technologies might invest in a new high-technology venture in order to participate in the development of new technology and to share in its profit. So any venture capital fund can go in for any of the above said strategies or a combination of these, varying the percentage of each. Relating back to the earlier studies, Hurry, D., Miller, A. T. and Bowman, E. H.17 (1992), in his research on 'High Technology Ventures & Venture Capital', has studied venture culmination strategy of the Japanese and the US venture capital funds and has brought out the fact that a significant number of the US venture capitalists summed to follow a project strategy being ignorant about technology shadow option while the strategic nature of venture investment was clearly visible in Japanese venturing which proceeds in accordance with an option strategy. This aspect found place in the
present study in relation to Indian venture capitalists to indicate a choice on venture culmination
with two options as 'project strategy' and 'option strategy'. Before that an effort has been made to
find out which of the three objectives -Maximization of ROI or entering new technology or a
combination of these in varied proportions holds more strategic importance than the rest. ROI
represents 'Project Strategy' and entering new technology spells out 'Option Strategy'.

It is, thus, evident from the above discussion that VCs opting for ROI want to cash out their gains
in 5-10 years after initial investments. Therefore, they play a positive role in directing the
company towards particular exit routes. The ease within which exit can be made out of venture is
of primary concern for venture capitalists and forms an important aspect of financial consideration
under evaluation criteria. Thus exit mechanism proves to be a 'payday' for the investor. The
essence of the venture capital philosophy is the realization of future liquidity and capital gains for
the venture capitalist. For exit purposes, following routes are present: IPO (Initial Public
Offering), acquisition by another company, repurchase of the venture capitalist’s shares by the
investee company and secondary purchase of the venture investor’s shares by a third party as
quoted by Sagari and Guidotti18 (1991). Earlier studies conducted have advocated that the
commonly used vehicle for venture capital funds is initial public offerings (IPO). The over-the-
counter exchange of India (OTCEI) which specializes in the trading of shares of the small and
medium sized enterprises, plays a critical role in such exits through IPOs and acquisitions.
However, if the entrepreneur wants to exercise full control over his company, he can opt for
repurchasing the shares held by the venture capitalist. So it depends upon the attitude of the
entrepreneur and philosophy of the venture capitalist to decide upon the exit route. One of the
most important aspects of exit policy is the time horizon in which a venture capitalist wishes to
withdraw from the investee company business. Although venture capital financing is a long-term investment, 'long term' can have many dimensions depending upon the attitude of the venture capitalist. This strategy of venture capitalist can be 1-5 years, 5-7 years, 7-10 years and 10 years and above. In a study conducted by Hurry, D., Miller, A. T. and Bowman, A. H (1992) concerning comparison between the US and the Japanese firms describe their venturing objectives in terms of long term indirect strategic gains while US firms will state their venturing goals in terms of short-term direct gains.

Initial public offering is generally called 'payday' for the venture capitalists. It is time to reap the rewards out of the venture. For proper pricing of IPO i.e. for avoiding underpricing timing of issue has to be taken care of. Various factors affect pricing of IPO such as quality of venture capitalists, quality of underwriters or auditors and quality of entrepreneurs' management. The venture capitalists would like to launch IPO in the market in such a manner that returns are maximized. The issue stands benefited on account of the quality of venture capitalists and that of entrepreneurs as their name carries goodwill ensuring adequate returns from the venture. In absence of any such reputation by either of these, IPO can be backed by quality of underwriters or auditors. Lerner (1994), in his study provides evidence that experienced venture capitalists can time the IPO market. In particular, he demonstrates that venture capitalists tend to bring their portfolio firms public at times when the market valuation of those firms is particularly high. On the other hand, privately financed firms tend to go public when market valuations are lower. These results suggest that more experienced venture capitalists have greater ability and greater incentives to time the market than their less experienced counterparts have. Gompers (1995) in his study suggests that venture capitalists without a substantial track record would be prone to
premature offerings. He concluded that the IPOs tend to be more underpriced than are offerings by the more experienced venture capitalists. He stated that distributions of firms brought public by lower quality underwriter and of less reasoned firms have comparatively more negative price reactions. This issue has been discussed with the units understudy (Appendix C) so as to find out their perceptions regarding the same.

It is quite evident that management of venture capital funds requires consideration of number of factors covering various financial and managerial aspects. Funds can be managed by either the venture capitalist himself through an in-house team or through a management consultant company. Alternatively, a combination of two i.e. depending upon outside experts for information and consultation in the specialized fields of marketing, technology or legal aspects only and making use of in-house team for other areas can be used. The management company provides all the services associated with selection, monitoring and assistance of investor companies and is paid about 1.5-3 percent in capital and a proportion of net capital gains. Here also, the kind of specialities being used depends upon the capabilities of in–house team as well as availability of external expertise.

POST-INVESTMENT ACTIVITY PROFILE

Once funds are put into the venture, it starts taking shape. Then comes the role of venture capitalist as far as non-cash contributions are concerned. This strategy is popularly known as 'hands-on' strategy of the venture capitalist so as to provide value-added finance to their entrepreneurs to generate better results benefiting both the parties. The post-investment activity profile of the venture capitalists requires consideration of various aspects such as level of
involvement of venture capitalist in investee company business, areas of involvement, forms and means of involvement, various inputs for the investee company and factors affecting behaviour of investee company relating venture capital funds. The prime among the above-mentioned factors is 'level of involvement' which provides answer to rest of the above said aspects concerning post-investment activities of the venture capitalists.

Venture capitalists add value to the investments by providing assistance to the investee company management besides financial assistance. Along with availability of VC money, the venture stands benefited on account of level of knowledge and experience of the venture capitalist.

The rationale for venture capitalists moving towards a more 'hand-on' approach in the future may be that it is deemed to be a way of creating higher 'value-addition' to their investors. By creating value to their investors, these particular venture capitalists hope to be able to generate better investment performances and to create a competitive edge. There are three levels of post-investment involvement adopted by venture capitalists as suggested by Macmillan\(^22\) (1985) as 'Laissez-faire' (no interference by venture capitalists), 'moderate' (not much interference, just monitoring is there) and close tracker (level of involvement is quite high). Although, it has been found that there was no significant difference in the performance levels of the ventures among these three groups, the above aspect has always been of considerable importance from the viewpoint of management of venture capital funds. Earlier studies conducted in this regard have brought interesting facts into the picture. Rosenstein\(^23\) (1993) found that CEOs rate outside board members (venture capitalists and others) most helpful in acting as a sounding board, interfacing with the investor group, monitoring operating performance, monitoring financial performance and
assisting with short term crises. Gomez-Mejia’s\textsuperscript{24} (1990) study concluded that CEOs viewed financial and networking activities as valuable but gave mixed reviews regarding managerial involvement of venture capitalists. Although it speaks of viewpoint of investee companies only, managerial assistance is found to be of great importance by both the parties i.e. the venture capitalists and the investee companies. One of the important features of venture capital, as contrasted with the traditional forms of financing, is the involvement of the venture capitalists in investee companies. A number of studies conducted earlier (Tyebjee and Bruno\textsuperscript{25} 1984; Gorman and Sahlman\textsuperscript{26} 1989; Sapienza and Timmons\textsuperscript{27} 1989; Timmons and Bygrave\textsuperscript{28} 1986) have shown that involvement of a venture capital in investor company’s affairs is of great importance. However, there exists no conclusive evidence that venture capitalists’ involvement leads to a better performance. Still a venture capitalist would like to involve him in investee company’s affairs. Such venture capitalists are concerned with providing non-financial assistance to entrepreneurs in areas of marketing, technology/production, general management or any other area. The degree of involvement in a venture’s operations depends on a venture capitalist’s policy. Involvement in day-to-day operations can be made by making contact with mid-level or lower-level employees, regular contact with outsiders, helping selection of top management personnel, high involvement in accounting activities, helping management dealing with a variety of other operating problems etc. It clearly indicates the strategy regarding exercising control over the investee company activities. However, Tyebjee and Bruno\textsuperscript{29} (1984) showed that it was undesirable for a venture capital fund to exert control over the day-to-day operations of the venture. If a financial or managerial crisis occurs, the venture capitalist may intervene and even install a new management team. Lerner\textsuperscript{30} (1994) found that if the entrepreneur did not have any prior experience in running the firm, the venture capital funds’ representation on board increased
significantly. He also found that when the entrepreneur was replaced in an organizational crisis', the monitoring became more intense. Venture capitalists have been asked about the level of involvement they would like to have in investor company business that would clearly bring out their strategy regarding involvement (hands-on), non-involvement (hands-off) or something in between. Moreover an effort has been made to find out the areas that are likely to be touched by venture capitalists in investor company.

It is generally said that venture capital funds are more concerned about the financial part of the overall performance of investee's business. Since a venture capitalist basically provides funds to the investee company, it is natural for him to get more involved in financial matters of the business. There may be some reasons for it such as limited knowledge on part of venture capitalists regarding investee's market, technology and production; accounting being the background training of many venture capitalists or due to the reason that they are responsible to communicate to the investors about the performance of investee company. That is why venture capital funds involve themselves more in financial matters of the business.

Whatever research has been done is just from the point of view of venture capitalists. No consideration has been paid to the investee companies who are recipients not only of the finance but also of the monitoring, control and management contributions of the venture capitalists activities. In a study conducted by Colville\(^31\) (1991) regarding entrepreneurs who had used venture capital finance, it was revealed that level of satisfaction was quite high with 95 percent of respondents being prepared to recommend the venture capitalist to a friend. It was found that investee companies believed that venture capital fund director did add value to their company.
Despite the venture capitalist’s desire to add value to the business, the investee company’s two primary reasons for choosing venture capitalists were the terms offered and availability of funds for expansion. Thus, earlier studies show that the investee companies feel satisfied on account of assistance, financial and otherwise, provided by the venture capitalists.

So as to investigate this aspect under present study following options have been given to venture capitalists: high satisfaction level, low satisfaction level and dissatisfaction. However, since the venture capital financing blended with a variety of non-cash contributions is directed towards providing value added financing to investee company, venture capitalists tend to achieve the highest level of satisfaction on part of investee companies.

A venture capitalist is a ‘probability lender’. He lends on ideas, the drive of the entrepreneurs and his assessment of the final product and the market. Venture capitalists are not just cheque writers. Once they bring new companies under their investment funds’ shelter, they become actively involved in managing the company’s growth. Apart from flow of funds from the venture capitalist to investee company, many other tangible and intangible factors become inputs for the investee companies. These inputs, apart from money, can be operating services, networks, image of the venture capitalists, moral support, discipline and general business knowledge which are of strategic importance for both the investee company as well as the venture capitalist.
Money input is what causes the relationship with the entrepreneur to form. Even those entrepreneurs who are not having satisfactory relationships with VC investors will have to utilize venture capital financing. Money as an input vests money-power with the venture capitalists.

So far, as operating services are concerned, venture capitalists are called ‘consultants with a financial interest’ in the company. The operating services indicating non-cash contributions made by the venture capitalists require regular contact with top management of the investee company. Rarely, if ever, is there any contact between the venture capital fund and mid or lower-level managers. Operating Services generally include arranging alternate sources of finance, arranging corporate partnerships or acquisitions, selecting top management personnel or serving as a sounding board for management’s ideas on dealing with a variety of other operating problems. The venture capitalists’ highest level of operational services occurs when he takes over the management of a company that happens occasionally.

Apart from an entrepreneur’s own networks, VCs also have networks available to Investee Company. Such networks available to investee company become source of potential managerial personnel, consultancy services and, even customers. Image of a venture capitalist proves to be plus point for the investee company. Venture capitalists who have a track record of backing successful companies will pass on a positive impact to their portfolio companies, and such image is helpful in getting potential management personnel and for marketing purposes also.
Moral support of any venture capitalist helps the entrepreneur in facing the challenges with confidence. Many managers use words like "supportive", "open" and "friendly" to describe their relationship with the venture capitalist.

General business knowledge, experience and discipline are also regarded as major VC inputs. Discipline can be exercised in two ways: ensuring performance in accordance with the objectives established in the business plan and evaluation & replacement of management.

Thus, apart from money, other inputs carry a lot of consideration for the venture capitalists as they decide about the quality of venture capital fund. It has been rightly said that venture capitalist is a 'relationship investor' as quoted by Fried and Hisrich\(^\text{32}\) (1995) as the success of any venture directly depends upon the relationship between the two. Timmon and Bygrave\(^\text{33}\) (1986) suggest that an ongoing co-operative relationship between entrepreneurs and venture capitalists is more important to the performance of the ventures than the provision of venture capital finance. So new business start-ups with venture capital backing depend on mutual cooperation between the two, but little is known about what makes these relationships work. Mutual relationships between a venture capitalist and an investee company can be established by professionalism, quality of service provided by the venture capitalists, speed and efficiency, understanding between two parties, flexibility, development of personal relationships and experience of the financers.

As said earlier also, the investee company is the recipient of not only cash contributions but also of various non-cash contributions made by the venture capitalists under post-investment activity profile. On this account the investee company's behavior is subject to the influence by the
venture capitalist. Fried and Hisrich (1995) bring out the fact in their study that it is easy to understand that VC affects company’s behaviour but hard to answer the ‘how’ and ‘when’ part since the upper level management process in a venture backed entrepreneurial enterprise is extremely dynamic and interactive. However, some general ways in which venture capitalists clearly influence the investee company behaviour can be identified.

The firm’s behaviour is influenced by the availability of VC money—both the initial investment as well as the venture capitalist’s willingness to make further investments. Thus the venture capitalist is in a position to use money power. Another factor affecting investee company behaviour is the attitude of venture capitalists towards involvement in the affairs of the investee company. The level of involvement as decided upon by the venture capital funds would determine the extent to which investee company can be managed independently. Level of knowledge of venture capital funds and their experience also affect the working of any investee company. Level of knowledge and experience become the basis of development of dominant logic i.e. a set of common views on the appropriate management processes and strategies. Thus, it can be concluded that a variety of factors related to venture capital funds affect the working of investee companies.

POST-INVESTMENT MONITORING OF INVESTEE COMPANIES:

After providing various cash and non-cash contributions to the investee company, a venture capitalist has to assure that the venture is moving in the desired direction. He tends to monitor the activities of the investee company. Thus post-investment monitoring also becomes an important aspect of venture fund management. Post-investment activity involves collection of information
related to the investee company through formal and informal means and exercising various control techniques to fulfil the objective. This aspect figures in the present study in the form of identification of factors responsible for failure of any investment, control areas of investee company, means of exercising control, sources of collection of information about investee company—both formal and informal, performance measures of the investee company, frequency of performance reviews and an appraisal of the status of portfolio of individual venture capital funds. This part of venture capital management has been emphasized on account of the fact that venture success or otherwise is a matter of probability and that venture cannot be left to chance to allow the destiny to decide upon the result.

Financial and non-financial assistance provided by the venture capitalist is no guarantee of success. It is not always that things turn out to be desirable. Sometimes performance does not measure up to expectations, which requires interference from the venture capitalist in the investee company. Some changes and some improvements are likely to be made. Venture capitalists may come across, during their lifetime, such ventures or such investments which prove to be unprofitable or unpromising. ‘Failure of Investment’ is a factor not covered much in the earlier studies. Since this study endeavours to examine how venture capital funds manage their funds, negative side of any investment i.e. failure of investment was desirable to be studied.

Whenever any venture fails, both parties i.e. the venture capitalist and the investee company begin shirking their responsibility for the same. However, this aspect is of great importance from the point of management of venture capital funds. Possible reasons for failure can be: shortcomings of senior management, unscientific methods used by the venture capitalists, lack of a sound
strategy and many others to be revealed by venture capital funds. An attempt has been made to identify the reasons for failure of investment so that proactive approach can be taken in future.

In order to avoid any instance of failure of investments made by the venture capital fund, it is necessary that monitoring of activities of investee company is taken place on a continuous basis so as to find out loopholes in regard to the same. Every venture capitalist has his/her own style of monitoring and controlling the activities of investee companies. First of all, they are required to collect information about the investee company. There can be various modes of collecting information about the investee such as telephone conversation, board meetings, company visits and contact with non executive directors appointed on the investee's board. Venture capitalists can make use of any of them or a combination of these for their purpose as informal sources of information. Use of a particular source will depend upon type of information needed. There are some formal sources of information as market share, return on investment, sales volume and net profits. These performance measures are being used by venture capitalists all over the world as formal sources of information of investee company. In earlier studies also, both venture capitalists and CEO ranked net profit as the most important measure of company performance followed by return on investment. Any change initiated about by the venture capitalists is also depicted on account of such performance measures. Venture capitalist can employ any or all of these tools to be informed of activities carried on by the investee company.

Besides involving themselves in the operational activities of any investee business, venture capitalists also tend to provide assistance on various strategic issues such as dividend payment levels, participation in mergers, sale of assets, debt/gearing levels, capital expenditure,
management remuneration, working capital maintenance, hiring of employees. As per the terms and mutual understanding, a venture capitalist can exercise control over the investee company in any or all of above said areas.

As quoted by Gorman and Sahlman\textsuperscript{35} (1989) that about half the time of venture capitalists is spent in monitoring the performance of investee company business. There can be various methods of monitoring of venture capital funds as study of budgets, business plans, monthly accounts and yearly audited financial statements. These financial documents provide information regarding the areas the business is making in, various activities it is undertaking and its future plans. It gives an idea whether or not the investee business is moving in the desired direction and performance is up to the mark.

One of the major issues is how frequently performance review of investee company is made by the venture capital fund. It depends upon the level of control any venture capital fund wishes to exercise over the investee company management. The dimensions in this regard may be annually, six-monthly and quarterly. It is an important aspect which determines the frequency of visits made by venture capitalists at the investee company. Visits can be made on monthly basis also asking for the venture capitalists to have a close interaction with the investee company business.

Venture capitalists provide financial assistance to entrepreneurs who have reasonable potential to make into the markets but with uncertainties. Once money is provided to entrepreneurs, venture capitalist keeps on monitoring the performance of various investor companies he has invested in so as to find out the status of each individual investment. The status of individual investments can
be: winners, dead, living dead and too soon to know. Appraising the status of portfolio is helpful for effective management of venture capital funds in case staging strategy is adopted by a venture capitalist in which he gets a right to monitor the performance before next stage financing is provided and accordingly right to abandon if the performance is not up to mark. However, close monitoring can be very time consuming and may be seen as an intrusion. Being on the board of investee companies gives venture capitalists access to additional formal and informal information regarding investee's performance. In an earlier study conducted regarding UK economy, Sweeting (1991) found that venture capitalists are also known to replace incumbent managers if they are driven to believe that all will be lost if change is not initiated.

INVESTOR-INVESTEE RELATIONSHIPS

Another important perspective relevant for the venture capital funds to consider is their relationship with the investee company. As quoted earlier also, since the investee company is not only the recipient of cash but also various non-cash contributions in form of managerial assistance provided by the venture capitalist. Thus, the venture capital backed projects are subject to dual management that may, sometimes, result in conflicts between the two parties. Keeping in view the fact that success or otherwise of the venture is at the mercy of the status of relationship between the venture capitalist and the entrepreneurs, the same has been studied in the present study under following dimensions: status of relationship between VC and the investee company as far as involvement of venture capitalists in investee company is concerned, reasons behind conflicts between the two, means of maintaining business as well as personal relationships and use of power by the venture capitalist vested in him on account of his supreme position in the whole financing arrangement.
As said earlier also, venture backed projects face dual management. As rightly said by Fried and Hisrich\textsuperscript{37} (1995) in their study that the relationship power is easy to emphasize upon but difficult to exercise. Things may not turn desirable as required and conflicts may arise between two causing a threat to the very survival of the venture. An attempt has been made in present research study to identify various reasons causing conflicts so as to be cautious about them since the inception of the financing arrangements.

Studies conducted earlier bring forward reasons behind conflicts between the venture capitalists and the investee company. Sahlman\textsuperscript{38} (1990) identifies staging capital as one of such reasons. The most important mechanism for controlling is staging the infusion of capital into companies at distinct stages in their development. As a result each company begins life knowing that it has only enough capital to reach the next stage when progress will be assessed. The purpose of staging is to preserve the right of the venture capitalist to abandon a project if its future prospects look dim. Refusal of refinancing may be used as a tool in initiating change in the company and creating a credible threat to the entrepreneurs.

An important reason of conflict as identified by Sweeting and Wong\textsuperscript{39} (1997) is difference in level of information known to entrepreneurs and that of venture capitalists. However, being on the board of investee companies or on account of other powers rising out of contractual arrangement, venture capitalists get easy access to formal and informal information regarding investees’ performance. However non-involvement in day-to-day activities may result in differences in level
of information known to them against that of investee company management giving way to conflicts.

The level of involvement may also contribute towards conflicts. The differences in perception regarding the role of venture capitalists with regard to post investment assistance between two may differ. The status of relationship between the venture capitalists and the investee companies can have three dimensions: investee company expectations outweigh venture capitalists' involvement, venture capitalist's involvement is much more than the investee’s expectations and both parties agree to a common point. In this respect, the first two cases may cause a mismatch between the level of involvement as perceived by venture capitalists as well as that of investee company resulting in conflicts between the two. The study conducted by Pandey, I. M. and Jang, A.40 (1996) shows that most of the venture capitalists consider their assistance to be more than as expected by the investees. The most desirable situation in this respect is when both parties agree to a common point. Thus, ascertaining the status of relationship between the venture capitalist and the investee company and bringing it to the desired level is of great concern for the venture capitalist necessitating study of the same in present study.

Admati and Pflieiderer41 (1994) have, in their study, focussed on the investment and continuation decisions when capital is provided in stages. They identify the over-investment problem – the problem that an entrepreneur who can attract outside funds may continue to invest in the project even when it is no longer valuable based on the entrepreneur’s inside information. Even if the information would show that a project has a negative net present value, as long as it has some probability of being successful, the entrepreneur’s option, like position suggests, he or she will
continue as long as others will provide the financing. The external investor, such as the venture capitalist, can enter the picture, invest, monitor and become equally informed. Timing of investment and state of disagreement on account of over-investment by the entrepreneurs may also contribute to the conflicts between the two. It was desirable to study this aspect in relation to Indian venture capitalists so as to find out the status of the same.

The very success of the venture depends to a large extent upon the level of harmony between the two parties. The question arises how to manage the matter between investees and venture capitalists in order to establish a good relationship between the two. Relations can be business relations as well as personal relations. Various means have been identified so as to maintain business relations between the venture capitalists such as joint research programme, licensing agreement for the venture's new technology, product technology development arrangements and debt-financing arrangement.

Another aspect of investor-investee relationship can be establishment of personal relationships between the venture capitalists and that of investee companies. Hatherly et al. (1994) in his study found that venture capitalists put less emphasis on monitoring and more emphasis on trust, openness and mutual support indicating the importance of informal/personal relationships between the two. It was observed that relationship between investor and investee was better categorised as a principal-agent relationship. In areas that would support an effective mutual relationship—professionalism, quality of services, speed, efficiency, understanding and flexibility, development of personal relationships and experience were rated highly. In all there is a strong suggestion that inappropriate matching investor-investee styles can be damaging. Mitchell et al.
(1995) have used an applied version of principal–agent analysis to analyse investor – investee relationships. Under this concept venture capitalists act as ‘principal’ and investees ‘agents’ who act on behalf of their principal. Hatherly et al (1994) considered from their statistical analysis of findings, that the relationship between investor and investees were best characteristics for a joint venture with a view to get substantial gain for both parties. Within a large capital organization it may be expected that while relationships may start, or be planned to start on basis of the joint-venture paradigm, circumstances may result in the need for the venture capitalist to become more involved, increase formal monitoring and remind the investee of sanctions that may be available to the investor in the terms of the formal venture capital agreement. Beyond a certain point, the relationship may be expected to ‘flip-over’ into a principal agent paradigm when a reversal back to a joint-venture relationship may be very difficult.

It can be thus summed up that a closer venture capitalist-investee relationship is the most viable way forward. Keeping in view this aspect the same has been studied in present study with following options for establishment of personal relationships between the two: Mutual trust and Principal-Agent relationships.

The venture capitalist makes various financial as well as non-financial contributions to the investee company. The venture capital fund is in a position to exercise three sources of power arising out of contractual arrangement-Money power, personal relationships and formal power. The impact of the VC’s inputs on the company varies with the venture capitalists’ power with management.
The ability to allocate money has long been viewed as a major source of power in large organizations. A golden rule applies here: “He who has the gold makes the rules”. This power is not based upon money invested in the past, but rather on company’s current or future needs for money. This power is often present in venture investments because investments are generally made in stages based on the company’s development. As a result, a venture-backed start-up is almost certain to need additional funding to survive. The company’s existing venture investors are its most likely source of funding particularly, since finding new investors is more difficult when the old investors are not willing to invest more. This power is the strongest when the venture is performing poorly and is the weakest when the company is performing well. Second form of power is relationship power. This power of personal relationships result from the venture capitalists’ expertise and effort devoted to the company. Relationship power is kind of power preferred by the venture capitalists as it is more pleasant to use, infringes less on the manager, and can still be very strong. While relationship power is extremely useful and enjoyable to use, it is also the most difficult to attain. Relationship power can have two dimensions: establishment of business relations as well as personal relations.

Formal power is the most controversial powers as perceived by the venture capitalists. Venture capitalists have a great deal of formal power as well, frequently being in control of the board. Even if they do not have voting control, there are usually contractual rights giving them control in case the venture fails to perform. However, formal power is often the least important of the three forms of VC power, especially for early stage venture capitalists. Since later stage investors often do not have money power, formal power is more important to them. VCs tend to avoid using
formal power as it is highly confrontational, and managers may have some countervailing formal power as well.

Thus, these are the three types of powers vested in a venture capitalist. Venture capitalists are generally reluctant to aggressively use any power. There are three reasons for it as identified by Fried and Hisrich (1995). First, the venture capitalist is highly dependent on the industry expertise and company-specific knowledge of management. Second, the power of the venture capitalist is diffused. When several VCs are involved in the venture’s funding, formal power is generally shared by a group of venture capitalists rather than one individual VC. Third, VCs want strong capable management. They have no desire to run a company. On the whole, it can be concluded that although various powers are vested in the venture capitalists, their use is decided by individual venture capital funds only.

FUTURE PROSPECTS OF INDIAN VENTURE CAPITAL INDUSTRY

Indian venture capital industry has a long way to go. Started just a decade ago, venture capital financing activity is catching fire in Indian market scene. Although presently at nascent stage, the future can be quite challenging for venture capital industry in India. No doubt, it is a late entrant in India in the field of industrial financing and is in its infancy stage, it has tremendous potential for growth. The present liberalized economic environment and steps taken by government to make it more conducive for the growth of VC industry tend to pose some challenges before the players so as to draw their attention towards reappraising their strategic positions in light of such threats caused to VC industry in India. So managing future challenges is also an important part of management of venture capital funds. ‘How to manage future challenges?’ has been studied...
under following aspects: Identification of sources of competitive threats, consideration of various alternatives for facing such threats, areas of specialization, forms of diversification strategies, and factors critical in view of future prospects of Indian venture capital industry as perceived by the venture capital funds in India.

After creating success stories in US economy, venture capital is catching fire in Asian countries. However, for the last 24 months, the entry of incubation funds, angel investors and intermediaries, and consultants has brought high specialization in the investment market. Indian market is becoming more challenging for venture capitalists following development of venture capital activities in the country. This study has endeavoured to cover this aspect by asking individual venture capitalists about challenges they'll be facing as per their perception of the same. The challenges can be in the form of increasing bargaining power of institutional investors, fears of future profit uncertainty expressed by funding institutions, entry of new parties/competitive threat, availability of substitute products to venture capital finance and difficulty in raising new funds. Relating to past studies, Murray, G. C.46 (1991), in his article, “A Challenging Marketplace for Venture Capital”, has made an attempt to appraise the contemporary situation facing the UK venture capital industry as it enters the second decade of venture capital activities. It recognizes the fact that in UK marketplace for venture capital activity, increasing bargaining power of venture fund clients into whose companies the venture capitalists allocate their funds has resulted in replacement of competitive threat earlier caused by the growth of new entrants and availability of substitute products to venture capital finance. It may not be the same in Indian scene as level of venture capital activity differs in India as compared to the UK. In India, since the venture capital industry is still at the nascent stage, no bargaining power of investee company exists. However,
competitive pressure may exist on account of entry of new players as India is becoming a lucrative place for both domestic and off-shore funds. According to him, in an increasingly competitive marketplace, UK venture capital firms are addressing strategic issues of product and market choice in order to meet the high investment expectations placed on them by their founders. In this regard, he has also quoted a growth matrix propounded by Ansoff\textsuperscript{47} (1968) to classify the range of product/market opportunities available to individual funds.

In view of Indian venture capital Industry becoming more challenging, an attempt has been made to find out the strategic choices individual venture capital funds are going to make to face the same. Ansoff’s\textsuperscript{48} ‘growth matrix’ (1968) has been used to clarify the range of product/market opportunities available to the individual firms.

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<td>New</td>
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**Quadrant I Product Development**

Firms can go for sectoral, geographical or stage financing specialization arguing the advantage of greater industry specific or local knowledge.
Quadrant II  Market Penetration

It advocates for market penetration that parallels recent trends in the US venture penetration sector. The higher the funds under management, the larger the number of deals to be supported which means more profitability.

Quadrant III  Market Development

It encompasses new market segments, new uses for existing procedures or geographical expansion. Since the first two can be fitted becomes the sole option available to the venture capitalist.

Quadrant IV Diversification

It speaks of diversification strategy. Although most risky because of inherent uncertainty on both axes i.e. new markets and new products, many economies of the world are opting for it. Diversification can be backward, forward, horizontal or a combination of these strategies adopted simultaneously.

It was desirable to know which of the above-mentioned strategies best suits any individual venture fund.

In regard to the above discussion, keeping in view challenges posed to Indian VC industry, one of the most important courses to face competitive threat can be differentiation between individual venture capitalists products or services. Alternatively, venture capital funds can go for specialization regarding investment in any particular industry on account of their in-depth
knowledge about the same on basis of experience gained from previous investments or provide financing through any particular instrument of financing because of similar reasons. Venture capital funds need to appraise their strategic positioning in the light of a likely constraint in future funds for investment. Thus, the study is aimed at strategies various venture capital firms will be following for better management of their funds in view of Indian venture capital marketplace becoming more challenging to remain in competitive position.

Another aspect of management of funds can be 'core competency factor'. A core competency factor is that positive factor which enables any company to have a competitive edge over its competitors. A key distinguishing characteristic of venture capital compared to the other forms of funding is its ability to provide money as well as business and management skills to the investee company to maximize the value of the firm so that a greater than normal capital gain can be reaped. This is especially true of venture capitalists who have some field of specialisation - industry, stage of financing and instrument of financing.

Earlier studies reveal that most of the venture capitalists are generalists and usually do not go for 'market niches'. An analysis of the funding criteria and preferences of U.K. venture capitalists, taken from the BVCA 1991 Directory, shows that the majority of venture capitalists are generalists. Their specialization is in the structuring of equity based venture deals, not in the segmentation of companies, locations or sectors to which their funds are applied. They manage their portfolios in such a way so as to reap the rewards by investing in a number of industries through various instruments in various stages.
In future, Indian market is going to be quite challenging for venture capitalists. In view of these challenges posed to venture capital industry in India, Ansoff\textsuperscript{50} (1968) has suggested a growth matrix to classify the range of product/market opportunities. According to this growth matrix, venture capital funds should go in for diversification strategies in case of new markets and new products. The U.K. venture capital industry is presently developing its experience in presenting established UK products to new country markets. Murray, G. C.\textsuperscript{51} (1991) quotes that venture capitalists occupy a clearly identifiable niche within the larger financial services market as specialist equity providers to growth businesses. So diversification strategy would take them out of their areas of greatest businesses. The alternative opportunities of backward, forward or horizontal diversification take the organization away from its present products and its present market. Forward integration moves the firm nearer to its final customers or marketplace. The customer for the venture capital firm is the provider of its investment funds. The venture capitalist deals directly with the institutional or parent company and market intermediaries are removed. Similarly, in backward integration, the venture capitalist also has a direct and immediate relationship with its supplier, the client investee company. Thus in forward and backward integration, the marketing chain between the venture capitalist and both providers and users of venture funds is short and very direct. Horizontal diversification, on the other hand, implies entry into complementary or competitive products. These diversification strategies are not mutually exclusive and can be simultaneously employed by a venture capitalist.

With due emphasis being given to the industry, there is lot of scope for development. Trying to put the domestic market at par with that in the US, may not be justified. Moreover, future is
going to be quite challenging for the venture capital industry in India with increasing competitive threat, both domestic and foreign. Some flaws are apparent in the environment causing obstacles in smooth running and growth of venture capital business. There are expectations from the government side, which will foster the growth of venture capital funds and help them face the challenge with more competitive advantage. The suggestions by various organizations are as follows:

1. **Eliminate anomalies in taxation**: Most of the venture capitalists in India share concern with regard to taxation practices prevailing upon them. Globally, venture funds and other funds incur minimum or no tax liability on their capital gains as empirical studies have shown that venture capitalists create high value addition for an economy and society. It is therefore suggested that venture fund capital gains be treated at least at par with mutual funds.

2. **Encourage participation of Provident Funds/Pension Funds etc**: Government of India could catalyse large inflow of venture capital funds by permitting Provident Funds and Pension Funds to invest a certain portion of their incremental inflows in venture capital and other such activities. This would not only lead to larger proliferation of domestic venture capital activity, but also results to realizing exponentially larger returns on asset base. This automatically permits larger retention capacity to government offers. The suggestion is at par with a similar policy already notified for banks. Government may further permit mutual funds to invest in venture capital funds.
3. **Government to expedite legislation for LLC/LLP**: Ministry of Information Technology has already moved the thinking for a legislation that would allow Limited Liability Companies (LLC) and Limited Liability Partnerships (LLP) to be established in India. These constitute evolved forms of company and partnership statutes that permit different forms of partners with varying liability and rights. Globally, LLC/LLP are prevalent forms of venture capital companies. In India, one of the major bottlenecks to high take off of venture capital culture has been its inability to be set up as an entity under LLC/LLP framework. In view of the same, Government of India needs to expedite legislation for LLC/LLP in order that the Silicon Valley phenomenon can be emulated in India.

4. **Encouragement to banks**: In 1998, subsequent to National IT Task Force's recommendations, Government of India had urged all banks to earmark 5 per cent of incremental deposits for venture capital investments. This policy, if implemented in true spirit, can lead to substantial availability of easy venture capital funds across the country. These funds can be utilized for not only high technology sector but also other niche areas where India has inherent or built – in advantage.

5. **IPO norms to be relaxed**: SEBI has notified minimum capitalization, profitability and age norms for companies planning to make public offering (at a premium) of their equity. It is suggested that such a norm be relaxed for young companies. This is, in view of the fact that generally, it is difficult for companies to realize their true valuation before a public float. Importantly, the very business model of internet based companies and other hi-technology start-ups would render it difficult to establish a profitability track record in three years. Thus, a
mandatory criterion in this regard may be a major dampener to quality companies approaching public markets, severely restrict exit options and also deprive public from acquiring equity in quality companies with latent potential and could erode the plans of making India a software superpower.

6. **VCFs can partake various forms of funds:** Venture capital also looks beyond seeding or funding companies, and often moves to rescuing faulting companies with good potential. It is suggested that venture capital companies be encouraged to establish Distress Funds / Turnaround Funds for helping ailing companies.

7. **Exit options:** Exit options to investors and promoters are a key to successful venture capital partnership. This is integral to realizing gains from a successful company. It is suggested that Government of India allows a liberal exit framework at par with that prevalent in USA.

8. **Early implementation of OTCEI plans:** Government of India should issue earliest permission for implementation of trading of unlisted securities on over the counter exchange of India (OTCEI). This could also be a key to having a vibrant pre-IPO market in India.

9. **Intricate linkages with NRI community:** Non Resident Indians (NRIs) are amongst the more positioned foreign communities in other countries, especially North America and parts of Europe. The constituents are known for their respected standing in professional world as well as personal wealth. It is suggested that industry in India should take steps to forge more intricate ties with NRI community that can lead to not only greater investments flowing to
Indian ventures, but also lead to assistance in venture development and probability of reverse brain drain.

10. **Introduction of Entrepreneurial course components**: Business Schools in India must come forward with course components on entrepreneurship and venture development. It would be great facilitator in exposing budding entrepreneurs and business management practitioners to dynamics of developing a venture.

11. **Standing committee of Government-Industry**: It is suggested that Government of India should join hands with industry to form a standing committee. This committee could be mandated with facilitating continuous appraisal of venture capital environment in India and to pave way for a conducive environment for greater wealth and employment generation.

12. **Venture investment fairs**: It is suggested that a series of venture investment fairs must be organized in all parts of the country. The objective is to bring together venture capitalists and entrepreneurs on same platform in a business environment for results.

Thus the above discussion presents a synoptical view of various aspects of management of venture capital funds. These aspects have been included in the questionnaire (Appendix B) and a summary of results appears in the following chapter.
NOTES


