CHAPTER – II
VENTURE CAPITAL – A THEORETICAL PERSPECTIVE

2.1 Introduction

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 skills needed to setup the firm, design its marketing strategy, organize and manage it. It is an association with successive stages of firms’ development with distinctive types of financing appropriate to each stage of development.

2.2 Meaning of Venture Capital

Venture Capital is long-term risk capital to finance high technology projects which involve risk; these projects also possess strong potential for growth. Venture Capitalist pools their resources including managerial abilities to assist new entrepreneurs in the early years of the project. Once the project reaches the stage of profitability, they sell their equity holdings at high premium.

2.3 Features of Venture Capital

Nature: Venture Capital is a long term investment. Since the project is risky, it may take time to earn profits. Therefore, it takes time to get the refund of capital as well as return on it. The investors can exist on success of the project by off-loading their investment. But it takes long time to get the success.

Form: Venture Capital is mainly in the form of equity capital. Investors can subscribe the equity capital and provide the necessary funds to complete the project. The amount of equity invested by the Venture Capitalist is normally up to 49% of the total equity capital required for the project.

Borrowers: The borrowers are the new entrepreneurs who raise Venture Capital because they cannot get such an amount from the general investors.
**Type of project:** Venture Capital projects are high risk, high technology and long
term projects.

**Management:** Venture Capital projects are managed jointly by the entrepreneurs and
Venture Capitalists. However, Venture Capitalist should not interfere in day to day
activities of the management. The Venture Capitalist can take active part in the
management and decision-making.

**New venture:** Venture Capital investment is generally made in new enterprises which
use new technology to produce new products, with an expectation of high gains or
sometimes, spectacular returns.

**Continuous involvement:** Venture Capitalists continuously involve themselves with
the client’s investments, either by providing loans or managerial skills or any other
support.

**Mode of investment:** Venture Capital is basically an equity financing method, the
investment being in relatively new companies when it is too early to go to the capital
market to raise funds. In addition, financing also takes the form of loan
finance/convertible debt to ensure a running yield on the portfolio of the Venture
Capitalists.

**Objective:** The basic objective of a Venture Capitalist is to make a capital gain in
equity investment at the time of exit, and regular on debt financing. It is a long-term
investment in growth-oriented small/medium firms. It is a long-term capital which is
 injected to enable the business to grow at a rapid pace, mostly from the start-up stage.

**Hands-on approach:** Venture Capital institutions take active part in providing value-
added services such as providing business skills to investee firms. They do not
interfere in management of the firms nor do they acquire a majority/controlling
interest in the investee firms. The rationale for the extension of hands-on management
is that Venture Capital investments tend to be highly non-liquid.

**High risk-return ventures:** Venture Capitalists finance high risk-return ventures.
Some of the ventures yield very high return in order to compensate for the high risks
related to the ventures. Venture Capitalists usually make huge capital gains at the time
of exit.
**Nature of firms**: Venture Capitalists usually finance small and medium-sized firms during the early stages of their development, until they are established and are able to raise finance from the conventional industrial finance market. Many of these firms are new, high technology-oriented companies.

**Liquidity**: Liquidity of Venture Capital investment depends on the success or otherwise of the new venture or product. Accordingly, there will be higher liquidity where the new ventures are highly successful.

### 2.4 Venture Capitalists

A Venture Capitalist is a person or investment firm that makes venture investments, and these Venture Capitalists are expected to bring managerial and technical expertise as well as capital to their investments. A Venture Capital fund refers to a pooled investment vehicle that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans. Venture Capital firms typically comprise small teams with technology backgrounds (scientists, researchers) or those with business training or deep industry experience.

A core skill within VCs is the ability to identify novel technologies that have the potential to generate high commercial returns at an early stage. By definition, VCs also take a role in managing entrepreneurial companies at an early stage, thus adding skills as well as capital, thereby differentiating VC from buy-out private equity, which typically invests in companies with proven revenue, and thereby potentially realizing much higher rates of returns. Inherent in realizing abnormally high rates of returns is the risk of losing all of one's investment in a given startup company. As a consequence, most Venture Capital investments are done in a pool format, where several investors combine their investments into one large fund that invests in many different startup companies. By investing in the pool format, the investors are spreading out their risk to many different investments versus taking the chance of putting all of their money in one start up firm.
2.5 Venture Capital Structure

Venture Capital firms are typically structured as partnerships, the general partners of which serve as the managers of the firm and will serve as investment advisors to the Venture Capital funds raised. Venture Capital firms in the United States may also be structured as limited liability companies, in which case the firm's managers are known as managing members. Investors in Venture Capital funds are known as limited partners. This constituency comprises both high net worth individuals and institutions with large amounts of available capital, such as State and Private pension funds, University financial endowments, insurance companies and pooled investment vehicles, called funds.

Diagram No. 2.1

Structure of Venture Capital Fund
Most Venture Capital funds have a fixed life of 10 years, with the possibility of a few years of extensions to allow for private companies still seeking liquidity. The investing cycle for most funds is generally three to five years, after which the focus is managing and making follow-on investments in an existing portfolio. This model was pioneered by successful funds in Silicon Valley through the 1980s to invest in technological trends broadly but only during their period of ascendance, and to cut exposure to management and marketing risks of any individual firm or its product.

In such a fund, the investors have a fixed commitment to the fund that is initially unfunded and subsequently "called down" by the Venture Capital fund over time as the fund makes its investments. There are substantial penalties for a limited partner (or investor) which fails to participate in a capital call.

Normally can take anywhere from a month or so to several years for Venture Capitalists to raise money from limited partners for their fund. At the time when all of the money has been raised, the fund is said to be closed, and the 10-year lifetime begins. Some funds have partial closure when one half (or some other amount) of the fund has been raised. "Vintage year" generally refers to the year in which the fund was closed and may serve as a means to stratify VC funds for comparison. This shows the difference between a Venture Capital fund management company and the Venture Capital funds managed by them.

From investors point of view funds can be traditional where all the investors invest with equal terms or asymmetric where different investors have different terms. Typically the asymmetry is seen in cases where there's an investor that has other interests such as tax income in case of public investors.

Venture Capitalist firms differ in their approaches. There are multiple factors, and each firm is different. Some of the factors that influence VC decisions include:

- Some VCs tend to invest in new ideas, or knowledge based companies. Others prefer investing in established companies that need support to go public or grow.
- Some invest solely in certain industries.
- Some prefer operating locally while others will operate nationwide or even globally.
VC expectations often vary. Some may want a quicker public sale of the company or expect fast growth. The amount of help a VC provides can vary from one firm to the next.

2.6 Role of Venture Capital Firms

The general partners and other investment professionals of the Venture Capital firm are often referred to as "Venture Capitalists" or "VCs". Typical career backgrounds vary, but, broadly speaking; Venture Capitalists come from either an operational or a finance background. Venture Capitalists with an operational background tend to be former founders or executives of companies similar to those which the partnership finances or will have served as management consultants. Venture Capitalists with finance backgrounds tend to have investment banking or other corporate finance experience.

Although the titles are not entirely uniform from firm to firm, other positions at Venture Capital firms include:

- **Venture partners**: Venture partners are expected to source potential investment opportunities ("bring in deals") and typically are compensated only for those deals with which they are involved.

- **Principal**: This is a mid-level investment professional position, and often considered a "partner-track" position. Principals would be promoted from a senior associate position or who has commensurate experience in another field, such as investment banking, management consulting, or a market of particular interest to the strategy of the Venture Capital firm.

- **Associate**: This is typically the most junior apprentice position within a Venture Capital firm. After a few successful years, an associate may move up to the "senior associate" position and potentially principal and beyond. Associates often have worked for 1–2 years in another field, such as investment banking or management consulting.

- **Entrepreneur-in-Residence (EIR)**: EIRs are experts in a particular domain and perform due diligence on potential deals. EIRs are engaged by Venture Capital firms temporarily (six to 18 months) and are expected to develop and pitch startup
ideas to their host firm although neither party is bound to work with each other. Some EIRs move on to executive positions within a portfolio company.

2.7 Need of Venture Capital

- There are entrepreneurs and many other people who come up with bright ideas but lack the capital for the investment. What these Venture Capitals do is to facilitate and enable the start up phase.

- When there is an owner relation between the Venture Capital providers and receivers, their mutual interest for returns will increase the firm’s motivation to increase profits.

- Venture Capitalists have invested in similar firms and projects before and, therefore, have more knowledge and experience. This knowledge and experience are the outcomes of the experiments through the successes and failures from previous ventures, so they know what works and what does not, and how it works. Therefore, through Venture Capital involvement, a portfolio firm can initiate growth, identify problems, and find recipes to overcome them.

  Further Venture Capitalists along with financial assistance, they helps in Efficiency of business processes, Opens up new business opportunities for entrepreneurs, Positive impact on top and bottom line, Corporate governance, Access to further capital, Enhanced visibility, Helps scale up business rapidly.

2.8 Stages of Venture Capital

  Venture Capital may take various forms at different stages of the project. There are four successive stages of development of a project viz. development of a project idea, implementation of the idea, commercial production and marketing and finally large scale investment to exploit the economics of scale and achieve stability. Financial institutions and banks usually start financing the project only at the second or third stage but rarely from the first stage. But Venture Capitalists provide finance even from the first stage of idea formulation. The various stages in the financing of Venture Capital are described below:
Development of an Idea - Seed Finance: In the initial stage Venture Capitalists provide seed capital for translating an idea into business proposition. At this stage investigation is made in depth which normally takes a year or more.

Implementation Stage - Start up Finance: When the firm is set up to manufacture a product or provide a service, start up finance is provided by the Venture Capitalists. The first and second stage capital is used for full scale manufacturing and further business growth.

Fledging Stage - Additional Finance: In the third stage, the firm has made some headway and entered the stage of manufacturing a product but faces teething problems. It may not be able to generate adequate funds and so additional round of financing is provided to develop the marketing infrastructure.

Establishment Stage - Establishment Finance: At this stage the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that it can reap economies of scale and attain stability. At the end of establishment stage, the firm is listed on the stock exchange and at this point the Venture Capitalist disinvests their shareholdings through available exit routes.

Before investing in small, new or young hi-tech enterprises, the Venture Capitalist look for percentage of key success factors of a Venture Capital project. They prefer projects that address these problems. After assessing the viability of projects, the investors decide for what stage they should provide Venture Capital so that it leads to greater capital appreciation. All the above stages of finance involve varying degrees of risks and Venture Capital industry, only after analyzing such risks, invest in one or more. Hence they specialize in one or more stages but rarely all.

2.9 Venture Capital Investment Criteria

Venture Capital investment refers to the capital invested into “risky” ventures to obtain a very high rate of returns. Venture Capital is invested into equities rather than loans to get a good rate of return. The Venture Capital is provided to companies in the various stages of development and Venture Capital investment criteria are the methodologies followed by Venture Capitalists to select appropriate ventures for investment.
Venture Capital investment criteria is not just meant for small and mid-sized businesses but it can be an investment into a project of a large business, or into a startup company aiming to grow significantly. The Venture Capital investment criteria are based on the potential of the company to grow fast within a limited time period and resources. The Venture Capital investment criteria define the set of rules for investment in ventures to get a high growth potential. The ventures which can provide great returns and the ventures where the investor can have a successful “exit“ within the desired time period of investment varying from three to seven years is considered to be an ideal Venture Capital investment option. The startup company which is based on innovative structure and a well designed business model supported by a strong management team attracts Venture Capitalists. The Venture Capitalists ensure stocks follow the desired Venture Capital investment criteria to make mature investment in stocks to get high returns.

Venture Capitalists should follow the some of the basic Venture Capital investment criteria before making any investment. The basic Venture Capital investment criteria are “never pay with pay off” and “keep an exit plan.” The Venture Capitalists should never pay with pay off and always keep money for personal needs before spending on Venture Capital because the failure rate in venture investment can be more than 50%. In some stocks it can more than 90% and if the venture fails, the entire funding is written off.

The Venture Capitalists spend money to raise more money and the Venture Capital investment criteria help them to make the right options. Some significant Venture Capital investment criteria are as follows:

**Criteria 1: More Risk More Returns**

One of the main - Venture Capital investment criteria is “more risk gives more returns.” Investment in risky ventures can get higher returns if the ventures are selected carefully. The investor should know for which stage of development the investment is needed. It will provide a basic idea of the risk factor involved and time period of investment. There are different options to make venture money – IPO, and Merger and Acquisition. The initial public offering or IPO of a large company is most attractive of Venture Capital investments because it comes with a low risk.
Criteria 2: Company’s Profile

The Venture Capital investment criteria are mostly based on the company’s profile. The company should be a fast growing company which has a huge market presence and the company should have abundant intellectual property to be able to put barrier to its competitor’s growth. The company should be large or reputed enough to be able to grow fast. The company should be into a promising business field.

Criteria 3: Company’s Development Stage

Venture Capital investment criteria are designed to know the stage of growth of the company and the risk involved. Generally, Venture Capital investment is needed for four different stages of the company’s development - Idea generation, Start up, Ramp up and Exit (ISRE). The Venture Capital can be for getting the “seed money” for introducing a new idea in the market. Since the risks involved in new venture is high, the profits are also high in new ventures. It can be for start up of a company, or the company may need funds for marketing and development. Some companies require Venture Capital for first round – early sales and manufacturing, and some companies may need working capital. The company may require money for expansion or for going public.

Criteria 4: The business model

Venture Capital investment criteria are about secure and high returns, and the business model of the company enables it to grow fast. A company fulfills the Venture Capital investment criteria if the products sold by the company have a high market demand. The company should be able to deliver products to make customers repeat customers. The company should be able to generate more revenues with limited resources. The business model should fulfill the Venture Capital investment criteria. It should have the potential to attract customers and stay ahead of competitors.

Criteria 5: Management team

A strong management team is needed for a company to sustain for long. If a company is not supported by a strong management, it will not be able to deliver its plans and the company may not perform well, therefore, a good management team is one of the most important Venture Capital investment criteria. There are many companies which fail to deliver the expected results because there are clashes within
the top management. The leading management of the company should be strong, professional and expert at its job. The management team should have skilled, realistic, honest and seasoned group of people who have the capability to turn plans into reality. The company should have people to be able to anticipate the problems and prevent the company from dangers. Both the top management and the marketing teams of a company should be strong to keep it going.

Criteria 6: Company’s Valuation

The market valuation of company in term of investments and equity should be attractive because a good valuation reduces the risks involved in the investment.

Criteria 7: The Exit Plan

Venture Capitalists mostly hold the stocks for three to seven years and they should have a proper “exit plan” to opt out of investment.

2.10 Investment Evaluation

There is abundant empirical research conducted in developed countries which address the relative investment evaluation criteria taken into account in the screening process for new venture investment proposals. Zopunidis (1994) provides a useful summary of the previous research in this field. The identification of selection criteria has been researched using different methodologies such as simple rating of criteria (perpetual and deal specific responses) (e.g. Wells, 1974; Benoit, 1975; Hoban, 1976; Pointdexter, 1976; Wilson, 1983; Tyebjee and Bruno, 1981, 1984; Bruno and Tyebjee, 1985; MacMillan, Siegel and SubbaNarsimha, 1985, 1987; Goslin and Barge, 1986; Knight, 1986; Dixon, 1991; Hall and Hofer, 1993; Rah, Jung and Lee, 1994), construct analysis (Fried and Hisrich, 1994), verbal protocols (Zhacharakis and Meyer, 1998), and quantitative compensatory models (Muzyka, Birley, and Leleux, 1996; Shepherd, 1999). Multi methods (case analysis, study of administrative records, published interviews, questionnaire and personal interviews) approach has also been used (Riquelme, 1994) to enhance understanding of investment criteria and also extend it to other aspects of investment process like deal structuring and divestment. Using the same investment evaluation criteria developed by MacMillan et al (1985) Knight (1988) conducted cross cultural comparison from countries including USA, Canada, Asia-Pacific and Europe. Studies were replicated in other countries; U.K.
(Dixon, 1991; Sweeting, 1991) Singapore (Ray, 1991), Japan (Ray and Turpin, 1993), South Korea (Rah et al, 1994), Europe (Riquelme, 1994), India (Pandey 1995), Thailand (Pandey et al, 1995) and Taiwan (Pandey, 1996). Almost without exception in these studies, personality of entrepreneur and his experience are prime focused, a result which is intuitively accepted (Guan and Cheong, 1989; Ray and Turpin, 1993 and Pandey, 1995).⁷

Out of the literature review researcher tried to compare the criteria adopted by some selected countries. It is presented in form of comparative table, which consists of Main Group criteria, features, countries and Mean. Out of this table researcher easily identified criteria which are most important criteria for Venture Capitalists for their investments in different countries.

Table No: 2.1

A Comparative Picture of Investment Criteria Adopted by Different Countries

<table>
<thead>
<tr>
<th>Sl. No</th>
<th>Investment Criteria</th>
<th>US</th>
<th>Canada</th>
<th>Asia Pacific</th>
<th>Europe</th>
<th>India Pandey</th>
<th>India Mishra</th>
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<td>I</td>
<td>The Entrepreneur Personality</td>
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<td>1</td>
<td>Capable of sustained intense effort</td>
<td>3.60</td>
<td>3.56</td>
<td>3.74</td>
<td>3.56</td>
<td>3.11</td>
<td>3.62</td>
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<td>2</td>
<td>Ability to evaluate &amp; react to risk</td>
<td>3.34</td>
<td>3.31</td>
<td>3.45</td>
<td>3.57</td>
<td>3.22</td>
<td>3.41</td>
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<td>3</td>
<td>Articulate in discussing venture</td>
<td>3.11</td>
<td>2.74</td>
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<td>2.77</td>
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<td>4</td>
<td>Attention to detail</td>
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<td>2.68</td>
<td>2.77</td>
<td>2.60</td>
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<td>Compatible personality</td>
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<td>2.19</td>
<td>2.10</td>
<td>2.00</td>
<td>3.41</td>
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<td>The Entrepreneur's Experience</td>
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<td>Familiarity with target market</td>
<td>3.58</td>
<td>3.68</td>
<td>3.57</td>
<td>3.54</td>
<td>3.22</td>
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<td>Demonstrated leadership ability in past</td>
<td>3.41</td>
<td>3.01</td>
<td>2.98</td>
<td>3.18</td>
<td>2.78</td>
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<td>3</td>
<td>Track record relevant to venture</td>
<td>3.24</td>
<td>2.68</td>
<td>2.92</td>
<td>3.03</td>
<td>2.67</td>
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<td>1.83</td>
<td>1.50</td>
<td>1.72</td>
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<td>4</td>
<td>Referred by trustworthy source</td>
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<td>5</td>
<td>Familiarity with entrepreneur's reputation</td>
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<td>Characteristics of the Product/Service</td>
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<td>1</td>
<td>Proprietary or otherwise protected product</td>
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<td>2.28</td>
<td>2.64</td>
<td>2.74</td>
<td>2.22</td>
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<td>2</td>
<td>Demonstrated market acceptance of product</td>
<td>2.45</td>
<td>2.66</td>
<td>2.81</td>
<td>2.85</td>
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<td>Product developed to the point of a Prototype</td>
<td>2.38</td>
<td>3.05</td>
<td>2.92</td>
<td>2.97</td>
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<td>High-tech product</td>
<td>2.30</td>
<td>1.25</td>
<td>1.42</td>
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<td>Characteristics of the Market</td>
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<td>High market growth rate</td>
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<td>2.86</td>
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<td>Market stimulated by the venture</td>
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<td>2.36</td>
<td>1.78</td>
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<td>Product in market familiar to VCF</td>
<td>2.36</td>
<td>1.81</td>
<td>2.10</td>
<td>2.14</td>
<td>1.78</td>
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<tr>
<td>4</td>
<td>Little threat of competition for first 3 years</td>
<td>2.37</td>
<td>2.40</td>
<td>2.42</td>
<td>2.23</td>
<td>2.22</td>
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<tr>
<td>5</td>
<td>Ability to create a new market</td>
<td>1.82</td>
<td>1.63</td>
<td>2.17</td>
<td>1.75</td>
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<td>Financial Consideration</td>
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<td>1</td>
<td>Expected return equal to at least 10 times the Investment in 5-10 year</td>
<td>3.42</td>
<td>2.56</td>
<td>2.94</td>
<td>2.86</td>
<td>1.67</td>
</tr>
<tr>
<td>2</td>
<td>Venture can be easily made liquid</td>
<td>3.17</td>
<td>2.39</td>
<td>2.67</td>
<td>2.72</td>
<td>3.33</td>
</tr>
<tr>
<td>3</td>
<td>Expected return equal to at least 10 times the Investment in last 5 years</td>
<td>2.34</td>
<td>1.99</td>
<td>2.12</td>
<td>2.10</td>
<td>1.78</td>
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<td>4</td>
<td>Subsequent investment not expected by VCF</td>
<td>1.34</td>
<td>1.92</td>
<td>1.72</td>
<td>1.57</td>
<td>1.00</td>
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<td>5</td>
<td>VCF will not participate in later rounds of investment</td>
<td>1.20</td>
<td>1.56</td>
<td>1.24</td>
<td>1.40</td>
<td>1.00</td>
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2.11 Conceptual difference between Private Equity, Venture Capital and Angel Investors:

Technically, Venture Capital is just a subset of private equity. They both invest in companies, they both recruit former bankers, and they both make money from investments rather than advisory fees. But researcher found that they are significantly different.

**Private Equity**: PE is a number of different types of investments that can be made with private money. These investments may be made to purchase a company, provide funding for a project, or simply make a private investment. Private equity firms generally focus on financial statements. They want to see what expertise they can bring to the income statement or balance sheet. These investors tend to emphasize the bottom line. They may propose operational changes or a comprehensive management restructuring to help the firm make more money. Capital structure, the amount and source of debt and equity a company has, may also be an area the private equity firm want to change.

They are established investment bankers. Typically:

(i) Invest into proven/established businesses
(ii) Have “financial partners” approach
(iii) Invest between USD 5 –100 million

**Venture Capital**: VC is a specific investment strategy designed to provide funding for startup companies. It’s a very popular financing source for technology based companies. It allows for fast growth without any need of revenue at an early stage. It’s highly risky, but can be quite lucrative. Rather than looking for immediate cuts, the Venture Capitalist may encourage the company to devote more time and money to planning and research. This type of financing is known for buying stakes in emerging industries. They get in early, faster innovation, and earn a profit after the product is ready for mass distribution. These different types of financing have significant impact on the companies they invest in. Small firms seeking private equity should be prepared for changes. Venture Capital investors are likely to have more patience and give the owners of the company they’re investing in time to realize their vision. In practical terms, Venture Capital firms provide money and patience.
**Venture Capitalists (VCs)** are organizations raising funds from numerous investors and hiring experienced Professional managers to deploy the same. They typically:

(i) Invest at “second” stage  
(ii) Invest over a spectrum over industries  
(iii) Have hand-holding “mentor” approach  
(iv) Insist on detailed business plans  
(v) Invest into proven ideas/businesses  
(vi) Provide “brand” value to investee  
(vii) Invest between USD 2 – 5 million  

**Angel Investing**: Before taking company to Venture Capitalists entrepreneurs need to probably get some funding. Entrepreneurs go to angel investors who provide similar startup financing as VC, only in smaller denominations. Entrepreneurs may only need $100,000, and for that entrepreneurs won’t find an interested VC firm, but they might find an angel investor for investment.  

**Angel Investors**: An angel is an experienced industry-breed individual with high net worth. Typically, an angel investor would:

(i) Invest only his chosen field of technology  
(ii) Take active participation in day-to-day running of the Company  
(iii) Invest small sums in the range of USD 1 - 3 million  
(iv) Not insist on detailed business plans  
(v) Sanction the investment in up to a month  

Help Company for "second round" of funding The Indus Entrepreneurs (TiE) is a classic group of angels like: Vinod Dham, Silesh Mehta, Kanwal Rekhi, Prabhu Goel, Suhas Patil, Prakash Agarwal, and K.B. Chandrasekhar. In India there is a lack of home grown angels except a few like Saurabh Srivastava and Atul Choksey (ex-Asian Paints).
Table: 2.2

The difference between Private Equity and Venture Capital is analyzed in the following table

<table>
<thead>
<tr>
<th>Point of Difference</th>
<th>Private Equity</th>
<th>Venture Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Company type</strong></td>
<td>PE firms buy companies across all industries</td>
<td>VCs are focused on technology, biotechnology and clean technology</td>
</tr>
<tr>
<td><strong>Percentage acquired</strong></td>
<td>PE firms almost buy 100% of a company in an Leveraged buyouts(LBOs)</td>
<td>VCs only acquire a minority stake i.e. less than 50%</td>
</tr>
<tr>
<td><strong>Size</strong></td>
<td>PE firms make large investments</td>
<td>VCs investments are much smaller</td>
</tr>
<tr>
<td><strong>Structure</strong></td>
<td>PE firm use a combination of Equity and Debt</td>
<td>VCs firm use only Equity</td>
</tr>
<tr>
<td><strong>Stage</strong></td>
<td>PE firms buy mature, public companies</td>
<td>VCs invest mostly in early stage-sometime pre-revenue companies</td>
</tr>
<tr>
<td><strong>Risk and Return</strong></td>
<td>In PE number of investments is smaller and the investment size is much larger- even one company fails, the fund would fail.</td>
<td>VCs expect that many of the companies they invest in will fail, but at least one investment will generate huge returns and make the entire fund profitable.</td>
</tr>
</tbody>
</table>

2.12 Importance of Venture Capital

Venture Capital funding is an increasingly important source for entrepreneurial ventures in both industrialized and developing countries. Venture Capital financing has become especially important in India in developing information technology sector (Nasscom, 2000). India has a history of state-directed institutional development with the exception that government is avowedly hostile to capitalism; government control over economy and the bureaucracy had a reputation for corruption. Such an environment would be considered hostile to the development of an institution like Venture Capital.

India has a number of strengths for venture fund development: an enormous number of small businesses, public equity market, and low wages not only for
physical labor but also for trained engineers and scientists, a home-grown software
industry that became a significant player internationally in the mid-1990s.
Experiencing rapid growth, some Indian software firms became significant successes
and were able to list on the National Association of Securities Dealers Automated
Quotation System (NASDAQ). Finally, beginning in the 1990s, but especially in the
1990s, a number of Indian engineers who had emigrated to the U.S. become
entrepreneurs and began their own high-technology firms. They were extremely
successful, making them multimillionaires or even billionaires, and some of them then
became Venture Capitalists or angel investors. So there was a group of potential
transfer agents (Dossani, 2001).

Despite the importance of Venture Capital to the Indian economy, little is
known about the decision process that Indian VCs use to determine which proposals
receive equity funding. The only Indian study researcher could access was conducted
at a time when the Indian Venture Capital industry was in its infancy, with only 13
Venture Capital firms in existence (Pandey, 1996). The Indian Venture Capital
industry has grown rapidly and matured since then, with well over 100 Venture
Capital firms today.

Venture Capital is a form of equity financing in which the investor actively
participates when the venture is financed. Although the concept as such is very old, a
formal market for Venture Capital in the U.S. started only after World War II. A
Venture Capital firms manages funds provided by investors and directs it to the most
promising ventures, mainly in the form of equity. The Venture Capitalist (VCs) is
responsible for managing investor’s funds, provides financial and strategic assistance
to the recipient company and actively participates in its management. The support
continues until the venture materializes, at which stage an outside investor might be
interested in acquiring the company, or the venture might be able to go public.
Returns then are distributed back to the original investors.

Venture Capital arrangements are information-intensive. The Venture
Capitalist must be an expert in both management and finance, and in the specific
industry to which the venture belongs. In addition, he must be involved in the detailed
operations of the recipient company. Theoretically, such arrangements can be most
rewarded in environments where uncertainty and asymmetry of information most
prevail. It is precisely such environments that traditional methods of financing, e.g.
banks loans or public capital markets, fail to accommodate well. This implies that young companies, which operate in a highly uncertain environment, might face prohibitive costs in obtaining external capital. If such companies were able to obtain Venture Capital, however, their financial constraints could be significantly relieved.

Since Venture Capital is based on equity financing rather than debt, financing development avoids financial instability typically associated with debt financing. The world debt crisis provided the need for alternative forms of financing that will promote growth and development while maintaining order and stability.

2.13 Advantages of Venture Capital Fund

(i) Advantages to Investing Public

- The investing public will be able to reduce risk significantly against unscrupulous management, if the public invest in venture fund who in turn will invest in equity of new business. With their expertise in the field and continuous involvement in the business they would be able to stop malpractices by management.

- Investors no means to vouch for the reasonableness of the claims made by the promoters about profitability of the business. The venture funds equipped with necessary skills will be able to analyze the prospects of the business.

- Investors do not have any means to ensure that the affairs of the business are conducted prudently. The venture fund having representatives on the Board of Directors of the company would overcome it.

(ii) Advantages to promoters

- The entrepreneur for the success of public issue is required to convince tens of underwriters, brokers and thousands of investors but to obtain Venture Capital assistance; he will be required to sell his idea to justify the officials of the venture fund. Venture Capital provides a solid capital base for future growth by injecting long-term equity financing.

- Public issue of equity; shares has to be preceded by a lot of efforts. Necessary statutory sanctions, underwriting and brokers arrangement, publicity of issue etc. the new entrepreneurs find it very difficult to make underwriting
arrangements require a great deal of effort. Venture fund assistance would eliminate those efforts by leaving entrepreneur to concentrate upon bread and butter activities of business.

- Costs of public issues of equity share often range between 10 percent to 15 percent of nominal value of issue of moderate size, which are often even higher for small issues. The company is required, in addition to above, to incur recurring costs for maintenance of share registry cell, stock exchange listing fee, expenditure on printing and posting of annual reports etc. These items of expenditure can be ill afforded by the business when it is new. Assistance from venture fund does not require such expenditure.

- Business partner: the Venture Capitalists act as business partners who share the rewards as well as the risks.

- Mentoring: Venture Capitalists provide strategic, operational tactical and financial advice based on past experience with other companies in similar situations.

- Alliances: the Venture Capitalists help in recruitment of key personnel, improving relationship with international markets, co-investment with other VC firms and in decision making.

(iii) Advantages to Society in General

- A developed Venture Capital institutional set-up reduces the time lag between a technological innovation and its commercial exploitation.

- It helps in developing new process/products in conducive atmosphere, free from the dead weight of corporate bureaucracy, which helps in exploiting full potential.

- Venture Capital acts as a cushion to support business borrowings, as bankers and investors will not lend money with inadequate margin of equity capital.

- Once Venture Capital funds start earning profits, it will be very easy for them to raise resources from primary capital market in the form of equity and debts. Therefore, the investors would be able to invest in new business through venture funds and, at the same time, they can directly invest in existing business when venture fund disposes its own holding. This mechanism will
help to channelize investment in new high-tech business or the existing sick business. These business will take-off with the help of finance from venture funds and this would help in increasing productivity, better capacity utilization etc.

- The economy with well developed Venture Capital network induces the entry of large number of technocrats in industry, helps in stabilizing industries and in creating a new set of trained technocrats to build and manage medium and large industries, resulting in faster industrial development.

- A Venture Capital firm serves as an intermediary between investors looking for high returns for their money and entrepreneurs in search of needed capital for their start-ups.

- It also paves the way for private sector to share the responsibility with public sector.

2.14 Venture Capital Investment process

The evaluation of the proposed ventures is the most crucial aspect of the operation of VCFs. Because the investment will generally be in small firms with a direct involvement of the Venture Capitalists, and because these firms will be new without past performance, venture evaluation cannot be subjected to a very high degree of quantitative analysis (Poindexter, 1976). This is borne out by the venture evaluation experiences in the developed countries like USA (Poindexter, 1976; Tyebjee and Bruno, 1984; Macmillan, Siegal and Subba Narasimha, 1985)

Process involving Venture Capital investment: The following are the steps involved in Venture Capital Investment Process

1. Deal origination
2. Screening
3. Evaluation or due diligence
4. Deal structuring
5. Post-investment activity
6. Exit
1. **Deal Origination**: How does a Venture Capitalist learn about potential ventures? In generating a deal flow, the VC investor creates a pipeline of deals or investment opportunities that he would consider for investing in. Deals may originate in various ways: referral system, active search system, and intermediaries. Referral system is an important source of deals. Deals may be referred to VCFs by their parent organizations, trade partners, industry associations, friends etc. Another deal flow is active search through networks, trade fairs, conferences, seminars, foreign visits etc. Intermediaries is used by Venture Capitalists in developed countries like USA, is certain intermediaries who mated VCFs and the potential entrepreneurs.

2. **Screening**: Venture Capital is a service industry, and VCFs generally operate with a small staff. VCFs, before going for an in-depth analysis, carry out initial screening of all projects on the basis of some broad criteria. For example, the screening process may limit projects to areas in which the Venture Capitalist is familiar in terms of technology, or product, or market scope. The size of investment, geographical location and stage of financing could also be used as the broad screening criteria.

3. **Evaluation or Due Diligence**: Once a proposal has passed through initial screening, it is subjected to detailed evaluation or due diligence process. Most ventures are new and the entrepreneurs may lack operating experience. Hence, a sophisticated, formal evaluation is neither possible nor desirable. The Venture Capitalists thus rely on a subjective, but comprehensive, evaluation. VCFs evaluate the quality of entrepreneur before appraising the characteristics of the product, market or technology. Most Venture Capitalists ask for a business plan to make an assessment of the possible risk and return on the venture. Business plan is the single most important document to be prepared by seekers of Venture Capital. It contains detailed information about the proposed venture. The evaluation of ventures by VCFs in India includes:
• **Preliminary evaluation**: The applicant required to provide a brief profile of the proposed venture to establish prima facie eligibility.

• **Detailed evaluation**: Once the preliminary evaluation is over, the proposal is evaluated in greater detail. VCFs in India expect the entrepreneur to have; Integrity, long-term vision, urge to grow, managerial skills, and commercial orientation.

VCFs in India also make the risk analysis of the proposed projects which includes: Product risk, Market risk, Technological risk and Entrepreneurial risk. The final decision is taken in terms of the expected risk-return trade off.

4. **Deal structuring**: Once the venture has been evaluated as viable, the Venture Capitalist and the investee company negotiate the terms of the deal, viz., the amount, form and price of the investment. This process is termed as deal structuring. The agreement also includes the protective covenants and earn-out arrangements. Covenants include the Venture Capitalists right to control the venture company and to change its management if needed, buyback arrangements, acquisition, making Initial public Offerings (IPOs), etc. Earned out arrangements specify the entrepreneur’s equity share and the objectives to be achieved. Venture Capitalists generally negotiate deals to ensure protection of their interests. They would like a deal to provide for a return commensurate with the risk; influence over the firm through board membership; minimizing taxes; assuring investment liquidity; the right to replace management in case of consistently poor managerial performance. The investee companies would like the deal to be structured in such a way that their interests are protected. They would like to earn reasonable return, minimize taxes, have enough liquidity to operate their business and remain in commanding position of their business. There are a number of common concerns shared by both the Venture Capitalists and the investee companies. They should be flexible, and have a structure which protect their mutual interests and provides enough incentives to both to cooperate with each other.
5. **Post investment activities:** Once the deal has been structured and agreement finalized, the Venture Capitalist generally assumes the role of a partner and collaborator. He also gets involved in shaping the direction of the venture. This may be done via a formal representation on the board of directors, or informal influence in improving the quality of marketing, finance, and other managerial functions. The degree of the Venture Capitalists involvement depends on his policy. It may not, however, be desirable for a Venture Capitalist to get involved in the day-to-day operation of the venture. If a financial or managerial crisis occurs, the Venture Capitalist may intervene, and even install new management team.

6. **Exit:** Venture Capitalists generally want to cash-out their gains in five to ten years after the initial investment. They play a positive role in directing the company towards particular exit routes. A venture may exist in one of the following ways:
   - Initial Public Offerings (IPOs)
   - Acquisition by another company
   - Purchase of the Venture Capitalists shares by the promoter or purchase by the Venture Capitalists share by an outsider.

2.15 **Methods of Venture Financing**

A prerequisite for the development of an active Venture Capital industry is the availability of a variety of financial instruments which cater to the different risk-return needs of investors. They should be acceptable to entrepreneurs as well. In developed countries, innovation in financial instruments is a distinct feature of Venture Capital. Venture finance, conceptually being risk finance, should be available in the form of quasi-equity (conditional or convertible loans). A straight or conventional loan, involving fixed payments, would be an unsuitable form of providing assistance to a risky venture. Venture Capital is typically available in the following forms in India:

1. **Equity:** VCFs in India provide equity but generally their contribution does not exceed 49 percent of the total equity capital. Thus, the effective control and majority ownership of the firm remains with the entrepreneur. They buy shares
of an enterprise with an intention to ultimately sell them off to make capital gains. Equity helps new enterprises since it puts no pressure on their cash flows as there is no obligation to pay dividends if the enterprise does not have liquidity. Once the enterprise becomes profitable, the Venture Capitalist can earn a high return through capital gains. It requires the existence of a stock market for the shares of small enterprises.

2. **Conditional Loan:** It is repayable in the form of royalty after the venture is able to generate sales. No interest is paid on such loans. In India, VCFs charge royalty ranging between 2 to 15 percent; actual rate depends on other factors of the venture such as gestation period, cost-flow patterns, riskiness and other factors of the enterprise. Conditional loans were used by VCFs in India in the initial years of their operations in a big way. They faced a number of problems in implementing this method of financing. The major problems were the high cost for well-performing companies; difficulties in administrating the scheme, particularly ascertaining the sales volume to determine the amount of royalty; minority shareholding of the VCF since conditional loan is a subordinate instrument; and in spite of high cost to the entrepreneurs, the low return to the VCF compared to return from highly profitable ventures financed through equity.

3. **Income Note:** A unique way of venture financing in India – a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales, but at substantially low rates. Income notes suffer from limitations similar to conditional loans. They do not promise high return to VCF; could be expensive for profitable ventures and are difficult to administer.

4. **Other Financing Methods:** A few Venture Capitalists, particularly in the private sector, have started introducing innovative financial securities like participating debentures, partially convertible debentures and cumulative convertible preference shares. CCPs are attractive as the shareholders do not have the right to vote. They are entitled to voting if they do not receive a dividend for two consecutive years. Both a convertible debentures and convertible preference shares require an active secondary market to be attractive securities from the investor’s point of view. In India, Venture Capitalists and entrepreneur favors a financial package which has a higher
component of loan because the promoters fear the loss of ownership and control to the financiers and also due to the traditional reluctance of financiers to share in the risk inherent in the use of equity.

2.16 Investment Philosophy

The basic principal underlying Venture Capital invests in high risk projects with the anticipation of high returns. These funds are then invested in several fledging enterprises, which require funding, but are unable to access it through the conventional sources such as banks and financial institutions. Typically first generation entrepreneurs start such enterprises. Such enterprises generally do not have any major collateral to offer as security, hence banks and financial institutions are averse to funding them.

Venture Capital funding may be by way of investment in the equity of the new enterprise or a combination of debt and equity, though equity is the most preferred route. Since most of the ventures financed through this route are in new areas (worldwide Venture Capital follows “hot industries” like Info Tech, electronics and biotechnology), the probability of success is very low. All projects financed do not give a high return. Some projects fail and some give moderate returns. The investment, however, is a long-term capital as such projects normally take 3 to 7 years to generate substantial returns. Venture Capitalists’ offer “more than money” to the venture and seek to add value to the investee unit by active participation in its management. They monitor and evaluate the project on a continuous basis. The Venture Capitalists are however not worried about failure of an investee company, because the deal which succeeds, nets a very high return on his investments-high enough to make up for the losses sustained in unsuccessful projects. The returns generally come in the form of selling the stocks when they get listed on the stock exchange or by a timely sale of his stake in the company to a strategic buyer. The idea is to cash in on an increased appreciation of the share value of the company at the time of disinvestment in the investee company. If the venture fails, the entire amount gets written off. Probably, is one reason why Venture Capitalists assess several projects and invest only in a handful after careful scrutiny of the management and marketability of the project? To conclude, a venture financier is one who funds a
startup company; in most cases promoted by a first generation technocrat promoter with equity. A VCs is not a lender, but an equity partner.

Venture Capitalists driven by wealth maximization, Venture Capitalists are sources of experts for the companies they finance. Exit is preferably through listing on stock exchanges. Venture funds have been credited with success of technology companies in Silicon Valley, USA. The entire technology industry thrives on it.

2.17 Divestment Mechanisms

The objective of a true Venture Capitalist is to sell off his investment at substantial capital gain but most venture funds in India aim to operate on commercial lines along with satisfying their development objectives. Public sector venture funds invariably have some developmental objectives and they would also like to disinvest their holdings at adequate return with a view to recycle their funds.

The disinvestment options generally available to Venture Capitalists in developed countries are the promoter’s buy-back, initial public offers (IPOs), sale to other VCFs, in OTC sale, management buyouts etc. a few of them are effectively feasible in India.8

1. **Promoter’s Buy-out:** The most popular disinvestment route in India is promoter’s buy-back. This route is suited to Indian conditions because it keeps the ownership and control of the promoter intact. The obvious limitations, however, is that in a majority of cases the market value of the shares of the venture firm would have appreciated so much after some years that the promoter would not be in a financial position to buy them back. In India, the promoters are invariably given the first option to buy back equity of their enterprises.

2. **Initial Public Offers (IPOs):** The benefits of disinvestment via the public issue route are improved marketability and liquidity, better prospects for capital gains and widely known status of the ventures as well as market control through public share participation. This option has certain limitation in the Indian context. The promotion of the public issue would be difficult and expensive since the first generation entrepreneurs are not known in the capital

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markets. Further, difficulties will be caused if the entrepreneur’s business is perceived to be an unattractive investment proposition by investors. Also, the emphasis by the Indian investors on short-term profits and dividends may tend to make the market price unattractive. Yet another difficulty in India until recently was that the Controller of Capital Issues (CCI) guidelines for determining the premium on shares took into account the book value and the cumulative average EPS till the date of the new issue. This formula failed to give due weightage to the expected stream of earnings of the venture firm. Thus, the formula would underestimate the premium. The government has now abolished the Capital Issues Control Act, 1947 and consequently, the office of the Controller of Capital Issues. The existing companies are now free to fix the premium on their shares. The initial public issue for disinvestment of VCF’s holdings can involve high transaction costs because of the inefficiency of the secondary market in a country like India. Also, this option has become far less feasible for small ventures on account of the higher listing requirement of the stock exchanges. In February 1989, the Government of India raised the minimum capital for listing on the stock exchanges from Rs.10 million to Rs.30 million and the minimum public offer Rs. 6 million to Rs. 18 million.

3. **Sale on the OTC Market:** An active secondary market provides the necessary impetus to the success of Venture Capital. VCFs should be able to sell their holdings, and investors should be able to trade shares conveniently and freely. The OTC Exchange in India was established in June 1992. The Government of India had approved the creation of the Exchange under the Securities Contracts (Regulations) Act 1989. It has been promoted jointly by UTI, ICICI, SBI Capital Markets, Canbank Financial Services, GIC, LIC and IDBI. Since this list of markets (who will decide daily prices and appoint dealers for trading) includes most of the public sector venture financiers, it should pick up fast, and it should be possible for investors to trade in the securities of new small and medium size enterprises.

The other disinvestment mechanisms such as the management buy-outs or sale to other venture funds are not considered to be appropriate by VCFs in India.
2.18 Development of Venture Capital: Global Experiences

Historical background and development of Venture Capital

Origin

Venture Capital as a new phenomenon originated in USA and developed spectacularly worldwide since the second half of the seventies. American Research and Development Corporation (ARDC), founded by Gen. Doriot (Georges Doriot) soon after the Second World War, are believed to have heralded the institutionalization of Venture Capital in the USA. Since then the industry has developed in many other countries in Europe, North America and Asia. The real development Venture Capital (VC) took place in 1985. When the Business Administration Act was passed by the US congress. In USA alone there are 800 Venture Capital firms managing around $40 billion of capital with annual accretions of between $1billion and 5billion. It is reported that some of the present day giants like Apple, Micro soft, Xerox etc. are the beneficiaries of Venture Capital.9

United Kingdom (UK) occupies a second place after US in terms of investment in Venture Capital (VC). The concept became popular in late sixties in UK. The Government’s Business Expansion Scheme which permitted individuals to claim tax reliefs for investment in companies not listed in stock exchange led to the success of Venture Capital in UK. The Charter House Development Limited is the oldest Venture Capital company established in 1934 in UK. The Bank of England established its Venture Capital company in late 40’s. The UK witnessed a massive growth of industry during 70’s and 80’s. During 1988 there were over 1000 Venture Capital companies in UK which provided $ 68 billion to over 1500 firms.

The success of Venture Capital in these countries prompted other countries to design and implement measures to promote Venture Capital and their total commitment has been rising.

Venture Capital in USA

In the United States of America, Venture Capital has contributed immensely to the growth of the economy. It has made significant contribution to the development of the computer and semi-conductor industry. It has also helped in the implementation of

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very large scale integration technology. While Venture Capital was instrumental in the development of American economy, its institutionalization did not begin until after World War II. Prior to that, it was a common practice for wealthy individuals, syndicates organized by investment bankers or by a few families to make venture investments. The institutionalization process was facilitated by the formulation of American Research and Development Corporation (ARDC) in Boston in 1946, passing of Small Business Investment Company (SBIC) Act in 1958 as a vehicle of small business financing and the substantial tax incentives provided to those investing their funds in VCFs. ARDC, started by Georges Doriot, was the first successful Venture Capital firm. Its first investment worth US$61,400 in 1957 was in the shares of Digital Equipment Corporation, a new company, which grew phenomenally in terms of sales, number of employees and market worth in its shares. Doriot’s philosophy was to build creative men and their companies. For him capital gains were the reward of this philosophy, not a business goal. The objective of this company was to seek out creative men with a vision of things to be done, help breathe life into new ideas and process and products with capital, and with more than capital with sensitive appreciation for creative drive.

The creation of Small Business Investment Companies (SBICs) as a means of small business financing in 1958 gave the real impetus to the development of the Venture Capital industry in the USA. The purpose of the SBIC Act was to establish government-controlled Venture Capital funds for developing new and early stage business and they proved to be very effective during the sixties and seventies. Even today, when large Venture Capital organizations dominate the US venture industry, SBICs, in their new and modified form, are the major source of its growth.

The Venture Capital industry in the USA has been growing ever since its inception. Its growth was, however, accentuated after 1978 when the capital gains tax was reduced from 49 to 29 percent. The rate was brought down to 20 percent for individuals in 1981. These resulted in substantial returns to investors; the Venture Capital was able to attract capital without difficulty. This coincided with the emergence of the very large scale integration which substantially reduced the cost of computer chips and gave a boost to the computer industry.

Although the Venture Capital finance is made available to all enterprise in the USA, the high technology businesses have received large funds over the years. Most
of the Venture Capital investments in the USA are confined to high-technology, high-risk and rapidly changing businesses. Substantial Venture Capital has been invested in the fields of information, communications, genetic engineering, medical electronics, biotechnology and artificial intelligence. In volume terms, the USA dominated the Venture Capital business with a pool of about US$30 billion in 1991, having increased from US$ 16.3 billion at the end of 1984 (OECD report 1986).

VCFs in the US can be categorized into four main groups (Clarke, 1987):

1. Private Venture Capital firms (PVCFs);
2. Small business investment companies (SBICs);
3. Subsidiaries of finance corporations; and

PVCFs include family firms and institutionally funded independent private partnerships and are the most dominant source of Venture Capital. They account for about 60 percent of the Venture Capital industry’s capital; and they are very experienced and sophisticated investors. Institutionally-funded private firms are generally organized as limited partnership where Venture Capitalist, in his capacity as general partner, is responsible for the management of the partnership. For their management, general partners are compensated in the form of an annual management fee—generally 2.5 to 3 percent of the capital invested and a percentage, quite often 20 percent of the net long-term capital gain.

SBICs, created under the SBIC Act 1958, have access to government loans in addition to private committed capital. They are of two types: equity-oriented SBICs which account for about 8 percent of the Venture Capital and mostly provide equity capital and debt-oriented SBICs: subsidiaries of finance and non-finance corporations account for about 17 percent of the Venture Capital.

In the USA, expansion-stage financing is much higher than the seed stage or the later stage of acquisition or buyout financing. This indicates the interest and objectives of the Venture Capitalists in associating with a business/product which has been successfully developed and pre-tested. Also, their goal is to make large financial returns. Thus, profits are made by structuring the transaction in a certain way. Analysis is focused much more on meeting the requirements of the transaction than on evaluating the long-term prospects of the company and strategic objectives.
According to Thomson Reuters and the National Venture Capital Association (NACA), Venture Capital performance showed positive returns across all investment horizons 3 years and longer for the period ending December 31, 2008. However, with the exception of the 20 year horizon, most categories experienced quarter over quarter and year over year declines.

Turmoil in the broader capital markets caused the one-year all venture Private Equity Performance Index (PEPI) (1) to decline significantly to 20.9 percent, a 18.8 percentage point decrease from the period ending September 30, 2008. The slowed exit markets in 2008 have driven lower one-year return numbers throughout 2008. The next largest consecutive quarterly change occurred in the three-year time horizon where all venture PEPI decreased by 2.1 points quarter-over-quarter to 4.2 percent. Five-year and ten-year performance posted similar declines from the previous quarter, decreasing 2.0 and 1.6 percentage points, respectively. Twenty-year performance was showed no change from the previous quarter at 17.0 percent.

Venture Capitalists invested some $29.1 billion in 3,752 deals in the U.S. through the fourth quarter of 2011, according to a report by the National Venture Capital Association. The same numbers for all of 2010 were $23.4 billion in 3,496 deals. A National Venture Capital Association survey found that a majority (69%) of Venture Capitalists predicted that venture investments in the U.S. would have leveled between $20–29 billion in 2007. (Source: Gordon and Natarajan, Financial Markets and Services, fifth revised edition).

**Venture Capital in Europe**

In Europe, Venture Capital started in the eighties. A number of European countries now have Venture Capital firms which are members of the European Venture Capital Association (EVCA) founded in 1983. In spite of these developments, about three-fourths of the Venture Capital investment in Europe is confined to three countries, namely the UK, France and the Netherlands.

The slow growth of Venture Capital in Europe in the initial years can be attributed to a number of factors. For example, it is suggested that ‘financial institutions, equity markets and company law have all evolved differently in these countries, with the result that Venture Capital along United States, or United Kingdom lines has scarcely developed (OECD, 1986). The government policy in the
USA has been to create a climate conducive to risk-taking and entrepreneurship, and deregulating markets and reducing taxes rather than providing special incentives for the financing of SMEs as was the case in a number of European countries.

In the late eighties, Europe witnessed a fast growth of Venture Capital due to changes in public policy and the economic conditions. The creation of over-the-counter (OTC) or secondary stock exchanges gave further impetus to the development of Venture Capital. For example, the Venture Capital pool increased from US$8.95 billion in 1986 to US$29 billion in 1990, slightly more than 80 percent of the size of the US Venture Capital (Bygrave and Timmons, 1992).

Private equity and Venture Capital provides investment opportunities to institutional and professional investors. The vast majority of these private equity and Venture Capital investors, called limited partners. The major source of funds in Europe is bank which contributes approximately about 20 percent of the capital, followed by government agencies, corporate investors, pension funds and insurance companies. Other than the United Kingdom, no other country has sources of funds like the United States, i.e. 25 percent of the capital comes from the pension funds. They do not manage all funds that they have invested in, and do not intervene at the level of the investee company. However, they regularly assess the quality of the investments made on their behalf. Of the €79bn funds raised in 2007, €60bn (76.0 percent) was allocated to buyouts and €10.3bn (13.1 percent) to venture and growth capital. Venture Capitalists in Europe focus on industrial products, consumer products, computer products and other electronic products. Owing to growing emphasis on development of technology, West Germany, United Kingdom, France and to a lesser degree, the Netherlands and Italy, have invested heavily in Research and Development.

A significant development with regard to Venture Capital in Europe is the establishment of a Pan-European network of VCFs by twelve companies including Bosch, Fiat, Olivetti, Petrofina, Philips, Pirelli and Volvo. This network has created a holding company with US$30 million funds for investing in European VCFs. Different types of investors were roped in for raising funds in Europe for the period 2003-2007. Pension funds had the largest share of 23 percent in the total funds raised. Next came the banks and the insurance companies having a share of 15.6 percent and
9.9 percent respectively. The other investors consisted of government agencies, private companies, corporate investors, capital markets, academic institutions etc.

The geographical origin of funds raised in Europe during 2003-2007 depicts that approximately three-fourth of the funds was raised by the Europeans and the balance by USA and rest of the world. Half of the total Venture Capital investment in Europe is invested in the United Kingdom. The Netherlands and France are the next largest players in the industry followed by Belgium and West Germany. The countries in Western Europe have started playing greater roles in this area, with exceptional growth resulting in Italy and Scandinavia. This has increased the start-up activities in Europe. On per capita basis, the number of start-ups in Western Europe is almost equal to the US.

The only difference is that the US started these 30 years back and Europe has been a new entrant. The Gross National Product of 12 Countries of European Community is over US$ 4 trillion, approximately equal to that of the US. Thus, there are tremendous opportunities for the growth of Venture Capital industry in the economy of Europe.

Investments by European private equity and Venture Capital firms amounted to €73.8bn in 2007, and approximately 5,200 European companies received private equity investments. About 85 percent of these companies have fewer than 500 employees. Studies show that between 2000 and 2004 European private equity and Venture Capital financed companies created 1 million new jobs, which translates to a compound annual growth rate of 5.4 percent per year (eight times the EU 25 total employment rate of 0.7 percent). Between 1997 and 2004, the average employment growth in buyout-financed companies was 2.4 percent, compared to 30.5 percent for venture-backed companies.

PE/VC fund investors have a long-term commitment horizon of generally ten years, which stems from contractual agreements which bind PE/VC funds to their investors. On this basis, PE/VC funds should not be considered as short-term investors, which imply holding periods of less than one year, as their average holding periods in investee companies is four years. More concretely, PE/VC firms also distinguish themselves from short-term investors by the way they manage their investments. Short-term investors take advantage of market trends but do not
influence the way the underlying companies operate, unlike private equity and Venture Capital.

The private equity industry is regulated on a national basis in most EU member states. Private equity houses deal almost exclusively with sophisticated, ‘professional’ investors. These investors are able to understand and accept the risks and rewards of investing in the asset class. This is largely reflected in the type and level of regulation across Europe. In addition, although there is no harmonized framework for private equity at the European Union level, a number of EU legislative measures in place indirectly affect the industry, such as MiFID, UCITS, the Pension Funds Directive, and the Capital Requirements Directive.

The European industry believes in high professional standards that are crucial to a stable, long term relationship with institutional investors and regulators. They are also vital to increasing overall transparency and trust in the asset class. For nearly three decades, the industry has worked to create the most advanced professional standards of any alternative asset class anywhere in the world. The European private equity industry has already enacted IFRS and US GAAP compatible valuation and reporting guidelines, management principles for private equity houses and OECD-inspired guidelines for the corporate governance of portfolio companies.

Europe has a large and growing number of active venture firms. Capital raised in the region in 2005, including buy-out funds, exceeded €60 billion, of which €12.6 billion was specifically allocated to venture investment. The European Venture Capital Association includes a list of active firms and other statistics. In 2006, the top three countries receiving the most Venture Capital investments were the United Kingdom (515 minority stakes sold for €1.78 billion), France (195 deals worth €875 million), and Germany (207 deals worth €428 million) according to data gathered by Library House.

European Venture Capital investment in the second quarter of 2007 rose 5% to €1.14 billion from the first quarter. However, due to bigger sized deals in early stage investments, the number of deals was down 20% to 213. The second quarter Venture Capital investment results were significant in terms of early-round investment, where as much as €600 million (about 42.8% of the total capital) were invested in 126 early
round deals (which comprised more than half of the total number of deals). Private equity in Italy was 4.2 billion Euros in 2007.

**Venture Capital in United Kingdom**

The early stirrings of the UK Venture Capital industry began in 1930s. The UK has the largest Venture Capital industry outside the USA and it accounts for about two-thirds of total VC investments in the European Community (OECD, 1986). In the past, the growth of new business in Britain had been hampered by the “equity-gap”. There was need for a steady and growing supply of Venture Capital to finance entrepreneurial talent (Lorenz, 1985).

The Venture Capital industry had invested only £ 10 million (pounds) in 1979 but the amount had increased to £ 284 million in 1984. It had made significant contribution in creating hundreds of new enterprises and in catalyzing the spirit of entrepreneurship. There are estimated to be well over a hundred of Venture Capital firms in UK having provided venture funds to thousands of companies. In 1988, for example, funds worth Rs, 37,000 million to over 1,500 companies were provided by the UK Venture Capital industry (Cottrell, 1989). The following reasons are attributed for the rapid growth of the UK Venture Capital industry (Mason, 1987; Kitchen, 1988):

- The demonstration effect of the high profitability of Venture Capital in the USA (e.g. the flotation of Apple Computer).
- The establishment of regional Venture Capital organizations such as Investors in Industry.
- Tax incentives to individuals investing in entrepreneurial companies.
- The establishment of the Unlisted Securities Market (USM) and the Business Expansion Schemes (BES). BES is designed to motivate private investors, through large tax exemptions, to invest in shares of private, unquoted companies.
- The growth in the number of management buyouts, which has created a demand for equity finance.
- The increased involvement of merchant banks, providing Venture Capital to small, growing companies with a view to obtaining future fee-earning work from them.
Historically, the small firms in the UK have received equity finance from the investment trusts. But in the post-war periods, investments trusts started investing in large, quoted companies at the cost of the small, risky companies. The most important source of equity finance for new firms during the 1960s and early 1970s was Investors in Industry or 3i.

3i was established in 1945 by the Bank of England and the major clearing banks with the purpose of supplying long-term finance to growing firms. About two-thirds of financing go to small firms. They provide finance in the form of loans and equity investments.

It was in the later part of the 1980s that a large number of private venture funds emerged in the UK. A number of factors, such as tax incentives, establishment of the Unlisted Securities Market (USM), and encouragement to investment trusts etc. contributed to this development.

The UK is an excellent example of a country where a number of tax incentives have been initiated specifically to give a fillip to the Venture Capital investment. In fact, it has been found in the UK that investors are motivated more by the potential tax breaks than by the quality of investments. It is estimated that only 2 percent of the BES total investments are invested in the high-tech sector and 6 percent in the young or very young start-up companies (OECD, 1986).

The UK’s USM was established in 1980 with highly flexible rules to admit start-ups. It operates on the same basis as the regular stock market, but with liberal regulations for trading the shares. For example, USM requires 10 percent of a company’s shares to be offered in the primary issues before they can be traded; in the listed market the requirement is 25 percent. The establishment of USM boosted Venture Capital activity since it made it much easier for entrepreneurs and Venture Capitalists to realize their capital gains. The UK experience has, however, shown that most business which obtained the USM listings were at the larger end of the SME scale. This necessitated the introduction of a third market in 1987 for smaller companies and with ever easier listing requirements than demanded by the USM.

Yet another policy change in the UK giving encouragement to Venture Capital was the liberalization of rules regarding investment trusts and investment companies
in 1981. It was made easier for these companies to invest in unlisted securities which encourage a large number of them to enter the Venture Capital business.

**Sources of funds:** While pension funds remain the richest source of UK private equity investment capital; there has been a surge of interest by banks, funds of funds, government agencies and private individuals.

**Investment in UK by industry:** Consumer services were the single most active sector with £6.1 billion worth of deals, 51 percent of the UK total.

**Regional investment:** London and the South East continue to dominate the UK investment landscape, attracting 42 percent of all UK investment.

**Divestments:** Private equity and Venture Capital firms generate returns for their investors by ‘divesting’ or ‘exiting’ part or their entire stake in a portfolio company. Divestments typically take place 3-5 years after the initial investment. There are a number of divestment types, the following being among the most common:

**Trade sale:** A private equity firm sells its stake in a portfolio company to another company, often operating in the same sector.

**Secondary sale:** A firm sells a stake in a portfolio company to another private equity firm.

**Flotation:** A company is floated on the stock market and the shares are passed on to investors or sold and the proceeds passed on at a later date.

**Venture Capital in France**

During the 1970s and 1990s, most European countries adopted public policies aimed at encouraging development of the innovation process in order to remain internationally competitive in the specialized high-tech sectors. As in Germany, in France the policy to support Venture Capital is part of a wider program to support innovation and reduce comparative handicaps. For the last 30 years, French authorities have constantly sought to maintain an active policy in this field.

In France, Sociétés Financiers ’Innovation (SFI), with the fiscal advantage of setting 50 percent of their new investment against taxable income, was established in 1972. They were not highly successful. This lack of success could be attributed to the SFIs failing to attract the right sort of managers, and failing to appreciate the importance of a direct involvement in the management of supported companies. The
French government introduced more tax incentives to revitalize the Venture Capital industry, which has led to the establishment of Fonds Commun de Placement à Risqué in 1983. Investors receive tax-exempt capital gains at the end of five years.

Venture Capital is the fast developing concept in France, with a number of genuine Venture Capital funds now in existence—mostly owned or supported by banks. Three of these funds are long-standing with experience of over 10 years; there are about 40 other sources of small company risk capital (Lorenz, 1985). The creation of the Second Marché in 1983 and development of financial instruments such as warrants and options have helped the growth of the French Venture Capital industry, accounting for as much as 65 percent of investment in recent years.

2.19 Venture Capital in India

History of Venture Capital in India

History of Venture Capital in India dates back to early 1970 when government of India appointed a committee laid by Late Sri R.S. Bhatt to find out the ways to meet a void in conventional financing for funding start-up companies based on absolutely new innovative technologies. Such companies either did not get any financial support or the funding was inadequate which resulted into their early mortality. The committee recommended starting of Venture Capital industry in India. In mid-80s three all India financial institutions viz. IDBI, ICICI, IFCI started investing into the equity of small technological companies.

In November 1988, Govt. of India decided to institutionalize Venture Capital Industry and announce guidelines in the parliament. Controller of Capital issues implemented these guidelines known as Controller of Capital Issues (CCI) for Venture Capital (VC). These guidelines were very restrictive and following a very narrow definition of Venture Capital (VC). They required Venture Capital to be invested in companies based on innovative technologies started by first generation entrepreneur. This made VC investment highly risky and unattractive. Nonetheless about half a private initiative were taken. At the same time World Bank organized a VC awareness seminar and selected 6 institutions to start VC investment in India. This included Technology Development and Information Company of India Ltd. (TDICI), Gujarat Venture Finance Limited (GVFL), Canbank Venture Capital Fund,
Andhra Pradesh Industrial Development Corporation Limited (APIDC), Risk Capital and Technology Finance Corporation Ltd. (RCTFC), and Pathfinder. The other significant organizations in private sector were ANZ Grindlays, 3i Investment Services Limited, IFB, and Jardine Electra.

After the reforms were commenced in 1991, CCI guidelines were abolished and VC Industry became unregulated. In 1995, Government of India permitted Foreign Finance companies to make investments in India and many foreign VC private equity firms entered India. In 1996, after the lapse of around 8 years, government again announced guidelines to regulate the VC industry. There were many shortcomings in these guidelines at the starting point. These guidelines did not create a homogeneous level playing field for all the VC investors. This impeded growth of domestic VC industry. Lack of incentives also made Indian Corporate and wealthy individuals shy of VC funds. With the result, VC scene in India started getting dominated by foreign equity fund.

In 1997, IT boom in India made VC industry more significant. Due to symbiotic relationship between VC and IT industry, VC got more prominence as a major source of funding for the rapidly growing IT industry. Indian Venture Capitalist’s (VC’s) which were so far investing in all the sectors changed their focus to IT and telecom industry.

The recession during 1999-2002 took the wind out of VC industry. Most of the VC either closed down or wound-up their operations. Most of them with the exception of one or two like Gujarat Venture Finance Limited (GVFL) changed their focus to existing successful firms for their growth and expansion. VC firms also got engaged into funding buyouts, privatization and restructuring. Currently, just a few firms are taking the risk of investing into the start-up technology based companies.
The Development Of Venture Capital In India Can Be Summarized Into Four Phases:

<table>
<thead>
<tr>
<th>Phase</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase I</td>
<td>Formation of TDICI in the 80s and regional fund as GVFL and APIDC in the early 90s.</td>
</tr>
<tr>
<td>Phase II</td>
<td>Entry of Foreign Venture Capital funds (VCF) like Draper, Warburg Pincus between 1995-1999</td>
</tr>
<tr>
<td>Phase III</td>
<td>2000 onwards, Emergence of successful India-centric VC firms like Helion, Infinity, Chryscapital, Westfridge, etc.</td>
</tr>
<tr>
<td>Phase IV</td>
<td>(Current) Global VCs and PE actively investing in India</td>
</tr>
</tbody>
</table>

Source: IVCA Publication

2.20 INVESTMENTS OF VENTURE CAPITAL IN INDIA

Table No: 2.3

Industry wise Cumulative Investment Details of SEBI Registered Venture Capital Funds (VCF) in India as on 2007 to 31st Dec 2012

(Rs. in Crore)

<table>
<thead>
<tr>
<th>Sectors of Economy</th>
<th>As on 31 Dec 2007</th>
<th>As on 31 Dec 2008</th>
<th>As on 31 Dec 2009</th>
<th>As on 31 Dec 2010</th>
<th>As on 31 Dec 2011</th>
<th>As on 31 Dec 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information technology</td>
<td>779</td>
<td>871</td>
<td>782</td>
<td>533</td>
<td>578</td>
<td>770</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>118</td>
<td>275</td>
<td>767</td>
<td>858</td>
<td>1185</td>
<td>1182</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>716</td>
<td>581</td>
<td>802</td>
<td>460</td>
<td>469</td>
<td>550</td>
</tr>
<tr>
<td>Biotechnology</td>
<td>354</td>
<td>603</td>
<td>389</td>
<td>187</td>
<td>188</td>
<td>216</td>
</tr>
<tr>
<td>Media/Entertainment</td>
<td>401</td>
<td>622</td>
<td>965</td>
<td>802</td>
<td>911</td>
<td>1101</td>
</tr>
<tr>
<td>Services Sector</td>
<td>1134</td>
<td>1618</td>
<td>1991</td>
<td>1215</td>
<td>1443</td>
<td>2137</td>
</tr>
<tr>
<td>Industrial Products</td>
<td>735</td>
<td>1095</td>
<td>1301</td>
<td>783</td>
<td>1110</td>
<td>1224</td>
</tr>
<tr>
<td>Real Estate</td>
<td>4207</td>
<td>4887</td>
<td>6753</td>
<td>8155</td>
<td>9373</td>
<td>10159</td>
</tr>
<tr>
<td>Others</td>
<td>8881</td>
<td>10664</td>
<td>11143</td>
<td>10029</td>
<td>12336</td>
<td>14218</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>17325</strong></td>
<td><strong>21216</strong></td>
<td><strong>24893</strong></td>
<td><strong>23023</strong></td>
<td><strong>27592</strong></td>
<td><strong>31556</strong></td>
</tr>
</tbody>
</table>

Source: SEBI
The above table and Graph represents the total investments of domestic Venture Capital firms made in India as on 31st Dec 2007 to as on 31st Dec 2012. Total investments made by domestic Venture Capital funds are 31,556 Crore. And also it can be observe that, the investments made in Information technology drastically decrease in 2009 because of the global recession and bad economic condition and same is continued till 2010. It recovered in 2011 and IT sector again started to attract good investments in 2011 onwards. And pharmaceuticals and biotechnology sectors also bears up’s and downs of investments by VCs, where as telecommunications, media/entertainment, service sector, industrial products, real estate and other sectors of economy gaining lot of prominence in terms of investments made by Venture Capitalists year by year. These leads create a lot of employment opportunities, increase in the standard of leaving and economic growth of the country.
**Table No: 2.4**

Industry wise Cumulative Investment Details of SEBI Registered Foreign Venture Capital Funds (FVCF) in India as on 2007 to 31st Dec 2012

(Rs. in Crore)

<table>
<thead>
<tr>
<th>Sectors of Economy</th>
<th>As on 31 Dec 2007</th>
<th>As on 31 Dec 2008</th>
<th>As on 31 Dec 2009</th>
<th>As on 31 Dec 2010</th>
<th>As on 31 Dec 2011</th>
<th>As on 31 Dec 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information technology</td>
<td>1390</td>
<td>1649</td>
<td>2082</td>
<td>3016</td>
<td>3813</td>
<td>3787</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>872</td>
<td>801</td>
<td>3502</td>
<td>7145</td>
<td>6778</td>
<td>6352</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>360</td>
<td>648</td>
<td>675</td>
<td>985</td>
<td>775</td>
<td>713</td>
</tr>
<tr>
<td>Biotechnology</td>
<td>31</td>
<td>31</td>
<td>72</td>
<td>140</td>
<td>140</td>
<td>100</td>
</tr>
<tr>
<td>Media/ Entertainment</td>
<td>69</td>
<td>284</td>
<td>469</td>
<td>701</td>
<td>720</td>
<td>209</td>
</tr>
<tr>
<td>Services Sector</td>
<td>1341</td>
<td>1358</td>
<td>1538</td>
<td>2039</td>
<td>2256</td>
<td>1596</td>
</tr>
<tr>
<td>Industrial Products</td>
<td>1312</td>
<td>856</td>
<td>1043</td>
<td>886</td>
<td>1217</td>
<td>1211</td>
</tr>
<tr>
<td>Real Estate</td>
<td>2141</td>
<td>1424</td>
<td>1432</td>
<td>3107</td>
<td>2725</td>
<td>1091</td>
</tr>
<tr>
<td>Others</td>
<td>7868</td>
<td>12749</td>
<td>16015</td>
<td>15223</td>
<td>20307</td>
<td>18716</td>
</tr>
<tr>
<td>Total</td>
<td><strong>15384</strong></td>
<td><strong>19800</strong></td>
<td><strong>26827</strong></td>
<td><strong>33241</strong></td>
<td><strong>38730</strong></td>
<td><strong>33773</strong></td>
</tr>
</tbody>
</table>

*Source: SEBI*
Graph No: 2.3

Industry wise Cumulative Investment Details of SEBI Registered Foreign Venture Capital Funds (FVCF) in India as on 2007 to 31st Dec 2012

(Rs. in Crore)

As on 31 Dec 2007
As on 31 Dec 2008
As on 31 Dec 2009
As on 31 Dec 2010
As on 31 Dec 2011
As on 31 Dec 2012

The above table and Graph depicts the total investments made by foreign Venture Capital funds (FVCF) in India as on 31 Dec 2007 to as on 31 31st Dec 2012. Total investments made by foreign Venture Capital funds are 33,773 Crore. It also depicts total investments made by FVCF in different sectors of economy. It clearly indicates that telecommunications, information technology, service sector, industrial products, real estate, and others got more magnitude by FVCF for their investments compare to biotechnology, pharmaceuticals, and media/entertainment during 2007 to 2012.
2.21 SWOT analysis of Indian Venture Capital

Strengths

- One of the fastest growing economies; high domestic consumption-driven growth
- Strong entrepreneurial ecosystem and private sector
- VCPE investments growing at of 63% (from US$ 1 billion in 2002 to US$ 51.6 billion by 2010)
- High intellectual capital, leading to emergence of VC hotspots (E.g., Bangalore)
- Active equity capital and transaction markets facilitating exit options
- Vibrant VCPE market with more than 250 GPs and most of the large global funds

Weaknesses

- Regulatory restrictions on foreign investment in certain sectors, albeit easing gradually
- Lack of availability of debt for transactions

Opportunities

- Significant growth in dispensable income and hence demand for products and services
- Capital is required for core sectors (e.g., infrastructure, manufacturing, health care)
- Stable government with a long-term secular and growth-oriented outlook

Threats

- Competition from emerging nations (e.g., Brazil, China) to attract foreign VCPE funds
- The impact of proposed widespread changes in regulatory and tax policy is not fully clear outlook
- Heightened PE interest and activity levels are expected as a result of broad-based economic growth, stable government and strong capital markets
- Growth capital minority deals are expected to remain the major theme with buyouts still rare
2.22 Venture Capital in Karnataka

Karnataka has a unique distinction among the states of our country. It has a language which has over 2000 years of literature; a culture that is just as old; enterprising and peace loving people, Bangalore hub of cutting-edge technology, has placed our country as a focal point in the global economy and is also a melting pot of cultures and languages from across the globe.

The greatest advantage the people of Karnataka enjoy is a proactive government that has moved step by step with the enterprising people of the state. The government has been supporting a variety of economic and industrial activities, by initiating specially designed policies to promote growth. The IT/ITEs policy is one such success story by the government which has resulted in exponential growth of the IT industry.

Karnataka is considered a pioneer in the field of industrialization in India. The state has been in the forefront of industrial growth of our country since independence. In the era of economic liberalization since 1991, the state has been spearheading the growth of Indian industry, particularly in terms of high-technology industries such as Electrical and Electronics industry, Information & Communication Technology (ICT) industry, Biotechnology industry and more recently in terms of Nanotechnology industry. However, the industrial structure of Karnataka presents a blend of modern high-tech capital goods and knowledge intensive industries on the one hand and traditional consumer goods industries on the other.

Entrepreneurs turn to Venture Capitalists when conventional means of funding are not available and it is not possible in the routine course to procure funds to meet the requirements of equity capital for a contemplated project. Venture Capital plays an increasingly important role in the financial system and the economy, providers of Venture Capital attempt to identify firms, typically in early or development stages, those possess strong potential for profitable growth. Like any providers of finance Venture Capitalists monitor the performance of the firms they found, including prospective involvement in the management and or governance of said firms. Once the underlying business has sufficiently developed the Venture Capitalist typically exist from its investment and diverts funds to new opportunities.
The VCF may be an old concept in some advanced continents like USA and Europe, but it is comparatively a new phenomenon in Asia. Although the first initiative to promote VCF in India was taken in 1973, yet it can be observed that there is a considerable presence of regional imbalances exists among the different states of India in terms of VCF penetration. The growth of Venture Capital in some of advance states of India where VCF has taken place in large numbers. Maharashtra is the leading state in terms of Venture Capital movement followed by Gujarat, Tamilnadu, and Karnataka.

Karnataka happens to be the state where it has been observed that, before the information technology (IT) revolution since 1995 onwards; there were negligible diffusion of Venture Capital funding, predominantly having an agro-based economy, Karnataka has shifted their focus from Agriculture to IT and IT enabled services (IT and ITES) during the first generation of reforms and has started enjoying the benefits during the second-generation reforms starting from 1995 onwards.

From the review of different literature and statistical data, it can be inferred that with higher human and social capital Karnataka is exploring the Venture Capital market extensively present study made an attempt to reveal the factors responsible for the growth of VCF in Karnataka.

Bangalore has rapidly made the transition to the new economy in Information Technology (IT). Bangalore plays a prominent role in international electronics, telecommunications and information technology contributing almost 40% of India's production in high technology industrial sectors. Bangalore is home of the corporate giants in IT like Infosys, Wipro, Satyam, Aditi, IBM, Compaq etc. Karnataka's IT industry is mostly concentrated in and around Bangalore. Karnataka's software industry has shown a steady and high growth rate in comparison with other states in the country.

Biotechnology is another sector in which Bangalore has showed a significant growth. Bangalore has the best "bio-cluster" in the country with sudden escalation in the biotech market, which was due to growing multinational collaborations and indigenous R&D efforts in this field. In India, it is the State of Karnataka that holds the pre-eminent position in the field of Information Technology & Biotechnology. In
fact, the State is called the ‘Silicon State of India’ and Bangalore is referred to as the ‘IT Capital of India’ as well as the ‘Biotech City’.

The several international-standard research institutes, the entrepreneurial spirit, pro-active policies by the Central and State Governments, the cultural and economic milieu of a high-tech city are all ingredients for the success Bangalore industry. The following points show that Biotech in Bangalore is in its exponential growth:

- Karnataka has attracted maximum Venture Capital (VC) funding in biotechnology in the country.
- Ninety percent of the biotech companies in Karnataka are in Bangalore.
- Bangalore has the best "bio-cluster" in the country.

Karnataka General Information

Capital:  Bangalore

Area:  4, 50,000 sq km

Population (Census2011):  6, 11,30,704 ( Male3,10,57,742  Female:3,00,72,962)

Principal Languages:  Kannada

Urbanization Ratio (2011):  38.57%

Literacy Rate (2011):  75.61%

Major Minerals:  High-grade iron ore, cooper, manganese, chromate, china clay, lime stone, magnetite, Gold.

Major Industries:  Aircraft, Rail, coaches, telephone instruments, electronic & telecommunication, equipments, glass, batteries, electric motors, textiles, silk, hosiery, ceramic, sugar, capacitors, mining-metal, tools, cement, motorcycles, fertilizers.
2.23 Karnataka Region and Brief History of Bangalore city

Karnataka, the eighth largest state in India in terms of area (1,92,000 sq. km), is situated in South India. Karnataka has a 320km long coastline that faces the Arabian Sea. The rest of the State forms a part of the sprawling Deccan Plateau. To the left, running almost parallel to the coast is the Western Ghats.

Karnataka State is a leading State in terms of Science and Technology personnel. The State accounts for 9.2% of the country’s science and technology personnel numbering about 151 thousand. There are eight Science and Technology personnel per ten sq. km of area, and four Science and Technology personnel in every one thousand population in the State.

Karnataka has a rich tradition in enterprise and in industrialization. It is a legacy that has been sustained and passed on through the contemporary times for the current generation.

Bangalore, the capital of the state of Karnataka, is situated halfway between the coasts in southern India. The city was found in the 16th century. Bangalore is nick named "India's Silicon Valley", "Fashion Capital of India", "The Pub City of India", "The Garden City",

Bangalore "India's Silicon Valley" is India's fifth largest city and the fastest growing city in Asia. Bangalore is the 4th largest Technology Cluster in the World. The city is well connected by air, rail and road to all the major cities including the four metropolitan cities, viz., New Delhi, Mumbai, Calcutta and Chennai (Madras).

Bangalore has easy availability of qualified and trained manpower, the supporting services for industries, and an environment that stimulates progressive development of technology. It is the city of electronics, and computers. It has the most significant public sector base in the country.

Bangalore-Coimbatore-Chennai-Madurai industrial Belt: This region has large number of silk units, sugar mills, leather industry, chemical and machine tools and automotive components. There are number of public sector units which, are situated in this region. The two locations, Bangalore and Coimbatore have witnessed rapid industrial growth in this region.
Karnataka has always been at the forefront of industrial growth in India. With its inherent capabilities coupled with its enterprising citizens. Karnataka provides the ideal choice for investment opportunities based on:

1. Superior Human Resources including trained technical manpower in Engineering, Management and Basic Sciences located in Karnataka.
2. High-level research & development facilities originating from a number of Central Government laboratories & research institutions.
3. Favorable climate and habitat.
4. Excellent communication facilities and accessibility provided by well-established railway, airport, national highways and seaports.
5. Harmonious industrial relations.

Industrial Base in Karnataka and Around Bangalore has the unique distinction of locating most of the major industries and the largest industrial estates in the country. The city has well-developed industrial estates e.g. ITI, BEL, HMT, BHEL etc., which are located at Peenya, Bommasandra, Veerasandra, Electronic City at Konappana Agrahara. As well it has a number of industrial areas like: Kumbalagody Industrial Area, Jigani Industrial Area, Hoskote Industrial Area, Attibele Industrial Area, Whitefield Industrial Area and an Export Processing Zone at Whitefield.

Of the 678 medium and large-scale industrial units in the State, 300 are located in and around Bangalore. There are about 115 thousand small-scale industrial units, in Karnataka. About 21 per cent of these are located in and around Bangalore alone.