CHAPTER – I

INTRODUCTION

1.1 An Overview of Venture Capital

Technology and knowledge based ideas will drive the global economy in the 21st century. India’s recent success story in the area of information technology has shown that there is a tremendous potential for the growth of knowledge based industries. This potential is not only confined to information technology but is equally relevant in several areas such as bio-technology, pharmaceuticals, media and entertainment, agriculture and food processing, telecommunication and other services. Given the inherent strength by way of its human capital, technical skills, cost competitive manpower, research and entrepreneurship, India can unleash a revolution of wealth creation leading to employment generation and rapid economic growth in a sustainable manner. What is needed is risk finance and Venture Capital environment which can leverage innovation, promote technology and harness knowledge based ideas.1

In an increasingly knowledge-intensive economy, the importance of Venture Capital for the funding of new high-growth potential firms is widely accepted. Venture Capital represents one solution to financing the high risk, potentially high-reward projects. Venture Capital industry plays an important role in technological and economic growth through its direct involvement in the development of wide variety of enterprises. Presence of Venture Capital encourages efficient capital allocation by seeking out and nurturing high growth entrepreneurial companies in the innovative process, further more high growth entrepreneurial companies are frequently refused finance from conventional sources. Institutions also tend to invest more in firms that are backed by Venture Capital funding2.

India has become one of the fastest developing nations in the new millennium. It is one of the hotspots for investments with reaping rich benefits. Beside from the success of information technology, there is a vast potential for investment, growth and

1Report of K.B. Chandrasekhar Committee on Venture Capital
development in several other sectors like Pharmaceuticals, Telecommunications, Healthcare, Electronics, Food Processing and Business Process Outsourcing (BPOs). The competitive edge of India over other developing nations like China, Russia etc., lies in its huge skilled human capital and knowledge entrapped in the research laboratories. There should be a form of finance that links all the available resources for exploration and effective utilization. This link is available in numerous forms such as bank loans, private debt, equity, bonds etc. However each of them has their own pros and cons which leads to inapplicability under different context. Development in the high growth sector needs not only high technology and huge capital but also the ability to take huge risks. Venture Capital is the vehicle that suits this role.

What is common between huge global corporations like Microsoft, Google, Yahoo, JetBlue, eBay? It is the same thing, which has spurred the boom in Information Technology (IT), Software, Biotech, Semiconductor and many other high-tech industries in the United States of America (USA). The common factor is Venture Capital that has provided a strong support in the establishment of these companies.

Traditional providers of finance such as banks, financial institutions etc. evaluate investment options based on tangible assets, regularity and certainty of cash flow as well as the past history of a business. This is clearly not appropriate for evaluation of the companies in which tangible assets are only small or negligible proportion of investments and for those where business idea are untested, cash flows cannot be predicted with certainty. Further the most important resources are human capital, their caliber and intelligence. In fact, all these are features of the sunrise sectors such as Information Technology (IT), Biotech, Semiconductor, Software, etc. Venture Capital financing, a specialized form of financing which has come to fill the vacuum existing the evaluation of such business. Venture Capital is a growing business of recent origin in the area of industrial financing in India. The various financial institutions set-up in India to promote industries have done commendable work. However, these institutions do not come up to the benefit of risky ventures when they are undertaken by new or relatively unknown entrepreneurs. They contend to give debt finance, mostly in the form of term loans to the promoters and their

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functioning has been more akin to that of commercial banks. The financial institutions have devised schemes such as Seed Capital Scheme, Risk Capital Fund etc, to help new entrepreneurs.

However, to evaluate the projects and extend financial assistance they follow the criteria such as safety, security, liquidity and profitability and not potentiality. The capital market with its conventional financial instruments cannot come to the benefit or risky ventures. Though new institutions such as Mutual funds, Leasing and Hire Purchase Companies have been emerged as another source of finance to industries, these institutions also do not mitigate the problems of new entrepreneurs who undertake risky, innovative and explorative ventures.

India is poised for a technological revolution with the emergence of new breed of entrepreneurs with required professional temperament and technical knowhow, as well as advancement. To make the innovative technology of entrepreneurs a successful business venture, support in all aspects particularly in the form of financial assistance is all the more essential.

The Venture Capital sector is the most vibrant industry in the financial markets today. Venture Capital is finance provided by professionals who invest in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture Capital is an important source of equity for start-up companies.

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

Venture Capital is a means of equity financing for rapidly-growing private companies. Finance may be required for the start-up, development/expansion or purchase of a company. Venture Capital firms invest funds on a professional basis, often focusing on a limited sector of specialization (E.g. Information Technology Infrastructure, Health/Life Sciences, Clean Technology, etc).

The goal of Venture Capital is to build companies so that the shares become liquid (through IPO or acquisition) and provide a rate of return to the investors (in the form of cash or shares) that is consistent with the level of risk taken. With Venture Capital financing, the Venture Capitalist acquires an aggresed proportion of the equity of the company in return for the funding. Equity finance offers the significant advantage of having no interest charges. It is “patient” capital that seeks a return through long-term capital gain rather than immediate and regular interest payments, as in the case of debt financing. Given the nature of equity financing, Venture Capital investors are therefore exposed to the risk of the company venture’s failure. As a result the Venture Capitalist must look to invest in companies which have the ability to grow very successfully and provide higher than average returns to compensate the risk. When Venture Capitalists invest in a business they typically require seat in the company’s Board of Directors. They end up with a minority share in the company and usually do not take day-to-day control. Rather, professional Venture Capitalists act as mentors and aim to provide support and advice on a range of management, revenue and technical issues to assist the company to develop its full potential. Every day; numerous promising entrepreneurs seek out the support of Venture Capitalists (VCs). Only few receive such support, and even fewer go on to build successful companies.

Concept of Venture Capital

The term ‘Venture Capital’ is understood in many ways. In a narrow sense, it refers to investment in new and untried enterprises that are lacking a stable record of growth.

Venture Capital refers to the commitment of capital as shareholding, for the formulation and setting up of small firms specializing in new ideas or new technologies. It is not merely an injection of funds into a new firm, it is a simultaneous input of skill needed to setup the firm, design its marketing strategy and organize and manage it. It is an association with successive stages of firm’s development with distinctive types of financing, appropriate to each stage of development.

Definitions of Venture Capital

Jane Kolvski Morries defines Venture Capital as providing “seed, start up and first stage financing and also funding”.

Frederick R Adler. Practitioner of the profession describes the process as one of investing of risk capital in an enterprise in which the venture investor shares ownership as well as Board of Directors level management responsibilities with the founding management team.

The European Venture Capital Association describes it is a risk finance for entrepreneurial growth oriented companies. It is an investment for the medium or long-term seeking to maximize medium or long-term return for both the parties. It is a partnership with the entrepreneurs in which the investor can add value to the company because of his knowledge, experience and contract base.

Steven James Lee defines it as actual or potential equity investments in companies through the purchase of stock, warrants, options or convertible securities. Venture Capital is a long term funding in investment discipline that often requires the Venture Capitalists to wait five or more years before realizing a significant return on the capital resource.

International Finance Corporation. Washington, (IFC) defines Venture Capital as equity or equity-featured capital seeking investment in new ideas, new
companies, new products, new process or new services that offer the potential of high returns on investment. It may also include investment in turnaround situations.

Venture Capital is the support by investors of entrepreneurial talents with finance and business skills to exploit market opportunities and thus obtain capital gains. Venture Capital commonly describes not only the provisions of start-up finance or ‘seed corn’ capital but also development of capital for later stages of business. A long-term commitment of funds is involved in the form of equity investments, with the aim of Venture Capital gains rather than income, and active involvement in the management of customer’s business.\(^5\)

Venture Capital is the organized financing of relatively new enterprises to achieve substantial capital gains. Such young companies are chosen because of their potential for considerable growth due to advanced technology, new products or services or other valued innovations. A high level or risk is implied by the term “Venture Capital” and is implicit in this type of investment, since certain ingredients necessary for success are missing and must be added later.\(^6\)

A precise meaning of the term Venture Capital financing from single definition is hard to come by. The Concise Oxford Dictionary defines the term venture as to run a hazard or risk, to expose to hazard. In the context of study of Venture Capital financing, venture would mean the assumption of risk. The term Venture Capital would then mean investment made in the business which stands exposed to high risk. Venture Capital financing is generally made in the form of long-term investment usually with equity funds to harness the business opportunities in the growth of the economy, left open by other financial institutions.

A plausible definition of Venture Capital financing would be “Venture Capital is providing risk capital through equity financing for start-up as well as for development thereby assuming high risk for higher reward, exploiting market opportunities by active participation in the management of business affairs and divesting at the time most suitable to the venture”

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\(^5\) Central Office of Information, London- (September 1989). The Growth of Venture Capital and Expansion of Small Firms Sector in Britain. (Classification5 (a)).

\(^6\) Kenneth W. Ruid, Venture Capital Investment, Handbook of Wealth Management
1.2 Need for the Study

One of the most important developments in Indian business scenario has been the growth of Venture Capital over the past decade. In India, Venture Capital funded companies are on rise after the introduction of economic reforms. Venture Capitalists helps the promoters in various ways to nurture the companies, such as providing a network, recruiting key management and building a team, developing financial systems, advising on company law and other legal matters, helping co-investment and arranging working capital facilities from various bankers, providing marketing links and contacts, sharing business perspective, helping to create an entrepreneurial climate and devising incentive systems to promote long-term work, and providing support and confidence during tough times.

Karnataka being a champion of information and bio-technology, ventures and being a home for dynamic entrepreneurs even in the historical evidences, there arise a need to study these Venture Capital firms which are providing financial assistance and other support to new venture creators. Hence the study is to evaluate and analyze the performance of Venture Capital in Karnataka. Moreover no significant study has been carried out in Karnataka with a special reference to Venture Capital and its allied activities. Hence the proposal is having a greater degree of hope on Venture Capital financing and firms in Karnataka.

1.3 Statement of the Problem

Venture Capital is a risky finance for entrepreneurial growth oriented companies and “In a growth hungry economy with a scarce funding environment, Venture Capital offers another resource for fueling the economic engine” It is an investment for the medium or long-term ventures seeking to maximize medium or long-term return for both the parties. It is a partnership with the entrepreneurs in which the investor can add value to the company because of his knowledge, experience and contract base.

During the course of exhaustive review of literature prominent questions which strike the mind, such as: How these contracts affect the firm’s performance? What is its impact on performance of firms funded by VC? How do they believe that VC firms add value to their venture? What evaluation criteria are being used by the
Venture Capitalists, particularly when the Venture Capital activity is in its infancy stage? Hence, there arises a need to address the aforesaid questions.

1.4 Objectives of the study

1. To understand the origin and development of Venture Capital firms in Karnataka.
2. To ascertain the functioning of Venture Capital firms and its regulatory mechanism.
3. To study the criteria adopted by Venture Capital firms while financing new generation entrepreneurs in Karnataka.
4. To study the Venture Capitalists involvement and monitoring in Venture Capital funded projects.
5. To study industry wise investment made by Venture Capitalists in Karnataka.
6. To offer suitable suggestions based on the findings of the study.

1.5 Hypotheses for the study

H_{1}: There is a significant role played by Venture Capital firms in promotion of new enterprises in Karnataka.
H_{2}: The present regulatory mechanism impedes the growth of Venture Capital firms.
H_{3}: There is a relationship between factors of lending and financing of new generation entrepreneurs.
H_{4}: The success of Venture Capital projects are attributed to the involvement of Venture Capitalists.

1.6 Scope of the study

The present study is confined to domestic Venture Capital firms located in Karnataka under the registration of SEBI. Out of 205 domestic Venture Capital funds which are registered under SEBI as on 31st December 2012, 20 Venture Capital funds and 12 of their firms are located in Karnataka and all 12 Venture Capital firms are located in Bangalore alone.

The study is based on the data of these Venture Capital funds and their firms for a period of 15 years between 1998 to 2012.
1.7 Research Methodology

**Area of study:** Karnataka state is chosen Locale for the study.

**Data collection:** In Karnataka total 20 Venture Capital funds and their firms are registered under SEBI regulations. Both primary and secondary data is collected from respective companies. Primary data was collected using the structured questionnaire and interview schedules. Secondary data was collected from Journals, Articles (International and National Journals), published reports, data base like Venture Intelligence, previous research studies and relevant websites.

**Sampling:** In this research data is collected from the entire population numbering 20 Venture Capital funds and 12 of their firms which are located in Karnataka.

**Descriptive Statistics of the Study:** In this study for the testing of hypotheses following statistical tools are used;

**Chi-square Test:** With the help of Chi-square test, researcher studied whether two or more attributes are associated or not.

**Factor Analysis:** The main purpose of Factor Analysis is to group large set of variable factors into fewer factors. Each factor will account for one or more components. Each factor is a combination of many variables. There are two most commonly employed factor analysis procedures. They are (i) **Principle component analysis**, (ii) **Common factor analysis**. When the objective is to summarize information from a large set of variable into fewer factors, principle component factor analysis is used. To analyze the components of the main factor, common factor analysis is used.

**Analysis of Variance (ANOVA):** It is statistical a technique. It is used to test the equality of three or more sample means. Based on the means, inference is drawn whether samples belongs to same population or not. There are two types of ANOVA, namely one way ANOVA and Two-way ANOVA.

**Factorial Analysis of Variance:** Research designs with more than one independent variable are much more interesting than those with only one independent variable. When there are two categorical independent variables(with non -experimental research, these are better referred to as factors, predictors, grouping variables, or classification variables), and one continuous dependent variable(with non-
10

experimental research these are better referred to as criterion variables, outcome variables, or response variables), with all combinations of levels of the first independent variable with levels of the second independent variable (or factor) consider the following design.

1.8 Chapterisation Scheme

Chapter 1: Introduction – It deals with an overview of performance of Venture Capital and the purpose of the study i.e. Need for the study, the statement of the problem, Objectives of the study, Hypotheses, Research Methodology evolved, Limitations of the study and scheme of Chapterisation.


Chapter 3: Review of Literature – This chapter consist literature survey as a process of developing an insight into both conceptual and research based studies available both at national and international on the area and topic chosen.

Chapter 4: Venture Capital Firms in Karnataka (SEBI Registered): A Profile – It consists of a profile of SEBI registered Venture Capital firms in Karnataka in brief and their portfolios and their scope and activities etc.

Chapter 5: Data analysis and Interpretation – This chapter deals with analysis and interpretation of data collected from primary and secondary sources relating to Venture Capital funds of the study.

Chapter 6: Summary of Findings, Suggestions and Conclusions: This chapter summarized the research findings with suitable recommendations, further, identified the scope for further research and drawn conclusion.
1.9 List of Registered Venture Capital Firms

List of Venture Capital firms in Karnataka which are studied for the purpose of the research are enclosed here under table.

Table No – 1.1
List of Registered Venture Capital Funds of Karnataka for the Study

<table>
<thead>
<tr>
<th>Sl. No</th>
<th>Name of the Venture Capital Firms</th>
<th>Name of the Venture Capital fund</th>
<th>Date of Registration</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.</td>
<td>Canbank Venture Capital Fund Limited</td>
<td>Canbank Venture Capital Fund</td>
<td>04.03.1998</td>
<td>Bangalore</td>
</tr>
<tr>
<td>3.</td>
<td>UTI Venture Fund Management Company Private Limited</td>
<td>UTI- India Technology Venture Unit Scheme</td>
<td>04.01.2000</td>
<td>Bangalore</td>
</tr>
<tr>
<td>4.</td>
<td>ICICI Venture Funds Management Company Limited</td>
<td>India Advantage Fund I</td>
<td>20.01.2002</td>
<td>Bangalore</td>
</tr>
<tr>
<td>5.</td>
<td>2i Capital (India) Private Ltd.</td>
<td>Indian Enterprise Fund</td>
<td>14.08.2003</td>
<td>Bangalore</td>
</tr>
<tr>
<td>6.</td>
<td>ICICI Venture Funds Management Company Limited</td>
<td>India Advantage Fund V</td>
<td>21.10.2005</td>
<td>Bangalore</td>
</tr>
<tr>
<td>7.</td>
<td>ICICI Venture Funds Management Company Limited</td>
<td>India Advantage Fund IV</td>
<td>11.08.2005</td>
<td>Bangalore</td>
</tr>
<tr>
<td>8.</td>
<td>ICICI Venture Funds Management Company Limited</td>
<td>India Advantage Fund III</td>
<td>06.06.2005</td>
<td>Bangalore</td>
</tr>
<tr>
<td>9.</td>
<td>Ascent capital advisors India private limited</td>
<td>UVF Private Equity Trust</td>
<td>08.04.2005</td>
<td>Bangalore</td>
</tr>
<tr>
<td>10.</td>
<td>Footprint venture India Private Limited</td>
<td>Footprint Venture India Fund</td>
<td>22.06.2007</td>
<td>Bangalore</td>
</tr>
<tr>
<td>12.</td>
<td>Ascent capital advisors India private limited</td>
<td>ACA Private Equity Trust</td>
<td>04.11.2008</td>
<td>Bangalore</td>
</tr>
<tr>
<td>13.</td>
<td>Forum Synergies India Trust</td>
<td>Forum Synergies India Trust</td>
<td>30.09.2008</td>
<td>Bangalore</td>
</tr>
<tr>
<td>14.</td>
<td>ICICI Venture Funds Management Company Limited</td>
<td>India Advantage Fund S3 (earlier known as India Advantage Fund VIII)</td>
<td>19.03.2008</td>
<td>Bangalore</td>
</tr>
</tbody>
</table>
1.10 Limitations of the Study

1. The study is mainly focused on 20 Venture Capital Funds of Karnataka; obviously the findings of the study may not be generalized for the entire Venture Capital Industry.

2. Venture Capital Firms are generally Private Limited in nature so they do not reveal certain information which is confidential in nature.

3. Data analysis and interpretation is done based on the information provided by Venture Capital Firms and reliability of the data may not be accurate to tune hundred percent.

4. Venture Capital funding is mostly based on need of the hour and availability of opportunities. Hence the findings of the study are mostly time bound and opportunity bound.