Role of Venture Capital in Indian Software Industry
In preceding chapters, we have described the characteristics of the Indian software industry. It has been observed that the Indian software industry operates at the lower level of the value chain or in the market that has already become standardized. The industry is also observed as surviving on competitive advantage of low cost as opposed to knowledge advantage. In this chapter we shall perceive the nature of venture capital based financing and investigate the role of this type of financing that assists Indian software firms to achieve spectacular export growth described in earlier chapters.

It has been argued in many literatures that in the era of information technology revolution, knowledge is the key factor to dominate. Human capital is the prime asset of IT industry and that is where major investments are made, with substantially lower investments in land, building, plant or machinery. The technology of software industry is not only advanced, but also continuously changing at a much faster rate than any other industry. Thus the heavily asset based or collateral backed lending instruments adopted for the hard core manufacturing industries are simply inadequate for software (knowledge based) industry, which often start with just an idea. To materialize the ‘novel-idea’ for a new software product with considerable market potential, commercialization of new technologies and support to smaller and medium size high-tech software companies, there is a requirement for financial resources, which can be channeled towards innovative investments. Because of high risks and lack of collateral associated with most new high-technology ventures, conventional lending institutions would not be willing to provide capital until a new company shows signs of success in terms of sales and orders. The venture capital firms might thus appear particularly suitable for this form of financing. This is a new type of financial service model of innovation, which emerged during
seventies in the USA (to support mainly new high-tech ventures in IT industry) and around late eighties in India (if at all).

In the pervious chapter we have observed that notwithstanding of having large pool of technically skilled manpower, the software industry operates at the lower level of the value chain. The product and services it offers has become standardized in the market. The performance of firms depends on the ability to strike foreign collaboration, or acquiring agencies of foreign firms and not on the capability to innovate new technology and thus edge on product differentiation. India’s software sector has focused on onsite services abroad, otherwise known as “body-shopping” or “manpower contracts,” in which Indian firms undertake mostly the routine tasks of coding and debugging (rather than design, analysis and project management). These contracts are generally short-term, low-risk, low-value-added, and low investment operations. Firms having longer experience in the market have been noticed to do better than the new entrants. Low-value, low-cost nature of work contract makes entry of small and tiny firms easier because they are able to offer further price advantage from their low overhead cost. Entry of new firms in the industry does not need to have any knowledge advantage over the existing firms. The start-up cost of a new company is also not very high, as start-up does not happen with a novel idea.

Moreover, software firms can not undertake high-tech innovation or product development, as social structure of innovation is virtually non-existent in the economy. The well-developed technological infrastructure is absent in Indian software industry. Software firms hardly have any opportunity or capability to perform risky R&D and high-tech entrepreneurial activity. A decision to form a new business with an innovative
idea often involves acceptance of risk and for that entrepreneurs should have the
determination to pursue their novel ideas for a new product which is absent in Indian
software industry. Venture capital financed innovation, which overcomes financial,
technological and organizational barriers and accelerates the process of technological
change, is likely to play a critical role here.

In this chapter, we shall therefore explore the role that venture capital has played
in the Indian software industry. In other words, we investigate how venture capital based
financing assists Indian software firms to grow by innovating new products in high
technology area. We expect that the behavior of venture capital would corroborate our
findings in the earlier chapters.

In the first section we shall understand the meaning of venture capital and its
characteristics. This will bring out the role that venture capital firms play as financial
intermediaries between investors & entrepreneurs. Second section describes how venture
capital helps to generate new model of innovation, which overcomes the obstacles
associated with other innovation models. Third section helps us to understand the use of
venture capital in different stages of the development cycle. Fourth section scrutinizes the
dynamics of existing venture capital industry in India and its role in domestic software
technology development. This section also outlines the structure of venture capital
industry in India. The last section presents summary and broad observations.

6.11 Meaning of Venture Capital

The term venture capital usually denotes a mutual fund or an institutional investor
that provides equity finance or risk capital to high-risk small or medium businesses
especially in technology-oriented and knowledge-intensive industries with the hope of
earning high rate of return. Venture capitalists invest in new, unproven enterprises which traditional financial institutions ignore since they have neither physical assets nor a low-risk business plan. Instead of lending money, venture capitalists exchange capital for an equity or ownership stake in the companies they finance. Internationally renowned companies, particularly in the computer field like Apple Computers, Microsoft, Sun Microsystems, Intel, Lotus Development, Digital Equipment, Compaq Computers etc., who became giant in their respective fields, had all been supported by venture capital funds in their early days. The phenomenal growth of Silicon Valley in the US as a torchbearer of technology changes has come about due to the activities of the venture capitalists. In other words, venture capital has transformed the innovation process in the US by overcoming financial, technological and organizational barriers, which characterize both entrepreneurial and corporate-based innovation (Florida 1988).

The concept of venture capital based financing for innovation was originated in USA in 1946 by American Research and Development Corporation, who became a pioneer venture capitalist. After recognizing the need for risk capital for unproven high-risk ventures, the US government promoted Small Business Investment Companies (SBIC) in mid 1950s. In late 1970s the tide began to move in favor of venture capital investment after massive reduction in capital gains tax rate and a high-profile IPOs by venture-backed companies. The late 1980s registered the transition of the primary source of venture capital funds from wealthy individuals and families to pension and other institutional funds. One of the important factors for rapid growth of venture capital industry in the USA in 1980s was well-developed stock market, which could perhaps provide a suitable exit route to venture capitalists. Since 1990s the venture capital
industry in US is having tremendous growth with current investments of US$ 48.3 billion in 1999, primarily into knowledge-based companies. The Internet related companies alone received more than 66 per cent of all venture capital amounting about US$ 32 billion in 1999.29

6.12 Traits of Venture Capital

Venture capital funds and the projects financed by venture capitalists typically have the following characteristics:

i) Finance new, rapidly growing, knowledge-based, sustainable, up scaleable companies:

The projects funded are in new and high technology areas, with high-risk, albeit with high growth and profitability potential where conventional sources of finance are usually unwilling to support. The projects funded also have high mortality rates and hence they are unattractive to risk-averse bankers and other traditional finance companies. Venture capitalists take higher risks with the expectation of higher rewards. They reduce investment uncertainty through careful screening of initial business proposals.

ii) Purchase equity / quasi-equity securities:

Venture capitalists are active investors, involve in the creation of young companies. They lend money for an equity/quasi equity or ownership stake in the companies they finance. Had the investment been debt financing the young companies could have faced the problem of schedule repayment of debt at the formation stage of the company. Getting equity assistance from venture capital firms, young companies may

29 Source: www.vfinance.com
reinvest their initial earnings to originate asset base that can be used to attract outside capital and enhance company’s credibility. But equity financing is assumed to take substantial investment risk by venture capitalist because of uncertain future of business and they can go bankrupt at any time. After some years when the assisted company reaches a certain stage of profitability, the venture capital firm sells his stake for an attractive premium. A sale or mergers with another company or initial public offering are the most common mechanisms for exiting an investment. A third option is a stock buyback whereby an agreement is reached between the company and the venture capital fund allowing the company to repurchase the shares held by the venture firm. The return sought by the venture fund is through ultimate capital gains rather than steady dividends or interest yields.

iii) Add value to the new company through active participation to assist in the development of new products or services:

Venture capital firms do much more than just to provide financial support. They furnish management assistance and technical advice throughout the early stages of company’s growth. Unlike bankers and stock investors, venture capitalists involve with their start-up companies; offer the entrepreneur consulting, recommendations about personnel, technical advice, and business and financial management. They have their own interest to get back good amount of return out of their investment. Because of their avaricious characteristic for money, they are often called ‘vulture capitalist’ in Silicon Valley.
iv) Actively cultivate networks:

Venture capitalists actively cultivate networks comprised of financial institutions, large corporations, universities and entrepreneurs to forge important linkages between large and small institutions. These networks along with the information flow at their disposal enable them to reduce many of the risks associated with new enterprise formation. As a result, networks help them to overcome many of the barriers that hold back innovation.

v) Have a long-term orientation:

Venture capital funds generally have a long-term orientation with assisted companies. Investments are not made with a view to short-term profit.

A venture capital firm thus plays the role of financial intermediary between investors looking for high potential returns and entrepreneurs who need some institutional capital as they are not yet ready or able to go to the public. Venture capitalists obtain money from wealthy individuals, pension funds, universities and research institution and from banks, insurance companies and other large corporations. In 1989, 80 per cent of the US venture capital industry’s capital came from private funds, 7 per cent from SBIC and rest from corporate groups. Thus independent private venture capital firms were the principal institutional source of venture capital in the USA.

---

6.2 New Model of Innovation

Venture capital has transformed the innovation process in the US in late 70s and early 80s, giving rise to a “new model” of innovation which is believed to bridge the gap between entrepreneurial-driven and corporate-led dichotomy posed by neo-Schumpeterian theory (Florida 1987). Let us discuss types of innovation model and then we would try to understand how venture capital financed innovation helps to integrate all models and plays a critical role to set the direction of technological change.

![Model of Innovation](image)

<table>
<thead>
<tr>
<th>Model of Innovation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entrepreneurial Innovation</td>
</tr>
</tbody>
</table>

- Individual or group of entrepreneurs drives innovation process
- Ideas drawn from science
- Employ technical know-how to launch new products and forge new product markets
- Technological & organizational changes generated by innovation creates new industries
- Large corporations organize the R&D process
- Internalize much R&D activity to remain at the forefront of new technology and generate successive waves of innovation
- Internalization of innovation makes technological change a less sporadic, more continuous process
- Large corporations & universities establish scientific & technological context needed for innovation
- Technological opportunities are exploited & commercialized by small entrepreneurial firms
- Such interplay act in a dynamic and complementary way as part of innovative process

Source: Richard L. Florida and Martin Kenney (1988)

Disadvantages of the above mentioned innovation models are discussed in table 1.
Table 1: Disadvantages of Innovation Models

<table>
<thead>
<tr>
<th>Entrepreneurial Innovation</th>
<th>Corporate Innovation</th>
<th>Large &amp; Small Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Innovation occurs in ad-hoc and unorganized way</td>
<td>Innovation is often impaired by organizational rigidity</td>
<td>Lack of market knowledge</td>
</tr>
<tr>
<td>Single-handedly manage the process of enterprise formation</td>
<td>Centralized decision making, flow of information is not intense</td>
<td>Lack of managerial capability</td>
</tr>
</tbody>
</table>

Source: Richard L. Florida and Martin Kenney (1988)

Venture capital-financed innovation overcomes many of the obstacles associated with above mentioned innovation models. Venture capitalists bring resources and contacts to help reduce the information and opportunity costs associated with new business formation. This type of innovation replaces organizational rigidity of financing, creates relatively flexible organizational environment characterized by frequent adjustment, decentralized decision making and intense flow of information. This helps to create significant incentives for innovation.

Figure 1 describes the venture capital-financed innovation model. As in the figure, venture capitalists are situated at the center of all networks. The connections of venture capitalists reach into large corporations, universities, financial institutions and varieties of other organizations, which play important roles in the innovation process.

Venture capital firms are generally located around high technology areas with extended network of integrative systems, so called “social structure of innovation”. This system comprised of universities, technology-oriented enterprises, highly skilled labor, public or private R&D organizations, extensive networks of supplies, manufacturers and vendors. Other than that venture capital firms get support from law firms and consultants specializing in high technology, associated with strong entrepreneurial networks and
informal mechanisms for information exchange and technology transfer. This network and resources drawn from various organizations help venture capitalists to form new

**Figure 1: Model of Venture Capital-financed Innovation**

![Diagram showing the model of Venture Capital-financed Innovation](image)

Source: Richard L. Florida and Martin Kenney (1988)

enterprise by creating a new interactive model of innovation. This type of interactive system played an important role to move the US economy across new technological frontiers and thus economic restructuring.

### 6.3 Investment Stages

The technology cycle has been described in table: 2, proceeding through five stages: R&D, start-up, risky growth, regular growth and maturity. As in table shown, venture capital is most important during the emergence stage, which begins with a major breakthrough or innovation. This phase is marked by experimentation with new
technology, uncertainty regarding future progress, wide open markets, low entry barriers and diseconomies of scale.

Table: 2 Development Stages of a New Technology-Based Firm

<table>
<thead>
<tr>
<th>Stages of Development</th>
<th>Activity</th>
<th>Financing</th>
<th>Why</th>
<th>When</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. R&amp;D</td>
<td>Feasibility studies</td>
<td>Seed financing</td>
<td>For innovation &amp; new product development</td>
<td>Conceptualization of initial business</td>
</tr>
<tr>
<td></td>
<td>Technical development</td>
<td>Own firms (mainly)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Market research</td>
<td>Venture capital firms (rarely)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Start-up</td>
<td>Manufacturing and commercializing product development</td>
<td>Venture capital</td>
<td>To meet working capital margin</td>
<td>Creation of new infrastructure</td>
</tr>
<tr>
<td>3. Risky growth</td>
<td>Further growth, developing second generation products</td>
<td>Joint involvement of several venture capital organizations</td>
<td>To meet initial cash loss and further working capital</td>
<td>After commercial scale implementation</td>
</tr>
<tr>
<td>4. Regular growth</td>
<td>Achieving economies of scale in production and sales</td>
<td>Investment banks, venture capital, takeover by larger firms</td>
<td>To increase production capacity, market or product development and/or provide additional working capital</td>
<td>Turnaround situations</td>
</tr>
<tr>
<td>5. Maturity</td>
<td>Broadening technological base and management capabilities</td>
<td>Stock market or other exit route</td>
<td>Willingness of venture capital firms to liquidate their investment portfolios</td>
<td>Operational and financial difficulties faced by companies</td>
</tr>
</tbody>
</table>

Source: Compiled from Different Sources

According to Florida (1988), to reduce investment uncertainty during emergence stage, venture capitalists carefully screen business plan and take decision whether to invest or not. They evaluate business plans in light of variety of criteria including:
The originality of the proposed product or technology

Potential competitors

Market size

Business strategy and projected sales

The availability of proprietary characteristics

The quality and business acumen of the entrepreneurial group

The prospective manner of exiting from the investment and realizing a substantial capital gain

With these understandings we illustrate the dynamics of Indian venture capital industry in the next section.

6.4 Dynamics and Structure of Indian Venture Capital Industry

In chapter III, we have seen the weakness of the Indian software industry as a result of its weak linkages with the domestic manufacturing industry. This is the area where opportunity exists for India to develop critical software capability. The high skill/high risk/high value embedded software segment (which is almost non-existent in India) can flourish only with wide applications of microelectronics in the industrial products and processes. It has been observed that embedded segment might offer the opportunity for independent growth of both hardware and software sectors of the Indian IT industry. Now we need to explore whether the existing financial market structure is strong enough for Indian software industry to enter the high investment high R&D area of the embedded software segment. How existing venture capital industry in India can help (financially) IT industry to enter into the high skill/high risk/high value embedded software segment?
Given the structure of the Indian software industry, nature of activity of Indian software firms and traits of venture capital firms indicate a preference for limited investment in technology-based software companies, a series of interviews conducted in December 2000, sought to address two key questions:

- In the Indian software industry, is there any prerequisite of venture capital type of financing, which is basically required for new, unproven enterprises to finance a new venture?
- Does the venture capital investment play the role to overcome financial barrier for development of embedded software segment in India?

In order to explore the answers of the above questions, first we have to make out the existing structure of venture capital industry in India. This section elaborates a brief overview of the Indian venture capital industry.

6.41 Overview of the Indian Venture Capital Industry

The concept of venture capital in India originated in late 80s with setting up of a Technology Development Fund (TDF) in the year 1987-88, through the levy of a cess on all technology import payments. The World Bank did the actual commencement of the venture capital industry in India in 1988 as part of its Industrial Technology Development Project in India. It all started with a seminar organized by the World Bank in 1988 to increase awareness about venture capital in India. The Government received a loan of $45 million from World Bank to support four venture capital entities for financing technologically innovative and growth oriented small enterprises. The need for creating the right environment was felt by Government, as a result of which the ‘venture capital guidelines’ was formulated in 1988. In this guidelines the details of establishment.
management, the nature of assistance, size of investment, eligibility of tax concession and the details of exiting from the venture were highlighted. The initial emphasis was to assist projects promoted by relatively new entrepreneurs, based on relatively untried technologies. However, these guidelines restricted the setting up of venture capital firms by the banks/financial institutions only, unlike the trend of international venture capital, which was being supplied by small scale.

It has been argued that the venture capital industry in India is at a nascent stage (IT Task Force 1998). Policy makers anticipate venture capital activity as very important to promote in India with a view to assist innovation, enterprise and conversion of scientific technology and knowledge-based ideas into commercial production. However, interviews (which has been conducted in December 2000) with venture capitalists clearly depicts a drought of good investment ideas in India. Venture capitalists typically invest in seed and early stage companies. But over the past six years, Indian and Pan Asian venture capital funds have invested Rs. 14,272 crore (where as total VC commitment till December was Rs. 25,000 crore) in Indian companies, not in seed and early stage, but at various stages of development. According to NASSCOM, fiscal 2001-02 saw an 8% decline in venture funding at Rs. 5,200 crore against Rs. 5,470 crore in fiscal 2000-01. The association projects that in 2002-03, funding will increase to Rs. 10,000 crore while the total quantum of funds to be raised by VCs during this period is projected at Rs. 15,000 crore. Add to this with Pan Asian’s about Rs. 10,000 crore non-disbursed venture capital funds, raises the quantum of total capital availability for fresh fund by over Rs. 25,000 crore. But the question remains whether this money is going to use for innovative ideas or not.
As we see in the previous chapters, Indian software industry is not a high innovative sector. Companies have not been started with innovative ideas, as is the case in Silicon Valley. Most of the companies are involved in IT enabled services where opportunity of innovation is almost insignificant. Business Process Outsourcing (BPO) is the buzzword of software sector, which is the easy way to earn money.

Figure 2: VC Investment Pattern

The features of the product and services offered by the Indian software industry have already been discussed in earlier chapters. We argued that the structure of Indian software industry is a direct consequence of the export centric product and services offered by the industry. Now we argue that the structure of venture capital industry is the repercussion of the structure of software industry to provide financial support.

6.42 Structure of Indian Venture Capital Industry:

In 1998, there were total 21 venture capital companies registered in Indian Venture Capital Association (IVCA). IVCA members fall into different categories. Some function as investment and fund management companies, others set up funds and
function as asset management companies. Some companies manage domestic funds, some manage offshore fund and some manage both.

Table 3 shows that in 1998, foreign institutional investors and all India financial institutions contributed more than three fourth of the pool of funds available for venture capital investment. Out of total pool of Rs. 29,885 million, only 42% (Rs. 12,560 million) had been invested in different instruments. Figure 3 shows the investment by method of financing in 1998. About 72% of total disbursed amount were invested in equity and preferred shares. According to ICVA, “this is as it should be, because venture capital is essentially investment in the equity of a company, with an expectation that it will appreciate over time.” But the question remains whether venture capitalists invested in start up companies or not. If so, then were the companies started their operation with innovative ideas?

Table 3: Contributors of Venture Capital

<table>
<thead>
<tr>
<th>Contributors</th>
<th>Rs. Million</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Institutional Investors</td>
<td>15,178</td>
<td>50.79</td>
</tr>
<tr>
<td>All India Financial Institutions</td>
<td>7,727</td>
<td>25.86</td>
</tr>
<tr>
<td>Multilateral Development Agencies</td>
<td>2,299</td>
<td>7.69</td>
</tr>
<tr>
<td>Other Banks</td>
<td>1,710</td>
<td>5.72</td>
</tr>
<tr>
<td>Other Public</td>
<td>725</td>
<td>2.43</td>
</tr>
<tr>
<td>Private Sector</td>
<td>624</td>
<td>2.09</td>
</tr>
<tr>
<td>Public Sector</td>
<td>442</td>
<td>1.48</td>
</tr>
<tr>
<td>Nationalized Banks</td>
<td>434</td>
<td>1.45</td>
</tr>
<tr>
<td>State Financial Institutions</td>
<td>365</td>
<td>1.22</td>
</tr>
<tr>
<td>Non-Resident Indians</td>
<td>313</td>
<td>1.05</td>
</tr>
<tr>
<td>Insurance Companies &amp; Mutual Fund</td>
<td>68</td>
<td>0.23</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>29,885</strong></td>
<td><strong>100.00</strong></td>
</tr>
</tbody>
</table>

Figure 3: Instruments of Finance

![Pie chart showing the distribution of financial instruments.]

<table>
<thead>
<tr>
<th>Non-convertible Debt</th>
<th>Other Instruments</th>
<th>Preference Shares</th>
<th>Convertible Debt</th>
<th>Equity Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>7%</td>
<td>1%</td>
<td>8%</td>
<td>20%</td>
<td>64%</td>
</tr>
</tbody>
</table>


Table: 4 Investment by stages of financing

<table>
<thead>
<tr>
<th>Investment Stages</th>
<th>Rs. Million</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Start-up Stage</td>
<td>5,146</td>
<td>41.0</td>
</tr>
<tr>
<td>Later Stage</td>
<td>4,479</td>
<td>35.7</td>
</tr>
<tr>
<td>Other early Stage</td>
<td>2,208</td>
<td>17.6</td>
</tr>
<tr>
<td>Seed Stage</td>
<td>644</td>
<td>5.1</td>
</tr>
<tr>
<td>Turnaround Financing</td>
<td>83</td>
<td>0.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>12,560</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>


One of the important traits of venture capital is the investment in seed and start-up stages. But the table 4 shows that more than 50% of total disbursed amount in 1998 went to stages of investment other than seed and start-up stages. More that 35% investment went to later stages. Moreover, the average amount of investments per project reveals an interesting result. It was Rs. 8.04 million per project in the seed stage, Rs. 9.21 million per project in the turnaround stage, Rs. 14.50 million per project in the start-up stage, Rs. 18.72 million per project in the other early stage and Rs. 26.98 million per project in the later stage. This shows that the average investment per project is the maximum in the
later stage, which contradicts the characteristics of venture capital investment. The preference for later stage investments is also demonstrated by the fact that 19 of the 20 members who had made venture capital investments had invested in later stage projects. One could argue that later stage projects require larger amounts of finance compared to seed stage investment per projects. But venture capitalists typically investment in seed and early stage companies. Traditional financial institutions, banks are there to provide financial support at the later stage of development. Therefore the question arises that why venture capitalists are interested in investing at the later stage of development.

Venture capitalists in India have not exhibited to make investments in specific stages of projects. According to IVCA, in 1998, 3 members had invested in projects all 5 stages, 5 members had invested in 4 stages, 6 members in 3 stages, 3 members in 2 stages and 3 members in 1 stage. Thus the majority had invested in at least 3 stages of investment. This indicates that unlike USA, where venture capitalists operate in specific areas, most venture capitalists in India invest regardless of the stages of projects.

We have seen that availability of funds is not a problem in India. But the availability of good idea is a problem. Interviews reveal that venture capitalists in Mumbai are now re-positioned themselves as "private equity investors" and this is probably where the genesis of the pool of "idle" capital lies. Private equity investors invest large investment in equity shares in established company, which are already making profits. But they are not considered as typical venture capitalists as they do not provide money for initial funding required starting a company's business with novel idea. They fund money to the company's expansion stage to either help company for consolidating its market presence or to grow inorganically through acquisition. Many
respondents believe that there does not exist venture capitalist today, everybody is equity investor. It is more so for venture capitalists who invest in software industry.

Some of the high-profile deals that has taken place recently reveals that most of the venture capital has been used in business process outsourcing (BPO) company. In BPO, there does not exist any innovative idea to start-up with. Thus the capital invested for BPO companies is basically private equity investors, which is the result of dramatic u-turn of venture capitalist into private equity investor. For example, Delhi-based Infinity Ventures recently did a late stage $2 million investment in the TCS-Ken Eldred promoted call center company Epicenter. Another Pan Asian VC, Westbridge Capital infused $3 million in Bangalore-based electronics engineering solutions company Celetron in February 2002 (Economic Times, 19th June 2002).

Foreign investors believe that India is not yet a highly innovative economy with lots of mature companies born out of innovation, as in case in the Silicon Valley. Which is why any VC money that is flowing is going to BPO sector, which is considered as tried and tested business model.

On the basis of above discussion, we can develop a venture capital model for India as follows:

**Figure 4: Model of Venture Capital in India**
For any venture idea to success, there should be a product, which has a growing market with a scalable business model. The IT industry is most suitable for venture funding because of its “ideas” nature. But in India, because of its service centric business model, venture capital does not play important role. Products developed for Indian markets lack scale.

6.5 Summary and Observations:

We have described a general model of the dynamics of venture capital. The crux of this dynamics is new ideas, new innovations that requires a different kind of investment environment. Venture capital fills up that gap. In case of India, we have observed that there is hardly any new ideas or innovation that needs a different investment environment. As a result, the dynamics of the Indian venture capital has emerged as much different from the general one. The alternative model that accommodates the Indian traits, the venture capital behaves more or less like equity investor than a new idea venture. They invest in activities where there is profit. This profit comes from low cost advantage and not from knowledge advantage. Therefore venture capital does not have any role to play other than operating as any normal capital investment in the current scenario of the Indian software industry.

As we mentioned earlier, venture capital is for new ideas, new innovation. If there is no venture capital that funds any new ideas or new innovations today, there is no likelihood that there will be any new innovation by the Indian software industry tomorrow. It, therefore, appears that retaining low manpower cost advantage will remain the lifeline of the Indian software industry.