CHAPTER - VII

Conclusion and Suggestions
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We could be on the threshold of a glorious revolution powered on by ideology and the individuals pursuing their own dreams. Change is the buzzword in the 21st century. This changing market scenario brings in the concept of different alternatives in different sectors. Past twelve years (since liberalization), financing sector saw a great change in India. Hence came in the concept of different funding alternatives for start-ups as well as developing and established companies. Many new players have entered to change the structure of the economy. The new entrepreneurs do have new ideas, technological skills but lack proper management and funds. This is where venture capitalists/angels come in and help the new ideas to take a real shape. The 90s was a boom period for the IT industry with many new start-ups coming up and many internet companies going public with IPOs but still the public companies played a central role in shaping the economy. With the debacle of the dot.com industry in the late 90s, the importance of public companies increased. The reason to this can be the lack of proper infrastructure. Funding is one thing but all the more important is management of such funds. The health of such companies depends to a large extent on their board of directors. A review of 50 of 1999s largest Internet IPOs (in US), suggested that the typical board has seven directors: two members of management, two VCs, one other significant shareholder and only two independent “outsiders” as directors. The small size and cohesiveness of such a board, together with a high level of commitment and industry knowledge of its directors, can help a start-up move with speed and flexibility that the new company demands (Lorsch et.al, February, 2001). Such type of board has its advantages as well as disadvantages. The biggest disadvantage is that since the board of directors consists of more number of insiders, therefore the exposure to the outside market is restricted to a certain level, which in turn may hinder the growth of the company. Since these people have their own interests involved with the company, they may work accordingly. Board of directors than the advisory body dominated the scene; even the primary
data available supports this. The need of the hour is to have a balanced management backed by a strong advisory body.

A survey says that eight of the richest men in India are first generation entrepreneurs (Outlook, Oct. 16, 2000). A study of global entrepreneurship done in 2001 shows that India is among the top three in largest number of entrepreneurs. The other two are U.S. and Brazil. India was ranked ninth amongst 29 countries relating to entrepreneurial activity, as measured by the percentage population involved in the start-up process or in a business less than four years. It also shows that less than 1% adult population invested in start-up business, which was amongst the lowest in the countries surveyed. This fact is supported by the primary data, which states that most of the start-ups are funded by either foreign funds or private funds than the public funds (Ganjoo, May 20, 2002).

**FACTORS FOR UNPOPULARITY OF INDIAN VCFs**

The reasons for the unpopularity of Indian VCFs can be attributed to the following factors:

- Access to capital
- Size of the market
- Legal framework
- Less certainty
- Restricted flow of information
- Investor friendliness

**Access to capital:** The entrepreneurs in India have little access to capital particularly for early stage development from the Indian or public funds. Most of the funding done in early stage is either by foreign or by private funds. The public Indian VCFs invest more in development stage.
The other reason for lack of funds is the cost of working capital. The cost of working capital is very high as it comes in scarce forms.

- **Size of the market:** The size of the VCF market in India is small as compared to the West. India has only 25 VC firms registered with SEBI and IVCA has only 30 members of which most of the VC firms are private in nature ([www.blonnet.com](http://www.blonnet.com)). The market is not transparent; this is another reason for small size. The Indian firms do not impart with the financial information, because of which the small investor is not able to know about the exact situation of the firm. The information flow is restricted to select areas and because of this there is no parity in the information flow.

- **Legal framework:** More than two regulatory bodies dominate the Indian venture capital industry. This poses lot of problems for the investors as the investors have to register with these authorities, then only they can start the process. Though the regulations have been relaxed to a certain extent, still the regulatory authorities have their say.

- **Less certainty:** The market is so volatile that the firms are not able to plan their projects. This increases the cost of capital resulting in loss of confidence of the entrepreneurs. The volatile market only resulted in the burst of dot.com bubble. Since the market is influenced by prejudices and sentiments, the practical approach to the whole process is lacking.

- **Investor friendliness:** In the west the financial intermediaries play the role of buying in symmetry in the information level of the investors and the firms i.e. the household and the users of the funds. The investments are based more on the extent of information as a trust factor comes in because of greater transparency.
This is not possible in India where the investors lack trust and confidence and there is no investor friendliness.

PERFORMANCE OF THE ECONOMY

The Indian economy was literally stagnant in the first half of the last century. The growth momentum started with independence. The annual growth rate was quite low at 3.17% in the 70s. It was only in the 80s that growth rate crossed 5% per annum. Between 1981-91 the growth rate fluctuated between 5-6% per annum (The Financial Express, Feb. 4, 2000). The liberalization process started in the 90s, which saw the growth in the GDP. The GDP has been growing in the post liberalization period but the growth in the GDP indicators is not as expected. The reason can be the fluctuating market conditions. The CMIE report predicts that India's economy will show still worse signs in 2002-03. There are many parameters, which decide the growth and decline in nations' economy. Capital formation is one such factor. Venture capital industry has played a vital role in acting as an indicator. The individual data to study the impact of venture capital industry on GDP is not available but venture capital does have the potential to drive a significant percent of India's GDP (Sethi, Feb. 99).

RESULTS: VENTURE CAPITALISTS

The primary survey indicates that the investment in early stage was more as compared to later stage and acquisition stage. The mentality of the Indian investor does not support this view. The main reason for this is the availability of foreign/private venture capital funds.

- The respondents feel that board of directors with a stake of approximately 73% dominates the participation area of the firm. This shows that the board of directors play a decisive role in the management process. This view is supported by the study conducted in the US (Lorsch et.al, Feb. 2001).
• Approximately 66% investors preferred young entrepreneurs with new ideas and technical skills and the secondary data does support the view that venture capital financing is normally for the new entrants.

• The availability of funds for new entrants was more, therefore the investors favoured the venture capital assistance for new product development and the general size of the assistance was quite high.

• The survey also revealed that approximately 80% finance was for the information and technology sector and that too in the early stage.

• Since maximum investment is by foreign or private funds, the most popular exit route opted is Initial Public Offering or going public.

PROBLEMS OF VENTURE CAPITALISTS

The venture capitalists face lot of problems while investing in a company whether new/ established. Some of the problems, which could be deciphered through the survey, are as follows:

• Most of the VCs felt that they did not get supporting loans or funding at the time of crisis or temporary illiquidity.

• The VCs feel that though the proposals with new ideas are available in large number but the quality proposals are only few.

• The VCs face difficulty in reselling the investments at a time when the money invested is not received on time.

• The strict guidelines do not allow VCs to invest in any other field except greenfields/small units.

• It is difficult to raise equity from the market, as the risk associated is quite high.

• Banks or other financial institutions are not eager to provide overdraft facilities to VCs because of high-risk nature of the investment activities.
• The VCs face difficulty due to multiple legislation i.e. they have to register with SEBI as well as RBI and to avail tax benefits, have to register with Central Board of Direct Taxes (CBDT). Many VCs feel that getting registered with one regulatory authority in itself is quite cumbersome, hence registering with three regulating bodies, poses more problems.

• One of the major problems is Disinvestment process. In a country like India, where capital markets are quite volatile, it is very difficult to exit through primary or secondary market. The failure of OTCE in India has led to further problems.

• Since venture fund is a long-term illiquid investment, funds are locked up for a longer period.

**SUGGESTIONS**

Since the eligibility criterion by Venture Capital Companies (VCC) is based on government guidelines, the choice of quality proposals is restricted. India is self-sufficient to have indigenous technology; hence the government can relax certain conditions, which will help the industry to grow. VCCs/VCFs feel that there is lack of awareness at the small and medium level firms about the advantages of venture capital. What the VCs feel about the venture capital industry is summarized below:

• Majority of VCs feel that their income should be tax-exempted fully in view of high risk involved in financing a new venture.

• Some feel that the income of VCCs/VCFs should be tax deductible from other incomes for five years after financing a particular unit.

• Almost all the VCs surveyed agreed that the venture capital industry should be treated at par with the mutual fund industry.

• VCs felt that the self-regulatory (like IVCA) body should regulate the financing process rather than the legislative enactment.

• VCFs must be allowed to use a wide range of financing instruments apart from the equity.
Venture capital has been given due importance in Budget 200-01 and SEBI has been made the nodal agency for its entry and monitoring. But the controversy regarding the tax structure still persists. Contrary to the K.B. Chandrashekhar Committee’s report on venture capital, such capital has been treated like any other equity capital and not been given the special "pass through" status it deserves (Sengupta, March 12, 2000). The Chandrashekhar Committee report says that VC funding is dominated by foreign funds, which account for 80% of the business (Tripathi, 2000). This shows that even after so many years the Indian funds could not bring themselves at par with the foreign funds.

RESULTS: VENTURE-BACKED COMPANIES

The companies backed by venture capital faced some problems regarding venture capital financing. The following results were derived from the survey conducted:

- About 63% of new entrants got funds from venture capitalists.
- Approximately 75% of the firms wanted funds for the start-up stage.
- Many of the firms felt that the promoters’ contribution was reasonable but the funds needed were insufficient.
- About 30% of the respondents felt that the procedure of getting finance is quite lengthy. Others did not comment on the appraisal procedure.
- 73% of the respondents felt that the unpopularity of the venture capital financing in India is mainly due the attitude of the government towards the industry.

The survey suggests and supports the view that venture capital is still a neglected avenue in India.

PROBLEMS OF VENTURE-BACKED COMPANIES

Since it was very difficult to get a complete list of venture-backed companies, a select list of companies was contacted. Whatever data was gathered, it was summarized to reach the conclusion regarding the problems of these companies.
• The appraisal procedure is so lengthy, which takes a lot of time for the start-up company to start.

• Like VCs, the entrepreneurs also felt that the government regulations hinder the growth of the industry.

• Due to restrictions and individual limitations certain quality proposals are rejected and the not so good proposals see the light of the day, as they are not able to complete the formalities.

• Most of the entrepreneurs felt that the funding is insufficient for the quality proposals.

• The involvement of insiders as board of directors is so high that at times it hinders the development of the company.

SUGGESTIONS

Many entrepreneurs feel insecure about the outside investments. They find it difficult to believe that they can get money without being taken over and losing control. They face a big problem of choosing the investor, whether public or private. Giving an adequate number of shares to the entrepreneur in the company to ensure that they are not out-voted can partly solve this problem. Some other suggestions to curb the problems of the entrepreneurs are as follows:

• The appraisal procedure by VCs should be made easy so that the decisions regarding the firm are taken quickly and on time.

• Investor-management relationship should be developed in such a way so as to develop a bond of trust between the two. This aspect is critically important for the success of the venture-backed companies.

• A very high degree of standard is required to establish, maintain and scrutinize the projects for their commercial viability. Developing an appropriate appraisal method by VCs for accessing risk and commercial viability can do this.
• It is the duty of the venture capitalists to take up the task of promoting entrepreneurs by identifying business opportunities, developing business plans and matching the two with the prospective entrepreneur. An agency must be established to bring together the VC and the entrepreneur.

• The restrictions or conditions imposed on the entrepreneur by the investing institutions should be reduced.

• Debt-equity ratio should be increased to at least 6:1 from the current equation of 1.5:1, which will allow the VCs to raise equity and debt from the market rather than depending on banks. Thus the access to capital will become easy.

• The guidelines should be relaxed to allow saving institutions like LIC etc. to invest.

Apart from these suggestions there can be many more ways to improve the present state of the industry. The basic crux is that the government guidelines need to be modified to such an extent that they support the development of indigenous technology all the more and develop a proper support system and a better coordination amongst the entrepreneur and the venture capitalists.

PROSPECTS OF VENTURE CAPITAL IN INDIA

The venture funding activity accelerated in the U.S. in the early 90s but in India the growth period was from 1997-2000. The SEBI guidelines of 1996 acted as huge incentive for VCCs. The rapid growth especially of the hi-tech sector meant that ideas, entrepreneurs and momentum all were available in full measures. This was the boom period for the Internet companies. Professionals working in organizations were actively wooed to transform themselves into entrepreneurs, backed by VCs. The type of VCs ranged from incubators, angels to classical VCs and even private equity players. But this was not all. The bubble did burst and India too witnessed the recession. The basic problem was the whole venture funding leading on to quick IPO game. The biggest drawback, the VC industry has is to pass on the role of VCs as risk-takers to the public investors thereby creating
an unsuitable system (Sudarshan, 2002). Despite of certain problems the Indian VC industry seems to grow though on a slow pace. For the success of the venture capital industry following points are to be considered:

- Optimism is the key to success.
- The glamour of success is to be replaced by hardcore reality. This process has already started.
- The VCs must realize that evolution of the business is an ongoing process.
- Adaptation to changing trends.
- Maintaining the transparency in the information.
- Full-fledged corporate commitment is a must.
- Leveraging the existing relationship.

To have a secure future, venture capitalism has to return to the basics with which it started. It is an accepted fact that new entrepreneurs, innovative projects and new technologies are engines of growth but the fact is supported by the truth that VC firms act as catalysts for growth. The boom period in India saw many new companies going public in the very first stage, succeeding in raising the share capital. The situation is changing. Many new companies whose promoters are relatively new (i.e. with no track record) are facing difficulty in raising capital from the stock markets for their new projects. This makes the role of venture capital more relevant than before. If the VC industry in India has to grow, in terms of size as well as resources committed by it, it is important for the government to provide the legal and financial framework for the development of suitable organizational and financial structures. The government must also consider appropriate fiscal incentives for venture funds to invest in new technology-based projects.

India has very little scope for alternative methods for structuring the deal. Though the concept of VC essentially means equity financing, venture capital firms in India find themselves in a difficult situation as they are not in a position to fund the entire project by way of equity and they
have to resort to financing through quasi equity or debt instruments. Apart from the relaxation in
guidelines, it is important to widen the scope beyond new technology-based financing. If steps are
taken to make venture capital firms more viable, more resources will be attracted to the industry. It is
therefore very important that investment in venture capital industry be much more attractive for
institutional and corporate investors by making venture capital firms more profitable.

VENTURE CAPITAL - A REVIEW

To sum up the analytical study, it can be said that venture capital is basically equity finance
in relatively new companies. The venture capital funding requires lot of patience as it has a
substantial degree of active involvement with the promoters of the business. This type of funding is
expected to provide superior returns essentially through capital gains at the time of exit. The basic
objective of the venture capitalist therefore, is to achieve capital gains on his/her equity at the time
of exit, and the loan finance will only be supplementary to this main objective.

Since 1996, there has been a flow of VC funds. A survey conducted by Walden says that
major India focused funds added to US $ 2-2.5 billion and the smaller funds added to approximately
US $ 5 billion (Sabrinathan, 2002). India is still a viable option. The dot.com experience has made
the industry wiser. Venture capital though a risky capital is nurtured through belief, and fertilized
through conviction. Despite of all problems and restrictions, it will continue to nourish ideas and
start-ups. India as a democratic nation has always welcomed change and has adapted to the
changing conditions with ease. Venture capital financing is one such change, is accepted along with
other financing alternatives, succeeded and had its decline phase but surely it is here to stay.
Venture capital wildfire is to spread again and fast and the entrepreneurs are going to love it.