Chapter

VENTURE CAPITAL INDUSTRY IN INDIA
AN OVERVIEW
3.0 INTRODUCTION

This chapter is designed to provide a comprehensive picture of venture capital industry in India, tracing out its evolutionary stages along the time line. It captures emergence of venture capital abroad as well as in India, recent trends, and its critical success factors. Reliable estimates of magnitudes of venture capital are difficult because of two primary reasons: firstly, all that is reported under venture capital is difficult to be verified for its validity; and secondly, under defined rules venture capital transactions fall outside official statistical system leading to under-reporting.

3.1 ORIGINS OF VENTURE CAPITAL ABROAD

Period of venture capital development can be divided into two sub-periods: prior to 1980 and post-1980. In the first sub-period
Venture capital was really a cottage industry in its rudimentary form. Before 1980 there were two venture capital investments in Massachusetts — the Saugus Ironworks in 1645 and the Middlesex Canal in 1789. Prior to 1980s individuals and families were the main sources of venture capital. Figure 3.1 presents landmark events in venture capital industrial evolution along the time line. To begin with individuals and families were sources of venture capital funds. Subsequently, there was a shift to influence companies and foreign investments as sources of funds. Presently its predominant sources are corporate pension funds, and public pension funds.

Figure 3.1: TIME LINE OF GROWTH OF VENTURE CAPITAL

It was John Witter who used the term ‘venture capital’ in 1939 while addressing the Investment Bankers Association of America\(^2\). Through 1930s to 1950s, there were intensive discussions in USA and UK as to lack of investment in small business, although there was a little agreement about what types of small businesses should be given funds and what would be the vehicles for providing finance to them.

Increased awareness of, and heightened interest in, small and medium enterprises (SMEs) led to the Small Business Investment Company (SBIC) in the year 1958. As a result of the implementation of the act, the term ‘venture capital’ evolved into a specific form financing exclusively small, privately owned firms with high growth potential.

Entrepreneurial finance has a long history in US going back to financing rail roads in 1800\(^3\), and later to industrial revolution. Prior to World War II there were wealthy American families investing in new promising firms. Soon after the war these families started hiring professional managers to discover, evaluate and invest in high-growth potential small firms. By providing start-up capital to companies, Eastern Airlines and Xerox\(^4\) became household names. In fact, the first entrepreneurial bank founded by Brother Pereire in 1852 operated with a concept, 'creative finance'\(^5\). Thus, venture capital firm is a US organizational innovation. Three role models in venture capital industry in USA are: American Research and Development Corporation (ARDC), Minute Maid Juice, and Eastern Airlines\(^6\). Each of these is discussed in what follows.
3.1.1 American Research and Development Corporation (ARDC)

In 1946, ARDC was founded by French-born military man by name General Georges who is considered as the "Father of Venture Capital". Its objective was to seek out creative men with a vision of things to be done, to breathe life into new ideas, processes and products with capital. Seeing greater promise for commercial application of technology developed in Massachusetts Institute of Technology (MIT), paved the way for formation of ARDC.

3.1.2 Minute Maid Juice

It was formed in 1946 by J.H. Whitney and Company whose founder was Jock Whitney, one of the venture capital industry's founder.

3.1.3 Eastern Airlines

It was founded by the Rockefeller family, particularly L.S. Rockefeller.

3.1.4 Small Business Investment Companies (SBICs)

Small Business Administration was created in 1954 in order to improve the government ability to promote formation and success of small business. In the background of concern of the US federal government to speed-up the development of advanced technologies, and Federal Reserve System's study findings that shortage of entrepreneurial capital was main obstacle in the development of entrepreneurial business, a number of small business investment companies were established under Small Business Investment Act,
1958 to leverage their private capital by borrowals from the federal
government at lower-than-market interest rates.\(^{10}\)

The glorious period of SBICs' ended with government
intervention in the light of the formers' fraudulent behaviour, which led
to two-thirds reduction in their number. As a sequel Employment
Retirement Income Security Act (ERISA), 1974, made pension fund
managers criminally liable for losses arising from high-risk investments.
Consequently pension funds shunned investments in venture capital,
which was a death flow to the venture capital industry as seen from the
sharp decline in venture capital raising and investment.\(^{11}\)

Consolidation of venture capital industry took place in a period
from 1978 to 1984, which was characterized by a high rate of entry of
new companies, and of activities. Number of causes underlying
consolidation was:

- High profits offered by new technology industries as compared to
  those of traditional industries;
- Change in public policy lowering tax rate on capital gains from
  48.50 per cent in 1977 to 20 per cent in 1981, inducing pension
  funds to interest in venture capital (Revenue Act of 1978 and Tax
  Recovery Act of 1981)
- The Small Business Innovation Development Act, 1982, which
  provides for government venture capital fund investing in seed
  (R&D of SMEs), solved the system failure in seed capital.

The most striking feature of post-consolidation period was
dramatic growth of the limited partnership firms as primary vehicles of
venture capital firms. Introduced in 1958, they grew rapidly registering a percentage share of 35 in 1977, 70 in 1987, and so in late 1990's in total venture capital firms. Under statutes the government also started acting as limited partner. Between 1994 and 1996, 71 new SBICs came into existence with 945 million dollars in private equity which amounted to more than private capital raised by SBICs in the preceding 15 years of their existence.

In 1995 the ratio of venture capital pool to the size of economy was 8.7 times higher in USA than in Asia, and 8.0 times higher in USA than in Europe. In 2001, lion's share of 62 per cent of global capital was invested in North America, 21 per cent in Western Europe, 12 per cent in Asia Pacific, 2 per cent in the Middle East and Africa, and less than 1 per cent in Central and Eastern Europe.

Supply of venture capital and willingness of venture capitalists to invest depend on the state of equity markets and other market forces. Disbursements by US venture funds had grown from just over $1 billion in 1981 to nearly US $42 billion in 2001, registering a compound growth rate of 10 per cent per annum.

In USA venture capital investment is heavily concentration in California and Massachusetts states which, together accounted for over half of the venture capital investment in 2005. Lerner reported that over half of the venture - backed firms in biotechnology sample had their venture capital directors within 60 miles of their head quarters. Powell, et.al, reported that more than half of the
biotechnology firms received locally-based venture capital funding in US\textsuperscript{18}.

Each venture capital firm has its unique style and character, as reflected in reputation, age and experience of the general partners, preference to lead or follow on investment, and their record of past success\textsuperscript{19}. Many choose to specialize in particular industry or in particular stage of venture capital financing. A few venture capital firms can boast of higher performance. According to Nesheism\textsuperscript{20}, 60 per cent of funded portfolio firms go bankrupt. IPOs of firms backed by reputed venture capitalists attract high quality underwriters, and are widely held by institutional investors\textsuperscript{21}. In summary, three factors—favourable public attitudes, dynamic financial system, and governmental support\textsuperscript{22}—contribute to the development of venture capital at international level.

3.2 INDIAN SCENARIO

Though entrepreneurial spirit of Indian business man is well known, institutional finance in no form was available to breathe life into the spirit. Soon after independence two-tier financial institutional structure—central and state levels—was created to promote industrial development through provision of long-term finance. But these development financial institutions (DFIs) do not provide venture capital to small industrial units with unproven technology. This is the major institutional deficiency in institutional structure. To correct this inherent lacuna venture capital emerged in India, whose evolution in India can be studied in three phases.
3.2.1 Venture Capital Development in India: First Phase (1973-94)

The first phase began with the government of India when the need for venture capital financing was first highlighted in 1973 by the government appointed committee on Development of Small, and Medium Enterprises (SMEs) under the Chairmanship of R.S. Bhatt, drew attention to the problems of new entrepreneurs and technologies in setting-up industries. Thereafter, though some public sector funds were set-up but the activity of venture capital did not gather momentum as the thrust was on high-technology projects funded on a purely financial rather than a holistic basis.

Beginning of Risk Capital and Seed Capital By Industrial Development Financial Institutions (DFIs)

In 1975 venture capital financing was introduced in India by the All-India Financial Institutions with the inauguration of ‘Risk Capital Foundation (RCF)’ sponsored by Industrial Finance Corporation of India (IFCI) to supplement “promoters’ equity” with a view to encouraging technologists and professionals to promote new industries. During 1976 the seed capital scheme was introduced by Industrial Development Bank of India (IDBI). The announcement of National Technology Policy Statement in 1983 by the Central Government setting guidelines towards technological self-reliance through commercialization and exploitation of technologies developed in the country, had established the need for venture capital. Till 1984 the concept of venture capital was known in the form of “Risk Capital and Seed Capital”. In addition to IFCI and IDBI, the Industrial Credit
and Investment Corporation of India Limited (ICICI), another all India financial institution, also took decision in 1984 to allocate funds for providing assistance in the form of venture capital to economic activities involving both risk and high-profit potential.26

Government Created and IDBI-Administered Venture Capital Fund

- To popularize venture capital financing the government announced the creation of a venture capital fund (VCF) in the document on long-term fiscal policy presented to Parliament by the Finance Minister on 20th December, 1985. The VCF, which became operational on 1.4.1986 is administered by IDBI. It was created on an experimental basis with an initial capital of Rs.100 million to provide equity capital for pilot projects attempting commercial applications of indigenous technology for wider domestic applications. As a result to the above decision, ICICI launched a venture capital scheme in 1986 to encourage new technocrats in the private sector in the emerging fields of high-risk technology.

Programmes for Application of Commercial Technology (PACT) of USAID

- Further, in August, 1986, ICICI undertook the administration of the Programme for Application of Commercial Technology (PACT) aided by USAID with the initial grant of U.S. $ 10 million. Under the R and D Cess Act, 1986 an R and D levy is imposed on all payments made for purchase of technology from abroad including royalty payments, lump sum payment for foreign collaboration and payment for
developers and drawings. The levies form a source for the venture capital fund.

Development of Venture Capital Companies (VCCs) in India

At the behest of the Government of India, a high level team led by the United Nations Development Programme (UNDP) was formed in May, 1987 for examining the possibility of developing Venture Capital Companies (VCCs) in the private sector in India and to make appropriate recommendations. The 'Technology Policy Implementation Committee' of the department of science and technology also specifically recommended the need for venture capital organization in the private sector. ANZ Grindlays, a foreign bank, set-up the first private venture capital fund known as India Investment Fund in 1987. It subsequently came out with the second India Investment Fund in 1989. This is the only foreign bank with a venture capital fund operations in India. In 1988, ICICI sponsored the Technology Development and Information Company of India Limited (TDICI) which took over venture capital operations of ICICI on 1.7.1988.

The necessity of venture capital institutions was also echoed by the then Finance Minister, N.D. Tiwari, in his budget speech 1988-89, referring to the need for introducing venture capital to help new entrepreneurs develop. He said, "we have one of the largest pools of scientific and technical manpower. Yet many of our young and new entrepreneurs find it difficult to raise equity capital because of the risks involved. Allowing venture capital companies to undertake high-risk equity financing, in anticipation of future capital gains". Can solve this
problem. The Finance Minister gave concessional treatment for capital gains to be made by VCCs/VCFs, in the wake of the failure of many new companies during 1985-86 boom which practically failed to come to the level of satisfaction of investors. He declared that it had been decided to formulate a scheme under which VCCs/VCFs would be enabled to invest in new companies and be eligible for the concessional treatment of capital gains available to non-corporate entities. It is increasingly realized that the companies should first go to venture capital fund for their financial requirements before they go to public for raising needed funds.

Guidelines for Venture Capital Financing

The first serious efforts of the government to promote and regulate venture capital industry simultaneously took the form of venture capital guidelines. The Department of Economic Affairs, Office of the Controller of Capital Issues, by its notification dated November 25, 1988 finally issued the long awaited guidelines for venture capital financing to fulfill the promise of the finance minister. These guidelines delineated, a scheme of venture capital financing of new companies. The guidelines provide broad framework for the operation of the VCCs, covers establishment of VCCs/VCFs, their management, areas for venture capital assistance, size, debt-equity ratio, underwriting, listing, and eligibility for tax concessions.

Financing of Venture Capital : Tax Concessions to VCC/VCF

In January 1989, the working group on the Development of the Capital Market, set-up by the Planning Commission under the
chairmanship of Mr. Abid Hussain, made relevant observations on organization and financing of venture capital industry in India. The budget proposals of 1989-90, recognized the importance of risk capital needs of projects upto Rs.10 crores promoted by technocrats possessing untried and improved technology. The proposals extended concessional treatment of 20 per cent tax on long-term capital gains arising to such venture companies on eventual sale of equity shares in the assisted companies. The clause II of budget speech of 1989-90 stated "in furtherance of the announcement made by the finance minister in his budget speech of 1988-89, that a scheme to obviate the difficulties faced by new entrepreneurs in raising equity capital would be framed, it has been decided to formulate a scheme for setting-up VCCs/VCFs to extend venture capital assistance to undertakings where the risk element is comparatively high and the entrepreneurs are relatively new and non-affluent". With a view to help the growth of VCC/VCF, by amending section 48 of the Income Tax Act, it is proposed to provide that the VCCs in respect of the capital gains on sale of shares of venture capital undertaking will get a deduction at "the same rate as available to non-corporate tax payers". This amendment will take effect from 1st April, 1990 and will accordingly apply in relation to the assessment year 1990-91 and subsequent years.

Over the Counter Exchange of India (OTCEI) and VCCs

A significant achievement during 1990 was the incorporation of the first Over the Counter Exchange of India (OTCEI) as a company under Section 25 of the Companies Act, 1956 on 25th September 1990.
The Union Finance Minister issued fresh guidelines revisiting those issued by the OTCEI itself earlier, on 9th May 1991, for the listing of VCCs on the OTCEI and the issue of securities.

Indian Venture Capital Association (IVCA)

In 1992, Indian Venture Capital Association (IVCA) being established, the prime mover of this Association was Sri Nadakami, its first President. In the association there are 9 members, the majority of whom are subsidiaries of Indian government agencies or banks and received funds from international development agencies. Venture capital and private equity investment accelerated around 1993 with the industrial recovery following the liberalization measures of the early 1990s. By 1994, a few foreign financial institutions began venture capital and private equity funds but with a focus towards larger and later stage investments. Till 1995, domestic VCCs/VCFs were paying a 20 per cent tax on capital gains from their investments. During the 1995-96 budget speech, the finance minister announced total exemption from tax dividends and long-term capital gains from equity investments made by approved VCFs/VCCs in unlisted companies in the manufacturing sector including software units but excluding other service industries. However, the income in the hands of their shareholders is fully taxable. For tax purposes the VCFs have been brought on par with the mutual funds. To operationalize these, the Central Board of Direct Taxes (CBDT) notified a scheme on 18th July, 1995. Moreover, with a view to augment the availability of venture capital, the government of India issued guidelines on 20th September, 1995, for overseas venture capital investments in India. Further, as a part of its mandate to regulate and to develop the Indian capital
markets, the SEBI framed the SEBI (Venture Capital Funds) Regulation, 1996

3.2.2 Venture Capital Development in India: Second Phase (1995-99)

The second phase was heralded in by the SEBI committee on Venture Capital Industry under the chairmanship of Mr. K.B. Chandrasekhar which laid down clear guidelines for venture capital funds for opening-up the industry. In 1998, only 8 domestic venture capital funds were registered with SEBI. Year 1999 was a year of rapid growth for venture capital industry in India when 12 new venture capital funds were registered with SEBI, taking the total to 20. Foreign venture capital funds like Draper International and Walden Nikko India Management Company Limited, among the more active funds, have chosen not to register themselves with SEBI, due to its constricting guidelines. In the year 2000 SEBI registered 13 more venture capital funds, which increased their number to 33. Presently, more than 75 venture capital funds are operating with a focus on India.

3.2.3 Venture Capital Development in India: Third Phase (Since 2000 till to date)

The third phase witnessed the introduction of new set of rules having a salutary effect on the venture capital industry. However, the dot com bust and global economic slowdown saw the plight of many venture capital firms. Though 2001 was a relatively bad year, investments in venture capital continued at the same level. In 2002, India became the second most active venture capital market among 10 major Asia-Pacific economies in terms of the total investment. Since then, there has been no looking back.
3.3 VENTURE CAPITAL OPPORTUNITIES IN INDIA

The Venture Capital opportunities in India-related deals appear to be better defined and depict strong trends in the value-added services area, the digital divide segment and recently, the biotechnology area, as discussed below:

There is a major opportunity in taking technology to the larger segment of the 'digital divide', as there are sizeable productivity and cost advantages still to be gained. Consequently, significant opportunities are available in building cutting-edge technologies with lower costs significantly and allow access to these low-end, but huge, markets. India is the choice destination because the domain knowledge to address these opportunities is best available here. Deals by venture capital funds such as Venture East Tenet, APIDC-VCF and Walden illustrate this. India still continues to have the biggest competitive advantage in providing IT services to the world, and a number of opportunities continue to emerge in both 'high-value added' and 'generic' IT services. On the 'generic' front, there has already been significant investment by venture capitalists in the business processing outsourcing (BPO) and IT-enabled services segments. There will continue to be investment opportunities in this area, albeit with increasing value-addition. In the higher value-added services category, a number of niche opportunities are emerging in areas as diverse as machine vision, bio-informatics and communication networks. A number of investments by the venture capital funds such as APIDC-VCF, Venture East Tenet Funds, ICICI ventures, SIDBI ventures, Chris capital and GE capital continue to be in this area.
India is also poised to carve out a huge chunk of the burgeoning bio-technology related technologies and services areas that are being lead by the recent mapping of the human genome and the attendant gene sequencing and high through-put drug discovery efforts around the world. India has a large pool of manpower trained in modern biology and chemistry at a national network of world-class laboratories; and IT professionals and infrastructure, available at internationally competitive cost. This gives India a position of early advantage in addressing the demand for 'wet lab' and the 'dry' services.

3.4 SOURCES OF VENTURE CAPITAL FUNDS

The growth in the number of venture capital firms, volume of capital invested and number of companies seeking venture capital in India is remarkable. Today, there are multiplex sources of venture capital in India. These may be broadly classified into general and special sources. The general sources include friends and relatives, commercial banks, investment banks, private inventors and large companies. The specialist source comprises of public and private venture capital organizations. The various sources of venture capital funds are presented in table 3.1.

It can be seen from the above table that main contributories to the venture capital funds. 18.53 per cent of the VCCs secured venture capital from financial institutions followed by individuals 16 per cent, banks 13 per cent, corporations 12 per cent, pension funds 11 per cent, and insurance companies 10 per cent. But the role of multilateral development agencies, government agencies and others in financing venture capital industry was quite negligible.
### Table 3.1

**SOURCES OF FUNDS FOR VENTURE CAPITAL COMPANIES IN INDIA: 2005-06**

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Sources of Funds</th>
<th>No. of Respondents</th>
<th>%ge to total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>1.</td>
<td>Banks</td>
<td>34</td>
<td>13.13</td>
</tr>
<tr>
<td>2.</td>
<td>Insurance Companies</td>
<td>26</td>
<td>10.04</td>
</tr>
<tr>
<td>3.</td>
<td>Public Sector</td>
<td>18</td>
<td>06.95</td>
</tr>
<tr>
<td>4.</td>
<td>Private Individuals</td>
<td>42</td>
<td>18.22</td>
</tr>
<tr>
<td>5.</td>
<td>Corporations</td>
<td>31</td>
<td>11.97</td>
</tr>
<tr>
<td>6.</td>
<td>Financial institutions</td>
<td>48</td>
<td>18.53</td>
</tr>
<tr>
<td>7.</td>
<td>Pension Funds</td>
<td>28</td>
<td>10.81</td>
</tr>
<tr>
<td>8.</td>
<td>Govt., Agencies</td>
<td>18</td>
<td>06.95</td>
</tr>
<tr>
<td>9.</td>
<td>Multilateral Development Agencies</td>
<td>10</td>
<td>03.86</td>
</tr>
<tr>
<td>10.</td>
<td>Others</td>
<td>04</td>
<td>01.54</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
<td><strong>259</strong></td>
<td><strong>100.00</strong></td>
</tr>
</tbody>
</table>

Source: Dickenson Intellinetics, Venture Capital Guide for India, Mumbai 2005-06

### 3.5 PREFERRED INVESTMENT PERIOD

Venture capital financing generally implies long-term investment in high-risk, high-return industrial projects, and may be at any stage of implementation of the project or its production cycle, viz., to start-up an activity or to improve a process or a product. It envisages investment in unlisted companies with a lock-in period of 5 or 10 years or more. The opinions elicited with regard to the preferred investment period of venture capital firms are presented in table 3.2
Table 3.2
PREFERRED INVESTMENT PERIOD BY VENTURE CAPITAL COMPANIES IN INDIA: 2005-06

<table>
<thead>
<tr>
<th>Period</th>
<th>Number of respondent VCCs</th>
<th>%age to total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Less than 5 years</td>
<td>31</td>
<td>38.28</td>
</tr>
<tr>
<td>5-10 years</td>
<td>10</td>
<td>12.34</td>
</tr>
<tr>
<td>No Preference</td>
<td>04</td>
<td>04.94</td>
</tr>
<tr>
<td>Not Disclosed</td>
<td>36</td>
<td>44.44</td>
</tr>
<tr>
<td>TOTAL</td>
<td>81</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source: Dickenson Intellinetics, Venture Capital Guide For India, Mumbai 2005-06

Reading the table it can be observed that 38.28 per cent and 12.34 per cent of the venture capital firms preferred to invest in less than 5 years and in between 5-10 years respectively. It can also be seen that 44.44 per cent of the venture capital firms are not interested in disclosing their preferred investment period, and rest of them did not have any preference period for investment.

3.6 TYPE OF VENTURE CAPITAL FUNDING

Various instruments such as equity, debt, convertible instruments bearing characteristics of both debt and equity have been introduced in the venture capital industry so as to varied financial needs of the investee companies. To know the revealed preferences of Indian venture capitalists regarding the most preferred instrument of financing, options were sought and presented in table 3.3
Table 3.3
INSTRUMENT-WISE VENTURE CAPITAL FUNDING IN INDIA: 2005-06
(N=165)

<table>
<thead>
<tr>
<th>Instruments</th>
<th>Number of respondent VCCs</th>
<th>%ge to total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>68</td>
<td>41.12</td>
</tr>
<tr>
<td>Private Placement</td>
<td>31</td>
<td>18.80</td>
</tr>
<tr>
<td>Debt</td>
<td>19</td>
<td>11.51</td>
</tr>
<tr>
<td>Leasing</td>
<td>06</td>
<td>03.64</td>
</tr>
<tr>
<td>Buyouts</td>
<td>23</td>
<td>13.94</td>
</tr>
<tr>
<td>Fund of Funds</td>
<td>04</td>
<td>02.42</td>
</tr>
<tr>
<td>Royalty</td>
<td>04</td>
<td>02.42</td>
</tr>
<tr>
<td>Discretionary</td>
<td>10</td>
<td>06.06</td>
</tr>
<tr>
<td>Total</td>
<td>165</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source: Dickenson Intellinetics, Venture Capital Guide for India, Mumbai 2005-06

It can be observed that 41.12 per cent of the venture capital firms prefer equity funding. Other instruments of financing - debts, buyouts, corporate strategy, and public to private placement are far behind.

It can be concluded, from the preceding analysis, that the most preferred form of venture capital financing was equity followed by private placement, buy-outs and debt financing. Least preferred forms of financing were royalty and fund of funds.
3.7 PREFERRED INVESTMENT STAGES OF VENTURE FINANCING

Venture capital is made available in equity form to finance a project in all its developmental stages which are spread to encompass the entire period of completion and growth of the project. The different stages of venture capital funding are set out in table 3.4.

Table 3.4
STAGE-WISE VENTURE CAPITAL FUNDING IN INDIA: 2005-06

\[(N=316)\]

<table>
<thead>
<tr>
<th>Stages</th>
<th>Number of Respondent VCCs</th>
<th>%ge to total</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Early Stage</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i. Seed</td>
<td>43</td>
<td>13.61</td>
</tr>
<tr>
<td>ii. Start-up</td>
<td>53</td>
<td>16.78</td>
</tr>
<tr>
<td>iii. Other early stage</td>
<td>59</td>
<td>18.67</td>
</tr>
<tr>
<td>II. Later Stage</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i. Expansion</td>
<td>61</td>
<td>19.30</td>
</tr>
<tr>
<td>ii. Mezzanine</td>
<td>37</td>
<td>11.70</td>
</tr>
<tr>
<td>iii. MBO/LBO</td>
<td>32</td>
<td>10.13</td>
</tr>
<tr>
<td>iv. Turnaround</td>
<td>31</td>
<td>09.81</td>
</tr>
<tr>
<td>Total</td>
<td>316</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source: Dickenson Intellinetics, Venture Capital Guide for India, Mumbai 2005-06

It can be seen that 19.30 per cent of the venture capital firms financed expansion stage deals, followed by other early stage (18.67 per cent), start-up (16.78 per cent), seed (13.61 per cent), and mezzanine (11.70 per cent). It can also be observed that venture
capital firms were not shying away from turnaround, Management Buyouts (MBO) or Leveraged Buyout (LBO) stage deals.

Classifying stages broadly into early stage and later stage, it can be noticed that 49.96 per cent of VC firms provided finance in the early stages of the projects they financed, and the remaining 51.94 of them in the later stages of the projects. Thus VC firms were equally distributed in financing the assisted projects in the early and later stages of growth and development.

3.8 SECTORAL PREFERENCE OF VENTURE CAPITAL FIRMS

IVCA's classification of assisted companies, as compared to financial institutions, banks or the government is different which is based on practice by British Venture Capital Association (BVCA) in the UK or National Venture Capital Association (NVCA) in the USA. It is on lines of bio-technology, computer hardware and systems, computer software and services, telecommunications, other electronics, energy related, medical, industrial products and machinery, food and food processing, consumer related and others. The information collected from respondent VCCs/VCFs with regard to sectoral preferences for VC investment is incorporated in table 3.5.

As seen from the following table, 26.21 per cent of the investee firms were in the information technology-enabled services sector in India.

The other sectors (16.61 per cent), telecommunications and networking sectors (15.70 per cent) were not far behind. Medical, consumer-related and the bio-technology sectors were among the emerging sectors for investments by the VC firms. The sectors such as
electronics, energy-related, food processing and industrial products and machinery accounted for very small percentage of the total number of assisted companies, leading to the conclusion that VCFs had not been significantly helpful in promoting these sectors. However, it can also be inferred that the interest level of the venture capital firms is more broad-based across the sectors.

Table 3.5
SECTOR-WISE CLASSIFICATION OF VENTURE CAPITAL INVESTEES COMPANIES: 2005-06
(N=885)

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Sectors</th>
<th>Number of investee companies</th>
<th>%ge to total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>1.</td>
<td>Biotechnology (02)</td>
<td>58</td>
<td>6.56</td>
</tr>
<tr>
<td>2.</td>
<td>Information technology (05)</td>
<td>232</td>
<td>26.21</td>
</tr>
<tr>
<td>3.</td>
<td>Telecommunications (03)</td>
<td>139</td>
<td>15.70</td>
</tr>
<tr>
<td>4.</td>
<td>Electronics (01)</td>
<td>43</td>
<td>04.86</td>
</tr>
<tr>
<td>5.</td>
<td>Energy related (02)</td>
<td>33</td>
<td>03.73</td>
</tr>
<tr>
<td>6.</td>
<td>Medical (03)</td>
<td>101</td>
<td>11.41</td>
</tr>
<tr>
<td>7.</td>
<td>Industrial products and machinery (01)</td>
<td>15</td>
<td>01.70</td>
</tr>
<tr>
<td>8.</td>
<td>Food processing (01)</td>
<td>19</td>
<td>02.15</td>
</tr>
<tr>
<td>9.</td>
<td>Consumer related (04)</td>
<td>68</td>
<td>11.07</td>
</tr>
<tr>
<td>10.</td>
<td>Others (07)</td>
<td>147</td>
<td>16.61</td>
</tr>
<tr>
<td></td>
<td>TOTAL</td>
<td>885</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Note: Figures in parentheses indicate number of sub-sectors under each sector

Source: Dickenson Intellinetics, Venture Capital Guide for India, Mumbai 2005-06
3.9 MINIMUM INVESTMENT SIZE OF VENTURE CAPITAL PLAYERS

VC investment size classes are micro, small, medium and large. Respondent VC firms according to their size of investment were classified and shown in table 3.6.

Table 3.6
SIZE-WISE INVESTMENTS BY VENTURE CAPITAL COMPANIES
IN INDIA: 2006-06

<table>
<thead>
<tr>
<th>Size of Investment (Rs. In millions)</th>
<th>Number of Respondent VCCs</th>
<th>%ge to total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro</td>
<td>41</td>
<td>50.00</td>
</tr>
<tr>
<td>Small</td>
<td>21</td>
<td>25.61</td>
</tr>
<tr>
<td>Medium</td>
<td>13</td>
<td>15.85</td>
</tr>
<tr>
<td>Large</td>
<td>07</td>
<td>8.54</td>
</tr>
<tr>
<td>Total</td>
<td>82</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Legend: Micro means $1 million; small: more than $1 million but less than $5 million; medium: more than $5 million but less than $10 million; and large: more than $10 million.
Source: Dickenson Intellinetics, Venture Capital Guide for India, Mumbai 2005-06

From table 3.6 it can be seen that the 50 per cent of venture capital firms invested in micro deals, an encouraging sign for entrepreneurs with a smaller start-up capital requirement.

3.10 FINANCING ROLES OF VENTURE CAPITAL FIRMS

The role of venture capitalists does not end with making an investment in the venture. Generally, they have seat on the board of directors and extends to providing guidance on financial matters and strategy. (See table 3.7)
### Table 3.7
CLASSIFICATION OF VCCs IN INDIA BY THEIR FINANCING ROLES

<table>
<thead>
<tr>
<th>Financing Role</th>
<th>No. of Respondents VCCs</th>
<th>%ge to total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Active management advice</td>
<td>63</td>
<td>24.80</td>
</tr>
<tr>
<td>Lead investor</td>
<td>58</td>
<td>22.83</td>
</tr>
<tr>
<td>Financial advice</td>
<td>59</td>
<td>23.23</td>
</tr>
<tr>
<td>Seat on board</td>
<td>68</td>
<td>26.78</td>
</tr>
<tr>
<td>Discretionary</td>
<td>06</td>
<td>02.36</td>
</tr>
<tr>
<td>Total</td>
<td>254</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source: Dickenson Intellinetics, Venture Capital Guide for India, Mumbai 2005-06

As depicted in the table 3.7 most of the VCFs favour seat on board in investee firms. It can also be observed that venture capital firms in India were involved in active management advice followed by financial advice and lead investor role.

#### 3.11 RECENT TRENDS IN VC FINANCE IN INDIA

The VC industry in India has grown over the last decade with over USD 5 billion being committed for investments. Activity in the first half-of 2005 witnessed an upsurge with investments aggregating Rs.26.5 billion (USD 589 million) as compared to Rs.33.2 billion (USD 738) in 2004. Continuing profitability, an enabling regulatory framework (with the modified SEBI venture capital guidelines and Indian Companies Act) and improved investment climate contributed...
towards making India an attractive VC destination. Significantly, India is the 3rd largest receiver of VC in Asia after Japan and Korea.

According to the Asia Private Equity Review, a publication that covers the VC industry's fund-raising and deal flows in Asia as a whole, India had the sharpest rise in investments in the Asia-Pacific region for the first half of 2005 at USD 315.3 million.34 VC and venture capital funds are now focusing on promising sectors on the upswing and coming-up with sector specific funds. For example, fire capital, a venture capital fund, was recently created for the real estate sector.35 Another example is the USD 200 million private equity fund created for the power sector by Petro Major Reliance group and the Singapore State Investment Arm, Temasek.36 In addition, India is one of the few emerging markets where venture capital funds have been successful in achieving profitable exits from their investments through a combination of initial public offerings (IPOs), strategic sales and promoter buy-backs.

From funding small start-up venture with emphasis only on new age companies, the Indian Venture Capital Industry has now matured to cover the entire spectrum of private equity products, seed funding, expansion capital, buy-out financing, financing restructuring of companies and providing mezzanine capital across a variety of sectors. Deal size has also reached new heights, from sub USD 5 million in the early days to the current USD 50 million and more.

On the funding side of the private equity business, it may be worth noting that till the recent past, a substantial portion of venture capital and private equity money in India has flowed from pension fund managers/investment institutions from the U.S. Far East, World Bank,
Other quasi governmental organizations and Multilateral Development Banks. What is striking, however, is the limited presence of domestic Indian investors. The peculiarity of this situation gets accentuated when one views it in the context of a robust banking and financial system present in the country. The availability of investible surplus and paucity of investment opportunities ought to have resulted in including private equity funds in the portfolio of large financial institutions.

With India becoming a preferred investment destination, this heightened level of private equity activity is likely to continue for some time to come. India Inc. is definitely rising-up to the challenge of not only becoming globally competitive but also in creating enterprises that would dominate the world over a period of time. The financial system especially private equity players need to support the Indian venture capital industry in this endeavour.

3.12 CRITICAL SUCCESS FACTORS IN VC FINANCING

There are certain critical success factors for the venture capital and private equity industry in India which would attract further investments and increase venture capital activity within the country:

- Lack of adequate and accurate information on venture capital sources is one of the major concerns for the industry. Timely and up-dated information will be the key to give impetus to the entrepreneurs who often use 'shoot in the dark' approach when it comes to approaching the venture capital community. A careful and filtered selection of firms to approach should enhance the through-put of quality transactions.

- Venture investors globally seek investment and exit on very flexible terms which provide them with certain levels of protection. Such exit should be possible through IPOs and mergers/acquisitions on a global
basis and not just within India. Hence, investment management and exit should provide flexibility to suit the business requirements and should also be driven by global trends.

➤ Another critical success factor is the treatment of tax on capital gains made by venture capital firms investing through the Mauritius route. Changing policies with a retrospective effect is undoubtedly acting as a dampener to fresh fund raising by venture capital firms.

➤ In order to enhance their ability to generate better returns, it is important that Indian venture capital firms as well as investee companies should search for opportunities for investment abroad. This would also add to their experience and expertise to function successfully in a global environment.

➤ Lack of advisory services for entrepreneurs is another major constraint, since often brilliant ideas by entrepreneurs are turned down by venture capitalists as they are not presented in an appropriate way. Hence, such services and resources need to be made available in a cost effective way for entrepreneurs to present quality proposals to the venture capital community.

➤ R & D needs to be promoted by the government as well as other organizations. Infrastructure development also needs to be prioritized using government support and private management. This involves creation of technology as well as knowledge incubators for supporting innovation and ideas.

➤ There is an urgent requirement of training for entrepreneurs, venture capital practitioners and consultants to present projects with globally well accepted valuation and capital budgeting models.
Globally, venture capitalists are not merely finance providers but are also closely involved with the investee enterprises and provide expertise by way of management and marketing support. Hence, it is important that venture capital in India be allowed to develop via professional and institutional management. Venture capital should become an institutionalized industry financed and managed by successful entrepreneurs, professional and sophisticated investors.

The government of India has already taken laudable steps to facilitate the creation of an environment that is conducive for venture capital funds in India. These include introduction of sweat equity, allowing venture capital funds to offset losses incurred in one company against profit from another, and establishment of government facilitated venture capital funds.

However, the regulatory framework should provide for an environment that lays stress on encouraging the flow of venture capital funds, mentoring, non-qualified availability of funds and flow of public funds for enterprise-building in India.

3.13 CONCLUSION

In the background of lack of investment in new small business and increased awareness of the need for promotion of SMEs, small business investment company came into existence in America. This was the beginning of VC abroad. Seeing greater promise for commercial application developed by MIT, ARDC was formed. Number of SBICs established in America to leverage their private capital by borrowers from the federal government at lower interest rates. The ratio of VC pool to the size of the economy was 8.7 times higher in U.S. than in India in 1995. In summary three factor- favourable public attitudes, dynamic financial system, and governmental support – facilitated development of VC at international level.
Two-tier institutional structure - central and state levels - evolved after independence in India to provide long-term finances to industry. The notable deficiency in the structure of lack of provision of VC to new industrial units. To correct this deficiency VC evolved in India in three phases: In the first phase (1973-1994) the need for VC was recognized in India. This phase witnessed inauguration of risk capital foundation by IFCI, creation of venture capital fund by IDBI, development of VCCs, tax concessions to VCCs/VCFs by the government and formation of venture capital association. The landmarks in second phase (1995-99) were establishment of clear guidelines to VCFs by SEBI. In the third phase, (which started in 2000) in addition to some overseas VCFs also entered into Indian industry. VCCs in India the funds are multi-sourced ranging from banks, insurance companies, public sector to pension funds. The preferred investment period for VCCs is less than 5 years. Instrument-wise, they prefer to make investment in equity. Their investments were equally distributed between early and later stages of financing. Coming to sector-wise investments by VCCs IT dominated their portfolio followed by telecommunications. On the count of size of investments made by VCCs 50 per cent of their investment was micro investment i.e., up to USD 1 million. VCCs in India play multiple financial roles such as management advice, lead investor, financial advice and sitting on the board of portfolio enterprises.
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