CHAPTER - I

Introduction
INTRODUCTION

India is the second largest country in the world in terms of population and arable land. It is the fifth largest economy in the world with 16% of world's population and 120% of world's arable land. It is a country with mixed economy in which both the state and the private sector have specific roles to play. The industries of basic and strategic importance are in the nature of public utility services or which require investment on a large scale, which only the state can provide are therefore in the public sector. The liberalization reforms since July 1991 have led to the strong revival of economic growth, rapid increase in employment, and reduction in poverty a boom in exports and decline in inflation (www.namasthenri.com, 2000). The government has now opened investment in the basic and infrastructure industries to private participation and even allows 100% foreign equity ownership in power generation and highway construction. India has progressed from a stage of importing basic requirement to a position where it exports precision tools and sophisticated electronic equipments.

90s saw a drastic change in the Indian financial sector. During the 70s and 80s, commercial banks and other financial institutions dominated Indian financial sector but capital markets took a back stage. With liberalization, capital markets now decide the nations economic structure. Liberal policies, relaxation in government regulations etc. attracted the financial sector as a whole and this led to the formal introduction of new financial services like leasing, hire-purchase, venture capital financing, mutual funds, factoring etc. Times have changed and so have changed the business values. The last decade saw boom in the technology sector. Many technocrats were enthusiastic to set-up a business on their own and capitalize on opportunities. In the highly dynamic economic climate that surrounds us today, few 'traditional' business models may survive. The need of the hour is innovation combined with hard-work. The traditional models also need innovation to survive in the market. Countries allover are realizing that it is not the conglomerates and the gigantic corporations that fuel the economic growth anymore. The essence of any economy today is the small and
medium enterprises. For example in US 50% of the exports, are created by companies with less than 20 employees and only 7% are created by companies with 500 or more employees (www.indiainfoline.com, 2000). Even the blue chip companies like Sony Corporation had to restructure themselves to stay in the competition with the new entrants.

This growing trend can be attributed to rapid advances in the technology in the last decade. Knowledge driven industries like InfoTech, healthcare, entertainment and services have become the cynosure of bourses worldwide. In these sectors the key is innovation and technical expertise that are big business drivers. This is a paradigm shift from the earlier physical production and 'economies of scale' model.

Côme April 2001, the recessionary trends started in the U.S. affecting the global economy as a whole. Nobody, not even the established business houses realized the impact of recession. Then came another blow in form of September 11, 2001 attacks on the World Trade Centre which led to the fall of economy worldwide. Most of the new firms bombed due to lack of creativity and effort. Most of the dot.com companies emerged in this period but only few could survive. The Internet arena suffered the most. Lots of money was blocked which resulted in the crash of the economy. Therefore it may not be easy to start an enterprise but it is still more difficult to stand in the competitive market in the long run.

To start an enterprise many parameters are to be taken into consideration, which contribute to the success or downfall of the business. Experience, integrity, prudence and a clear understanding of the market are among the sought after qualities of a promoter. However, there are other factors, which lie beyond the control of the entrepreneur. Prominent among these is the timely infusion of funds. This is where the concept of venture capital comes in, with money, business sense and a lot more.

Venture capital is the risky capital collected through different sources to invest alongside management in rapidly growing industries. It is a private and important source of equity for start-up companies. Usually venture capital firms are closely held corporation funded by public and private pension funds, endowment funds, foundation, corporations, wealthy individuals, foreign investors.
and the venture capitalists. Companies like Digital Equipment Corporation, Apple, Federal express, Compaq, Sun Microsystems, Intel, Microsoft in the global arena and Satyam Info way, Hinditron, Rediff on the Net, Planetasia.com, Mastek, SQL etc. in the Indian arena are some of the famous examples which would not have been possible without venture backup. A survey conducted by Coopers and Lybrand tells that majority of venture-backed companies feel that had they not been backed by venture funding, they would have neither existed nor grown fast ([Suthanan & Chittal, 2000); also refer observations]. According to a Nasscom survey India is said to be one of the major techno power. The growth in the info tech centre may prove to be a boom for venture capital. Though the growth was slowed down after September 11 attacks but it is here to stay.

VENTURE CAPITAL FINANCING: A BRIEF HISTORY (website loc.cit)

The concept of venture capital is not new. It has existed for long in the informal form. A story follows the discovery of venture capital, which relates to the story of Christopher Columbus in the fifteenth century. He wanted to travel towards west instead of east from Europe and planned to reach India. He wanted finances for his travel but did not get some from the King of Portugal and finally got the finances from Queen Isabella of Spain and the voyages of Christopher Columbus are now marked in the books of history.

Post World War II saw the beginning of modern venture capital industry. A saying goes like this 'people decide to become entrepreneurs because they see role models in other people who have become successful entrepreneurs'. Same saying applies for to venture capitalists. There are many role models in the venture capital industry but the following three members of the organized venture capital industry play an important role:

American Research and Development Corporation (ARD): It was formed in 1946 by General Georges Doriot. He is considered to be the 'father of venture capital'. The biggest success of ARD was Digital Equipment.

J.H. Whitney& CO.: It was also formed in 1946, one of whose early hits was Minute Maid juice. He is considered to be one of the early founders of the industry.
Rockefeller Family: L.S. Rockefeller in particular was one of the industry's founders. He made one of the earliest investments in *Eastern Airlines*, which is now defunct but was one of the earliest commercial airlines.

Most of the technological innovations took place in during Second World War, primarily with military applications. The investment in *Minute Maid* was intended to commercialize an orange juice concentrate that has been developed to provide nourishment for troops in the field. In 1957 a study was conducted by Federal Reserve System, which concluded that a shortage of entrepreneurial financing was the chief obstacle to the development of what is called 'entrepreneurial businesses'. As a result a number of Small Business Investment Companies (SBIC) were established to 'leverage' their private capital by borrowing from the federal government at below-market interest rates. Soon commercial banks were allowed to form SBICs and within four years, nearly 600 SBICs were in operation.

The 1960s saw a boom period in the IPO market that allowed venture capital firms to demonstrate their ability to create companies and produce huge investment returns. In the 1970s, venture capital suffered a double setback. First a red-hot IPO market brought over 1,000 venture-backed companies to market in 1968, the public markets went into a seven-year slump. In 1974, after Congress legislation, all high-risk investments were halted. Venture fund raising recorded an all time low in 1975 because of poor public market and the pension fund legislation.

Begin 1978, things started improving with regulatory changes improving the climate. Around the same time, there were a number of high-profile IPOs by venture-backed companies. These included Federal Express in 1978, Apple Computer and Genetech incorporation in 1981. In 1980s, the venture capital industry began its greatest period of growth. In 1980, venture firms raised and invested less than US $ 600 million and number increased to about US $ 4 billion by 1987. The decade also marked the explosion in the buy-out business.

The late 1980s was the transition period when primary source of VCF shifted from wealthy individuals and families to endowment, pension and other institutional funds. The expectation was very high with many investors anticipating return of 30% or higher. The expectations could not be
fulfilled, as they were unrealistic. The normal convention says that private equity investments generally should give the investor an internal rate of return of 15% to 25%, depending upon the degree of the risk the firm is taking.

By 1990, the average long-term return on VCFs fell below 8% leading to yet another slowdown in venture funding. The economic recovery and the IPO boom have gone a long way towards reversing the trend in both private equity investment performance and partnership commitments. In 1998, the venture capital industry in the U.S. continued its seventh straight year of growth. It raised U.S. $ 25 billion in committed capital for investments by venture firms, who invested over U.S. $ 16 billion into domestic growth companies in all sectors but primarily focused on IT. 2000 saw a decline period wherein venture investment in Q1 were U.S. $ 6.2 bn, 52% below the $ 12.8 bn recorded a year earlier. The results were further confirmation of the risk-conscious stance of venture firms after the Internet bubble burst and technology markets turning sour, leaving early-round investors with billions of dollars in losses from stakes in start-ups that could not be sold (Christie, May 3, 2000).

**HISTORY: INDIAN CONTEXT**

Indian transition of VC industry goes back more than 150 years when many of the managing agency houses acted as VCs providing both finance and management skill to risky projects. It was due to the managing money system through which Tata Iron and Steels and Empress Mills were able to raise equity capital from the investing public. The Tatas were the pioneers in starting the managing agency house, named Investment Corporation of India in 1937 which acted as VC and promoted hi-tech entrepreneurs such as CEAT tyres, Associated Bearings, National Rayon etc. (Gordon & Natraj, 1997). Managing agency system was abolished later and the public sector term lending institutions took the baton with meeting a part of venture capital requirement through seed capital and risk capital for hi-tech industries, which were not able to meet promoter's contribution. All these institutions only supported sound technology, while technology development remained largely confined to government labs and academic institutions.
Concept of venture funding entered India nearly after 25 years of its existence elsewhere. The IDBI has been managing venture capital fund scheme established by the Union Government in 1986. The ICICI in association with the UTI has set up a venture finance company named TDICI, which commenced its operations in 1988. Canara Bank launched its funds in 1989. Private sector has large number of players. Credit capital venture fund (I) ltd., supported by Asian Development Bank (ADB) and Bank of India. ANZ gindlays Indian Investment fund is another fund supported by NRIs (Avadhani, 1991).

REGULATIONS

The growth of venture capital in India started in 1973 with R.S. Bhatt committee recommending formation of Rs.100 crore venture capital fund. The seventh five-year plan (1985-90) emphasized the need for developing a system of funding venture capital. The R&D cess act enacted in May 1986 introducing a cess of 5% on imports. The long-term fiscal policy announced in 1986, emphasized the need for venture capital. It proposed the setting up of VCF with an initial capital of Rs. 10 crore to provide equity capital for pilot plants. Technology policy Implementation committee and United Nations Development Programme (UNDP) in 1987 on behalf of the government examined the possibility of developing VC in private sector. Formal introduction of venture capital took place when Comptroller of Capital Issues (CCI) issued venture capital guidelines in November 1988.

In 1992 SEBI was empowered to regulate VCCs/VCFs under section 11(2)(c). The amendment became effective from January 25, 1995. The same year SEBI came up with certain guidelines, which made the guidelines issued by CCI dysfunctional. In recognition to the growing importance of venture capital as one of the alternatives of finance, the then Finance Minister in his speech for the budget 1995-96 announced an exemption from tax on income by way of dividends and long-term capital gains from equity investment made by approved VCFs/Cs in unlisted
companies in the manufacturing sector including software units but excluding other service industries. Before this the VCs had to pay a 20% tax on capital gains from investments. To make this operational, the Central Board of Direct Taxes (CBDT) notified a scheme on July 18, 1995. To increase the availability of VC, Government of India issued guidelines on September 20, 1995 for overseas VC investments in India. During the budget speech of 1996-97, Finance Minister announced that VCs would exercise the voting rights in the assisted concern. Some relaxation in the tax structure was in 1999. Budget 2000-01 gave due importance to the venture capital finance with SEBI becoming as the nodal agency for its entry and monitoring. Despite of these regulations and amendments, the government must take some more initiatives to improve the status of venture capital industry in India.

NEED OF VENTURE FINANCING IN INDIA

The need for specialized venture capital institutions has been felt for quite some time even though the development banks in India play an important role in financing new entrepreneurs and form an integral part of the financial system. The need is because of the following factors:

- Requirement of due diligence.
- Financing highly risky investments.
- Willingness to support new technologies and innovative projects.
- Monitoring of the financed projects.

Apart from these factors it is necessary to have these institutions to invest in the equity of small companies to any significant extent.

VENTURE MANAGEMENT

Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic
contributors. Professionally managed venture capital firms generally are private partnerships or closely held corporations funded by private and public pension funs, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves.

In common parlance, the venture capitalist while considering an investment, carefully screens the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. They also actively work with the company’s management, especially with contacts and strategy formulation.

The basic principal underlying venture capital is investing in highly risky 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. Since most of the ventures financed are in new areas, the probability of success is very low. All projects financed do not give a high return. Some fail and some give moderate returns.

Venture management is an approach to new product development and marketing that is based on the systems approach to corporate planning. It is the management of the whole project from its conception to commercialization. The project is handled by a small team, which is responsible for the creation, evaluation, and marketing aspects of new product development and testing (Diwan, 1997). Venturing is an attempt to make innovation more predictable and less random. To be most effective, venture management requires the multi-stage evaluation process, which includes the following steps:

- Concept testing;
- Qualitative screening;
- Economic analysis;
- Product testing;
- Test marketing and;
- Phased launched/National launch.
Each particular new product venture will be unique, and will require its own specific combination and sequence of evaluation steps.

INDIAN IT INDUSTRY

The information and communication technology (ICT) revolution opens up the new prospects for mankind. The third millennium witnesses a new role that developing countries and nations with transitional economies may play in the world economy landscape. India’s unique experience in IT is definitely worth studying. Within a short period of time, it has managed to build a powerful ICT industry with a dramatically growing software export sector (www.auriga.com, 2001). Government incentives and liberal policies relating to IT companies have resulted an impressive boost in the IT industry revenues. In 1991-2000, the Indian IT industry has recorded an average annual revenue growth of about 50%.

Venture capital firms from all over the world has invested in Indian companies especially in IT sector and many of them operate in India. The exact number of firms operating in India is not known. IVCA provides some data regarding the operations of these firms. The Indian Venture Capital (IVCA) is the nodal center for all venture activities in the country. The association was set up in 1992 and over the last few years, has built an impressive database. Only 25 Vc firms are registered with SEBI whereas IVCA has 32 members. According to the IVCA 2000 saw unusually high VC funding activity with close to $ 1.2 billion flowing into the country. In the year 2001 the things slowed down with an expected inflow of around $ 800 million. The expected outlook for the year 2002 is $ 1 to $ 1.5 billion (Srivastava, 04/12/01).

REVIEW

According to a study published in The Economic Times, VC funding in India in 2000 recorded a seven-time increase, which was highest in Asia. According to Hong-Kong based Journal
Asia Private Equity Review, the increase was due to lot of funding from NRIs. But the year 2001 was a bad year for the Indian venture capital industry matching with the global trends.

Over the years, venture funds have witnessed a change in the dimension. Before the reforms were initiated on the Indian landscape, there were about a dozen odd domestic players, the bulk of whom were from the financial institutions. They together jotted up Rs. 200 crore of investments (Pinto, 1999). Post-reforms, the number of funds has grown and the kitty has burgeoned to more than Rs. 5,000 crore. Today about 2/3rd of the players constitute international funds. Most of the money has come from FIIs, NRIs and private foreign banks. A significant portion of industrial output is entrepreneur driven; employment generated by the entrepreneur driven enterprise is many multiples of that generated by the organized corporate sector. With the crash of the stock markets, the prospects of even the very successful companies are also being questioned. VCs are no longer undoubted financial gurus (Green a & Alster, 2000). Today, they are increasingly finding themselves forced back into the market to prop up flagging startups. Now, investors are disillusioned with the very model that promising e-tailers depend on for growth. Looking at the present trends, many VCs are eager to prop up the valuations of their lagging investments but the times will change and surely for the good.