CHAPTER 1

INTRODUCTION

1.0 Background

Setting up a business is a formidable task. There are plenty of challenges that an entrepreneur has to face. Raising start up capital for a business venture has always been a bigger challenge for aspiring entrepreneur. This is especially true for firms in knowledge based industries. Various observers describe today’s global economy as one in transition to a ‘knowledge economy’, or an ‘information society’ where resources such as know-how are more critical than other economic resources like labour and capital as recognized by neo-classic economics (Skyrme, 1997; Houghton and Sheehan, 2000). In India, also new economy is driven by technology development, wherein major investments are being made in the knowledge based industries with substantially low investments in land, building, plant and machinery. These knowledge based industries often start with just an idea hence, the asset/collateral-based instruments adopted for the hard core manufacturing industries, are proving to be inadequate for the knowledge based industries.

From the entrepreneur’s perspective, the available financing sources could be considered as debt versus equity (Zimmere and Scarborough, 2005), however, debt financing is not an option for such firms as these enterprises are characterized by significant intangible but limited tangible assets, a period of negative returns and uncertain prospects. These characteristics make a debt financing difficult (Povaly, 2007). Similarly, high quality and useful information on their activities and prospects may be difficult or very costly to obtain externally resulting into lower level of capitalization. All these factors lead to serious moral hazard problems that must be controlled by an outside investor, and that cannot adequately be dealt with pure debt-type contracts (Sagari, 1992). Thus, alternative source of finance is required to enable these ventures to pass from the startup to expansion phase. Within this context, probably venture capital is the financing mechanism that will fit with the financial and managerial needs of such innovation based entrepreneurship. Besides the equity gap of these firms with high growth potential, venture capital may also fill the competence gap as the involvement of these venture
capital firms in the companies that they invest in goes beyond the provision of financial resources (Isaksson, 2006). Venture capital firms devote significant management resources to understanding new technologies and markets, finding promising startups in those spaces, and coaching them through the early part of their lives (Davila et al., 2001).

An entrepreneur needs venture capital at different stages of company’s growth. Historically, venture capital evolved as a method of early stage financing, but the notion of venture capital recognizes different stages of financing including development, expansion and buyout financing for the enterprises which are unable to raise funds through the normal financing channels (Pandey, 1996).


It can be seen from the above figure that when the investment risk is high during the development stage and seed stage; the founder’s family and friends are typically financing the deal but the resources made available by them are often limited. So as the deal move close to the startup stage, business angels begin to enter into the picture (Benjamin and Margulis, 2001). Venture capital funds typically invest in companies that have the seed and early stage developments and are looking for expansion capital. This is because by investing at later stages, there is less risk in the company and potentially less time to harvest. Also the size of today’s venture funds does not allow them to make smaller investments (Bradley et al., 2002). Fixed costs of project screening and monitoring make it uneconomical for venture capitalists to make small investments. In order to deal with the uncertainties in the startup investments (characterized in the form
of asymmetric information, moral hazard problems, higher intangible assets etc.), venture capital firms tend to focus on a few industries that they get to understand very well (Gupta and Sapienza, 1992).

1.1 Venture Capital: Concept and Characteristics

Venture capital investing is popularly referred to as the ‘business of building businesses’ (Benjamin and Margulis, 2001). Venture capital means many things to many people and as such it is in fact nearly impossible to come across one single definition of the concept.

Jane Koloski Morris, editor of the well known industry publication; Venture Economics, defines venture capital as 'providing seed, startup and first stage financing' and also 'funding the expansion of companies that have already demonstrated their business potential but do not yet have access to the public securities market or to credit oriented institutional funding sources (Chary, 2005). The European Venture Capital Association describes it as risk finance for entrepreneurial growth oriented companies. It is investment for the medium or long term to maximize returns. It is a partnership with the entrepreneur in which the investor can add value to the company because of his knowledge, experience and contact base (Kumar, 2005). According to a definition of National Venture Capital Association (NVCA) “Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors (Retrieved from http://www.work.com/finding-venture-capital-918/ as on August, 2008). Venture capital is an important source of equity for startup companies. Professionally managed venture capital firms are generally private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves.

In reality, there is a difference between the US and the European definition of venture capital. This difference stems from the field of specialization of these firms and their preferences regarding the development stage of firm. The definition of venture capital as it is used in the US comprises includes seed, startup, and expansion investment and excludes buyouts. In the US, private equity firms supplying buyout and restructuring funds to the large established funds are not accepted as being proper venture capitalists
and as such are subsequently not accepted as members of North America Venture Capital Association (NVCA). In Europe, on the other hand, these types of venture capital firms are accepted as proper venture capitalists and thus are accepted as members of the corresponding association (Centindamar, 2008).

Pandey (1996) has given a comprehensive definition of venture capital in the Indian context. According to him, venture capital is an investment, in the form of equity, quasi-equity and sometimes debt-straight or conditional (i.e. interest and principal payable when the venture starts generating sales), made in new or untried technology, or high risk ventures, promoted by a technically or professionally qualified entrepreneur where the venture capitalist expects the enterprise to have a very high growth rate, provides management and business skills to enterprise, expects medium to long term gains and does not expect any collateral to cover the capital provided.

From all the definitions as highlighted herein, we can derive certain features of venture capital investments. Venture capitalists commonly take an equity position in the company and play an active role in the governance of the firm (Sapienza and Gupta, 1994). They generally sit on the board of directors and periodically monitor performance (Sahlman, 1990). This monitoring goes beyond what a traditional financing institution would do and includes spending time at the companies, frequent meetings with managers, and being involved in developing companies’ strategies, hiring decisions and fixing up top management compensation (Lerner, 1995). In addition, venture capitalists bring their experience in evaluating the prospects of startups through their screening of potential investments (Hall and Hofer, 1993). Most importantly, they also provide access to a strategic network including potential clients or suppliers, management talent (Bygrave and Timmons, 1992), additional funding (Gorman and Shalman, 1989), strategic partners and infrastructure providers like accounting firms, law firms, and public relations firms. They also bring specific knowledge from their collaboration with other startups and their understanding of the solutions to the problems that these firms may face.

While venture capital investment involves high risk, they likewise involve high potential for return (Benjamin and Margulis, 2001). Venture capital fills the void between sources of funds for innovation and traditional lower-cost sources of capital available to ongoing
concerns. Filling that void successfully requires the venture capital industry to provide a sufficient return on capital to attract private equity funds, attractive returns to its own participants, and sufficient upside potential to entrepreneurs to attract high quality ideas that will generate high returns. Thus, the challenge is to earn consistently superior returns on investment in inherently risky business ventures (Zider, 1998).

Usually, private equity investors do not primarily invest their own capital, but rather raise the majority of their funds from institutions and high net worth individuals known as ‘Limited Partners’. These institutions often do not have the professional staff or the expertise to make such investments themselves and hence channel capital to venture capital funds with the necessary expertise and resources (Povaly, 2007). Venture capitalists who work for the venture capital firms and run such firms are known as ‘General Partners’. Limited partners benefit from the expertise of the general partners. For this, general partners normally charge fees, taken normally as a percentage of the positive returns they generate. They also generally charge an annual management fee of about 2% of the fund’s committed capital (Berk et al., 2008).

To sum up, the accumulated evidence on venture capital investment highlights that venture capital is a non-conventional, risky finance to new ventures based on innovative entrepreneurship. It is basically capital investment that includes both equity and debt and carries substantial risk and uncertainties. This investment is made in novel or untried concepts, promoted by technically or professionally qualified entrepreneurs. Here, the risk taken by the investor (venture capitalist) is offset by participation in the future success of the firm as part owner. The basic features of venture capital investments include an equity participation of the "outside" investors, a long-term investment horizon and an active, on-going involvement (hands-on approach) in the business of the investee company.

1.2 Need for the Research

Since provision of venture capital is so fundamental for knowledge based entrepreneurship and innovation, it has attracted many researchers from different disciplines such as management, entrepreneurship, finance and economies. The literature review has revealed that the majority of the research in this area relates macro level
analysis of venture capital industry and micro level comparisons of venture capital behaviour across different countries. Sapienza and Villanueva (2007) have acknowledged certain areas of venture capital financing that have been studied widely. As per them, majority of the studies have focused upon institutional form of venture capital while corporate venture capital and informal venture capital (i.e. Business Angels) have not received adequate attention from the researchers. Further, the criteria used by the VCs for investment and the value addition post venture capital investment have been studied at length. According to Gorman and Sahlman (1989), venture capitalists spend 60% of their time on post-investment activities. So, the time and effort is inefficient if they make investments in marginal ventures. Improving investment decisions can improve their performance. Therefore better understanding of how they make decisions can lead to more efficient use of their time and higher overall returns (Zacharakis and Meyer, 2000). Hence, it is not surprising that the evaluation process of venture capitalists has received much attention by the research community in entrepreneurship and finance (Franke et al., 2006). And all these studies have been made from the investor’s perspective rather entrepreneur’s perspective.

Review of literature on venture capital reveals that most of the academic researchers have tried to describe and understand venture capitalists’ decision making process. (Silva, 2004) Though there are many studies in western countries mainly in US, on venture capital process (Sweeting, 1991; Bygrave and Timmons, 1992; Tyebjee and Bruno, 1984; Fried and Hisrich, 1994), still this investment process is complex and unclear as VCs follow their own guidelines in making investments. The primary objective of research into venture capitalists’ decision making is to determine the criteria used by venture capitalists in the evaluation of potential investments. The majority of empirical research on venture capitalists’ decision making has produced lists of criteria that venture capitalists report they use when evaluating new venture proposals (e.g., Tyebjee and Bruno, 1984; MacMillan et al., 1985; MacMillan et al.,1987; Sandberg and Hofer, 1987). As per these studies, the criteria used by the VCs generally relate to the quality of the entrepreneur/team, uniqueness of the product/service, attractiveness of the market as well as financial considerations.
All these studies on venture capital investment process have produced a number of valuable insights, but majority of these researches are carried out in the context of western countries like US, Europe, Germany and UK. However, the behaviour of the VCs would vary from the country to the country given the variety of political, legal, economic and technology developments. In Indian context, there are very few comprehensive studies on the entire investment process starting from generating the deals to the exit of VCs from the investee companies. The extant research on venture capital in India is mainly focused upon macro analysis of the trends in this industry with the help of investment data in various sectors and stages of venture development. Indian studies on venture capital decision making by Pandey (1996), Kumar and Kaura (2003) and Mishra (2005) are largely on the evaluation criteria used by the VCs. There is only one study by Sharma (2002) that brings out important findings on various stages of venture capital investment process, but the external and internal scenario has changed considerably over the last number of years. Adding to this research gap, there are almost no studies on demand side of venture capital funding in India i.e. from the entrepreneur’s perspective. All these studies as mentioned herein are based on supply perspective i.e. providers of funds.

Besides, since the present study is conducted with a special reference to Gujarat, the empirical research on venture capital in the state has also been investigated. Unfortunately, there is no published work in this area found in Gujarat. Gujarat, known for the enterprising spirit of its people, is an ideal investment destination and has lot of potential for venture capital industry to flourish. At present there is only one venture capital firm in the state i.e. Gujarat Venture Finance Limited; investing at the startup and early expansion stages. In India, venture capital industry is basically concentrated around three specific regions i.e. Bangalore, Mumbai and Delhi due to their technological, financial and political superiority. Gujarat is at systematic disadvantage with respect to supply of venture capital, due to absence of such clustering as well as low demand for venture capital by the knowledge based enterprises in the state. However, the state has the people with right mindset and social conditioning required for the development of the ecosystem for venture capital. Recent political, economic, technological and social initiative by the government, educational as well as research institutes and industries;
will help in boosting the knowledge based entrepreneurship which is considered to be a pre-condition for the development of the venture capital in the state.

Thus, the review of international, Indian and regional studies suggest that there is a real and apparent need to fill the research gap at this stage. The present study attempts to address some of these issues and intends to provide a comprehensive view on venture capital decision making process of Indian venture capitalists by studying all the stages of the investment process. Besides, the research also covers the role played by the venture capitalist in the development of the venture with respect to Gujarat. Further, the research also examines the funding preferences of the young entrepreneurs to shed light on the potential for the development of the venture capital industry in future.

1.3 Outline of the Study

The present study is divided into three parts. As mentioned before, the research covers the demand as well as the supply side of venture capital financing i.e. entrepreneurs (seekers of funds) and venture capitalists (providers of funds); both have been focused herein. On the supply side, the study attempts to investigate the venture capital decision making process of Indian venture capitalists. All the stages of venture capital investment process have been investigated starting from the generation of deals, screening and evaluation, deal structuring, post-investment activities and finally exit from the venture. Along with these stages other issues like geographical preference of the venture capitalists for funding the ventures, syndication practices and the reasons for the same. On the demand side, the study is further bifurcated in to two parts. In the first part, the investments made by Gujarat Venture Finance Limited (GVFL) have been scrutinised with respect to the role of GVFL in the growth and development of the venture. The involvement, interaction and the monitoring by GVFL for its portfolio investee companies have been studied in detail. The expectations of the entrepreneurs before the venture capital investment and the actual contribution post-investment as perceived by these entrepreneurs have been examined with respect to different areas of the investee’s business like production and technology, marketing, finance and other managerial areas. In the second part of the study, as mentioned before, the funding preferences of the young entrepreneurs have been investigated at length. Here, an attempt has been made to discover the awareness level of the entrepreneurs regarding various funding options at
different stages of venture development like incubation, angel capital and venture capital. Further, their positive and negative perceptions regarding the venture capitalists have been checked. By focusing upon their preferences for funding their ventures in future, the potential for various financing options has been explored.

1.4 **Significance of the Study**

As mentioned before, there are many studies that have improved the understanding of the venture capital investment process and the role played by venture capitalists. Besides, most of these studies are based upon archival data or single respondent surveys especially focusing upon the venture capitalist’s perspective. The present study is the rigorous empirical study that systematically analyses the venture capital decision making in India (supply side) and the venture capitalist’s role in the growth and development of the venture in Gujarat (demand side). Researching the various perspectives and objectives from venture capitalists and entrepreneurs may have significant practical implications. For prospective entrepreneurs, this study provides information on the criteria sought by venture capitalists that can aid the entrepreneur in seeking venture capital funding. The entrepreneurs also get to know about the regional preferences of the VCs for investment and accordingly they can decide approaching the VCs in different geographic regions. Entrepreneurs can reach out to these VCs through preferred channel/sources desired by venture capitalists as suggested by the study. As the venture capital investment results into equity dilution, the entrepreneurs would realize how much equity can be shared with VCs and the kind of monitoring and control exercised by these VCs in return. Most importantly, as the study investigates the degree of venture capital involvement in various areas of portfolio companies, entrepreneurs can accordingly expect the networking and mentoring support by these investors in their operations.

For venture capitalists, this study has provided a synthesis of various stages of venture capital decision making process like deal sources, screening and evaluation, value addition, monitoring and exit. Also, the entrepreneurs’ pre-investment expectations regarding the involvement of the venture capitalist in various operations of the portfolio companies may help the VCs in providing the value added support accordingly. Analysis of various positive and negative perceptions held by entrepreneurs for VCs would help the VCs in balancing their negative images in the minds of entrepreneurs. As the
entrepreneurs funded by GVFL have been studied in this research, these findings would be beneficial particularly to GVFL. Further, the study of awareness level of the young entrepreneurs of Gujarat towards venture capital will help these investors in undertaking various educational programmes for increasing the knowledge and interest of the entrepreneurs.

For government policy makers, the study carries a lot of importance as various recommendations of the study at the national as well as at the state level would be beneficial for facilitating the further growth of the venture capital industry. The study offers a valuable suggestion to the government and regulatory authority like allowing pensions funds to invest in the venture capital funds, harmonization of regulations for venture capital industry, development of relevant secondary capital market/stock exchange for smaller companies, provision of venture capital funding to small and medium enterprises (SMEs), entrepreneur and investor education, more involvement by the corporates, angel investors and incubators etc. These recommendations if implemented will help in creating conducive environment characterized by structural flexibility, fiscal neutrality and operational adaptability for venture capital to flourish and act in keeping with global trends.

1.5 Organisation of the Thesis

The present study is divided into ten chapters and the content of these chapters are organized as follows.

**Chapter 2 Literature Review** This chapter presents in detail the empirical studies conducted so far on venture capital decision making from the venture capitalists’ and the entrepreneurs’ perspective at the international, national and regional level. More specifically, the chapter includes a review on various stages of venture capital investment process including deal origination, screening, evaluation, deal structuring, post-investment activities and exit. As the present study is comprehensive in nature covering many other areas besides the decisions making of the venture capitalist, the studies on other areas such as geographical preferences of venture capitalists, syndication practices, boot strap financing, incubation and business angels have also been briefly highlighted.
Chapter 3 Research Methodology  As mentioned before, the study covers supply as well as demand side of venture capital funding. On supply side, the decision making of the venture capitalists have been analysed across India while on demand side, the role of the venture capitalist in the growth of the venture as well as the funding preferences of young entrepreneurs from Gujarat have been examined. This chapter covers the research approach of all these three studies. More specifically, research objectives, research design framework, sample/data description methodology, sources of information, content of the questionnaire and data analysis methods for all the three studies have been focused upon.

Chapter 4 Global Venture Capital Industry  This chapter reviews the global trends for venture capital industry. As the venture capital has its main base in US, the chapter discusses the historical evolution of venture capital industry in US and highlights the differences in the global fund raising and investment trends across North America, Europe and Asia-Pacific. The chapter ends with discussion on emergence of venture capital industry in developing countries of Asia-Pacific rim.

Chapter 5 Indian Venture Capital Industry  Like the previous chapter, this chapter contributes to the understanding of the venture capital industry in India. The historical evolution of the venture capital industry in India and its growth across different stages, sectors (Industries) and Indian cities have been discussed in detail. The chapter ends with a highlight on regulatory structure for venture capital industry and different types of venture capital funds in India.

Chapter 6 Ecosystem for Development of Venture Capital in Gujarat  The chapter takes a regional perspective on the existence of venture capital industry in Gujarat. As the state has only one venture capital fund based at Ahmedabad i.e. Gujarat Venture Finance Limited (GVFL), various funds floated by the firm and its investment approach is discussed in detail. Various roadblocks for the development of the venture capital industry in the state have been investigated and finally various initiatives by government, academic institutes, incubation centres and corporates; classified as PEST factors i.e. political, economic, social and technological; have been analysed.
**Chapter 7 Data Analysis and Interpretation** The responses of the venture capital firms and the entrepreneurs with venture capital funding have been analysed here and the results are interpreted. Frequency distribution, descriptive statistics and various non-parametric tests like *Mann-Whitney U test, Wilcoxon Rank Sum test, Kruskal-Wallis test* and *Friedman One Way Anova test* have been applied wherever applicable. As the sample size for the studies was less, the use of parametric statistical models was not desirable. The more appropriate methodology to approach a small sample situation is to employ distribution free non-parametric statistical models.

**Chapter 8 Findings and Discussion** This chapter is divided into three parts for the studies as mentioned above and these parts discuss in detail results of these studies.

**Chapter 9 Recommendations and Conclusion** Based upon the analysis of national and regional scenario of venture capital industry, various recommendations are proposed for India as well as Gujarat. This chapter also describes the implications of the study, various limitations and the scope for the future research.