Chapter I
Introduction: Venture Capital- A Theoretical Perspective
CHAPTER 1

INTRODUCTION: VENTURE CAPITAL - A THEORETICAL PERSPECTIVE

This chapter will give the reader with a brief background of the topic and the existing literature on it. Subsequent the argument, the rationale of this thesis will be served and the related key conceptions analyzed in the end of the chapter.

1.1 Overview of Venture Capital

Venture Capital as a latest phenomenon originated in USA and developed outstandingly worldwide since the second half of the seventies. American Research and Development Corporation (ARDC), founded by Gen. Doriot (Georges Doriot) in a little while 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 actual 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 $1 billion and 5 billion. It is reported that some of the current day giant like Apple, Microsoft, Xerox etc. are the beneficiaries of Venture Capital (Gordon and Natarajan, 2009). United Kingdom occupies a second place after US in terms of investment in Venture Capital.

The thought became accepted in late sixties in UK. The Government’s Business Expansion Scheme which acceptable 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 very old Venture Capital Company established in 1934 in UK. The Bank of England established its Venture Capital Company in late 1940’s. The UK witnesses 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.¹

The victory of Venture Capital in these countries provoked other countries to design and implement measures to encourage Venture Capital and their total dedication has been growing.

1.1.1 USA Venture Capital

In the United States of America, Venture Capital has contributed enormously to the growth of the economy. It has made important contribution to the development of the computer and semi-conductor industry. It has also assist in the achievement of very large scale integration technology. Whereas Venture Capital was instrumental in the development of American economy, its institutionalization did not begin until after World War II. Earlier to that, it was a general practice for wealthy individuals, syndicates organized by investment bankers or by a few families to build venture investments. The institutionalization procedure was facilitated by the formulation of American Research and Development Corporation (ARDC) in Boston in 1946, transitory 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 main winning 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 beliefs were to construct creative men and their companies. In favor of him capital gains were the reward of this philosophy, not a business goal. The object of this company was to look for 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 thanks for creative drive.

The formation of SBICs as a means of small business financing in 1958 gave the real force to the development of the Venture Capital Industry in the USA. The purpose of the SBIC Act was to create 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 rule the US venture industry, SBICs, in their new and modified form, are the major source of its development.2

The Venture Capital Industry in the USA has been growing ever since its inception. Its growth was, accentuate after 1978 when the capital gains tax was condensed from 49 to 29 percent. The rate was bringing down to 20 percent for individuals in 1981. These resulted in considerable returns to investors; the Venture Capital was able to attract capital without

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difficulty. These coincide with the appearance of the very large scale integration which substantially reduced the cost of computer chips and gave a boost to the computer industry.\textsuperscript{3}

Even though the Venture Capital finance is made available to all enterprise in the USA, the high technology businesses have received large funds over the years. A large amount of the Venture Capital Investments in the USA is confined to high technology, high risk and rapidly changing businesses. Extensive Venture Capital has been invested in the fields of information, communications, genetic engineering, medical electronics, biotechnology and artificial intelligence. In volume terms, the USA conquered 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 comprise family firms and institutionally funded independent private partnerships and are the most leading source of Venture Capital. They description for about 60 percent of the Venture Capital Industry’s capital; and they are extremely experienced and sophisticated investors. Institutionally funded private firms are normally organized as limited partnership where Venture Capitalist, in his capability as general partner, is accountable for the management of the partnership. For their management, general partners are compensated in the form of an annual management fee usually 2.5 to 3 percent of the capital invested and percentage, quite often 20 percent of the net long-term capital gain.

SBICs, formed under the SBIC Act 1958, have access to Government loans in adding 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 concerning 17 percent of the Venture Capital.

In the USA, expansion-stage financing is much superior to 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 deal in a certain way. Analysis is paying attention 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 encouraging returns across all investment horizons 3 years and longer for the periods ending December 31, 2008. On the other hand, with the exception of the 20 year horizon, most categories experienced quarter over quarter and year over year declines (Source: NACA Report 2009). 

Turmoil in the broader capital markets cause the one-year all venture Private Equity Performance Index (PEPI) (1) to turn down considerably to 20.9 percent, an 18.8 percentage point decrease from the period ending September 30, 2008. The slow exit markets in 2008 have driven lower one-year return numbers throughout 2008. The then 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 like 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 (Source: PEPI report 2008). 

Venture Capitalists invested some $29.1 billion in 3,752 deals in the US 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 US would have leveled between $20-29f billion in 2007. (Source: Gordon and Natarajan, Financial Markets and Services, fifth revised edition).

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1.1.2 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 restricted to three countries, namely the UK, France and the Netherlands.\(^5\)

The sluggish growth of Venture Capital in Europe in the early 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 US or UK lines has scarcely developed. 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 unusual incentives for the financing of SMEs as was the case in a number of European Countries (Source: OECD, 1986).

In the late eighties, Europe witnesses a rapid growth of Venture Capital due to change 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 (Source: Bygrave and Timmons, 1992).

Private equity and Venture Capital provide investment opportunities to institutional and professional investors. The huge majority of these private equity and Venture Capital investors, called limited partners. The main 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 run all funds that they have invested in, and do not intervene at the level of the investee company. However, they regularly evaluate the quality of the investments made on their behalf of the € 79 billion (13.1 percent) to venture and growth capital. Venture Capitalists in Europe focus on industrial products,

\(^5\) Chary, T. S. (2006). Venture capital is post-war phenomenon in the business world, mainly developed as a sideline activity of the rich in the USA. To connote the risk and adventure and some element of investment, the generic name of: Financial Sector Reforms In The World, 54.
consumer products, computer products and other electronic products. Due to growing emphasis on development of technology, West Germany, United Kingdom, France and to a lesser degree, the Netherlands and Italy, have invested a lot in Research and Development.

An important 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 set-up has created a holding company with US$ 30 million funds for investing in European VCFs. Different types of investors were rope in for raise funds in Europe for the period 2003-2007. Pension funds had the largest share of 23 percent in the total funds raised. Next come 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.\(^6\)

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 (Source: EVCA).

The only dissimilarity 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 incredible opportunities for the growth of Venture Capital industry in the economy of Europe (Source: EVCA).

Investments by European private equity and Venture Capital firms amounted to €73.8 billion in 2007; 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 translate 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

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2004, the average employment growth in buyout-financed companies was 2.4 percent, compared to 30.5 percent for venture-backed companies (Source: EVCA).

PE/VC fund investors have a long-term obligation prospect 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 in four years. The 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.7

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, even though there is no harmonized framework for private equity at the European Union level, a number of EU legislative procedures in place indirectly affect the industry, such as MiFID, UCITS, the Pension Funds Directive, and the Capital Requirements Directive.

The European industry believes in more professional standards that are vital 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 make 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 (Source: OECD).

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 (Source: EVCA).

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 (Source: EVCA).

1.1.3 Venture Capital in United Kingdom

The early days 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 (Source: 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.

In history, 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.²

³i was established in 1945 by the Bank of England and the main clearing banks with the reason 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 big 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 support to investment trusts etc., contributed to this development (Source: OECD, 1980).

The UK is an outstanding example of a country where a number of tax incentives have been initiated specifically to give a boost to the Venture Capital investment. In fact, it has been found in the UK that investors are motivated more by the possible 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 acknowledge 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. These necessitate the opening of a third market in 1987 for smaller companies and with ever easier listing requirements than demanded by the USM.

However 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 firms 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.

**1.1.4 Venture Capital in France**

During the 1970s and 1990s, most European countries adopted public policies aimed at encourage development of the innovation process in the order to remain internationally competitive in the specialized high-tech sectors. As in Germany, in France the policy to hold up 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, Societies 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 support 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 a Risque in 1983. Investors receive tax-exempt capital gains at the end of five years.

Venture Capital is the rapid 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 understanding of over 10 years; there are about 40 other sources of small company risk capital (Lorenz, 1985). The creation of the Second Marche in 1983 and development of financial instruments such as warrants and options have helped the growth of the French Venture Capital industry, accounting for a much as 65 percent of investment in recent years.

1.1.5 Venture Capital in India

The record of Venture Capital in India dates back to early 1970 when government of India selected 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 completely 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 suggested 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, Government of India determined 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. These guidelines were very restrictive and following a very narrow definition of Venture Capital. 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. Nevertheless 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.

Following the reforms was 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 a lot of shortcomings in these guidelines at the starting point. These guidelines did not generate a homogeneous level playing field for all the VC investors. These impede growth of domestic VC industry. Be short of incentives also made Indian Corporate and wealthy individuals shy of VC funds. With the result, VC scene in India started getting conquered by foreign equity fund.

In 1997, IT boom in India made VC industry more important. Due to symbiotic relationship between VC and IT industry, VC got more importance as a main source of funding for the rapidly growing IT industry. Indian Venture Capitalist’s (VC’s) which were so far invest in all the sectors changed their focus to IT and telecom industry.⁹

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 busy into funding buyouts, privatization and restructuring. At present, 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:

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1.2 Venture Capital Environment in India

Aylward (1998)\(^\text{10}\) has shown that the very different regulatory and legal frameworks in developing countries pose special challenges for the development of a venture capital market. In addition, different economic and fiscal environments can lead to very different patterns of fund-raising and investment in developing and US/Western European markets (Boocock and Presley, 1993)\(^\text{11}\).

The growth of venture capital in India was stimulated in the late 1980s with a series of measures to establish government sponsored risk capital corporations and capital gains tax concessions for venture capital investments (Verma, 1997)\(^\text{12}\). The venture capital industry in India subsequently witnessed increased activity with a rise in the number as well as the pool of funds for investment (AVCJ, 2001). In 1998 total investment funds under management amounted to approximately $1.1 billion (IVCA, 1999). In 1998 foreign institutional investors contributed 51 percent of the total pool of funds as compared to 26 percent contributed by all India financial institutions. The balance of funds was provided by a mixture of multinational agencies, commercial banks, insurance companies, corporate sector, mutual funds, on-resident Indians, other public sector providers, etc.

There were few incentives for individuals to invest in risk capital (Chitale, 1989)\(^\text{13}\). Companies found it difficult to raise loans but venture capital had not become a major competitor to replace bank credit for early stage ventures (SEBI, 1999). The Securities and Exchange Board of India (SEBI) has introduced a number of reforms and developments to Indian securities markets in 1998/99 including a phased introduction of trading in derivatives, the facility for listed companies to buy-back securities, mandatory disclosure of quarterly financial results, the establishment of an interconnected stock exchange to link together regional stock markets, and a reduction in the minimum percentage of shares required to be listed to 20% (SEBI, 2000).

The legal and regulatory framework relating to venture capital firms in India has posed major problems. Until recently, venture funds were regulated by three authorities, the Government


of India, the SEBI and the CBDT. A venture fund thus has to adhere to three different sets of guidelines that were mutually contradictory (SEBI, 1999). In addition, although there has been relaxation of government policy concerning multinational companies (Venkata Ratnam, 1998)\textsuperscript{14}, until recently very different regulations applied to domestic and foreign venture capital funds operating in India (SEBI, 1999). Domestic funds were required to register with the SEBI but overseas funds were not. In addition, domestic funds needed to apply to the CBDT to seek tax exemptions, whereas foreign funds need the approval of the Government. Moreover, while overseas funds operating in India but registered in Mauritius were only subject to minimal taxation, the Indian funds are not similarly exempted.

Recognizing the importance of developing a vibrant venture capital market in India, the Chandrasekhar Committee on Venture Capital (Chandrasekhar, 2000)\textsuperscript{15} made a number of recommendations to achieve this goal, including: the consolidation of regulations affecting venture capital into one instrument, tax pass through in order to avoid double taxation of gains, registration of foreign venture capital firms with the SEBI to provide them with ‘hassle free’ investment and disinvestment without the need for further regulatory approval, tax exemption for all foreign venture capital investors whether registered in Mauritius or not, increasing the list of sophisticated institutional investors allowed to invest in venture capital funds, neutrality of venture capital investment structures, flexibility of investment ceilings and sectoral restrictions, and relaxations in listing requirements for venture backed IPOs.

Following amendments to the Venture Capital Funds Regulations of 1996 relaxed a number of the limits on domestic venture capital firms, while the Foreign Venture Capital Investor Regulations of 2000 also brought the regulation of domestic and foreign venture capital firms very much into line. Both are necessary to invest at least 75% of investible funds in unlisted equity shares or equity linked instruments (previously 80% for domestic funds). Neither domestic nor foreign venture capital firms are able to invest more than 25% of their funds (previously 20%) in one investee (although foreign firms may do so outside India). Limitations on domestic venture capital firms investing in financial services were detached.

The important features of the New Companies Act, 2013 center on Private equity and venture capital encompass corporate governance, board conduct, duties and liabilities of key


management personnel, insider trading, M&A structuring, protocol for mergers with foreign companies, revised audit and reporting requirements, disclosure requirements and penalties, amongst others, which are of direct relevance to Private Equity & Venture Capital fund (New Companies Act, 2013).

1.3 Venture Capital Investments Sectors

In a more and more knowledge-intensive economy, the significance of Venture Capital for the funding of new high-growth potential firms is widely accepted. Venture Capital represents one solution to financing the high risk, potentially high-reward projects. Venture Capital industry plays a vital role in technological and economic growth through its direct involvement in the development of wide variety of enterprises. Presence of Venture Capital encourage efficient capital allocation by seeking out and development high growth entrepreneurial companies in the innovative process, additional more high growth entrepreneurial companies are frequently refused finance from conventional sources. Institutions also tend to invest more in firms that are backed by Venture Capital funding.16

India has become one of the fastest developing nations in the new millennium. It is one of the hotspots for investments with reaping rich benefits. Beside from the success of information technology, there is a huge potential for investment, growth and development in several other sectors like Pharmaceuticals, Telecommunications, Healthcare, Electronics, Food Processing and Business Process Outsourcing (BPOs). The competitive edge of India over other developing nations like China, Russia etc., lies in its huge skilled human capital and knowledge entrapped in the research laboratories. There should be a type of finance that links all the available resources for exploration and effective utilization. This connection is available in numerous forms such as bank loans, private debt, equity, bonds etc. However each of them has their own pros and cons which leads to inapplicability under different context. Development in the high growth sector needs not only high technology and huge capital but also the ability to take huge risks. Venture Capital is the medium that suits this role.

What is common between huge global corporations like Microsoft, Google, Yahoo, JetBlue, eBay? It is the same thing, which has spurred the boom in Information Technology (IT), Software, Biotech, Semiconductor and many other high-tech industries in the United States of

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America (USA). The similar factor is Venture Capital that has provided a strong support in the establishment of these companies.

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

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

India is on the edge for a technological revolution with the emergence of new breed of entrepreneurs with required professional temperament and technical knowhow, as well as advancement. To make the innovative technology of entrepreneurs a successful business

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venture, maintain in all aspects particularly in the form of financial assistance is all the more essential.¹⁶

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

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

1.4 Concept of Venture Capital

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

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

1.5 Definitions of Venture Capital

**International Finance Corporation, Washington, DC** defines “Venture Capital as an equity or equity-featured capital seeking investment in view of ideas, new companies, new products, new processes or new services that offer the potential of high returns on investment. It may also include investment in turnaround situations”.

**According to SEBI (Venture Capital Funds) Regulations, 1996**, “as venture capital is a fund established in the form of a trust or a company including a body corporate and registered under these regulations that has a dedicated pool of capital raised in a manner specified in the regulations and investments in accordance with these regulations”.

**According to the Bank of England Quarterly Bulletin of 1984**, Venture Capital investment is defined “as an activity by which investors support entrepreneurial talent with finance and business skills to exploit market opportunities and thus obtain long term capital gains”.

**According to Dr. Neil Cross, a Senior Executive with 3i** one of the world’s largest and oldest Venture Capital companies and a former chairman of the European Venture Capital Association defined venture capital investment “as the provision of risk bearing capital,
usually in the form of participation in equity, to companies with high growth potential. In addition the venture company provides some value added in the form of management advice and contribution to overall strategy. The relatively high risks for the venture capitalists are compensated by the possibility of high return, usually through substantial capital gains in the medium-term”.

According to a definition of National Venture Capital Association (NVCA) “Venture Capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have a potential to develop into significant economic contributors. Venture capital is an important source of equity for start-up companies. Professionally managed venture capital firms are generally private partnerships or closely held corporations funded by private and public pension funds, endowment funds, foundations, corporations’ wealthy individuals, foreign investors and the venture capitalists themselves”.

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

Federick R Adler, practitioner of the profession, describes “the process as one of investing of risk capital in an enterprise in which a venture investor shares ownership as well as board of directors level management responsibilities with the founding management team”.

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

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

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

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

Venture Capital is the support by investors of entrepreneurial talents with finance and business skills to exploit market opportunities and thus obtain capital gains. Venture Capital commonly describes not only the provisions of start up finance or ‘seed corn’ capital but also development of capital for later stages of business. A long-term commitment of funds is involved in the form of equity investments, with the aim of Venture Capital gains rather than income, and active involvement in management of customer’s business.\(^\text{19}\)

Venture Capital is the organized financing of relatively new enterprises to achieve substantial capital gains. Such young companies are chosen because of their potential for considerable growth due to advanced technology, new products or services or other valued innovations. A high level or risk is implied by the term “Venture Capital” and is implicit in this type of investment, since certain ingredients necessary for success are missing and must be added later.\(^\text{20}\)

A form of equity financing intended especially for funding high risk and high reward projects is known as Venture Capital. Venture Capital acting an important role in financing hi-tech projects, besides helping research and development projects to turn into commercial production. By financing the technology, venture capital assists in fostering the growth and development of enterprises. In Western countries, much of this capital is used for establishing technology and expanding business.

\(^{19}\) Central Office of Information, London- (September 1989), The Growth of Venture Capital and Expansion of Small Firms Sector in Britain. (Classification5 (a)).

\(^{20}\) Kenneth W. Ruid, Venture Capital Investment, Hand Book of Wealth Management
1.6 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 Capitalists should not interfere in day to day activities of the management. The Venture Capitalists 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 the 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.

### 1.7 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.
1.8 Stages of Venture Capital

Venture Capital may take a variety of 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 varieties of stages in the financing of Venture Capital are described below:

1.8.1 Development of an Idea- Seed Finance: In the initial stage Venture Capitalists provide seed capital for translating an idea into business proposition. This stage involves primarily Research and Development financing. The European Venture Capital Association defines seed capital as, “the financing of the initial product development or the capital provided to an entrepreneur to prove the feasibility of a project and qualify for start-up capital”.

1.8.2 Implementation Stage- Start up Finance: The term ‘Start-up’ refers to the stage where a new activity is launched. The European Venture Capital Association defines start-up
capital as, “capital needed to finance the product development, initial marketing and the establishment of product facilities”.

1.8.3 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.

1.8.4 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 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.

1.9 Venture Capital Investment Criteria

Venture Capital investment refers to the capital invests into “risky” ventures to obtain a very high rate of returns. Venture Capital is invests into equities rather than loans to get a good rate of return. The Venture Capital is provide 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 some of the basic Venture Capital investment criteria before making any investment. The essential 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:

1.9.1 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.

1.9.2 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.

1.9.3 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.

1.9.4 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 models should fulfill the Venture Capital investment criteria. It should have the potential to attract customers and stay ahead of competitors.

1.9.5 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.

1.9.5 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.

1.9.6 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.
1.10 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.

1.10.1 Private Equity: it 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

1.10.2 Venture Capital: VC is a specific investment strategy designed to provide funding for startup 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.

1.10.3 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

1.10.4 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.

1.10.5 Angel Investors: An angel is a knowledgeable 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

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

<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, bio-technology 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>Size</td>
<td>PE firms make large investments</td>
<td>VCs investments are much smaller</td>
</tr>
<tr>
<td>------</td>
<td>---------------------------------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td>Structure</td>
<td>PE firm use a combination of Equity and Debt</td>
<td>VCs firm use only Equity</td>
</tr>
<tr>
<td>Stage</td>
<td>PE firms buy mature, public companies</td>
<td>VCs invest mostly in early stage-sometime pre-revenue companies</td>
</tr>
<tr>
<td>Risk and Return</td>
<td>In PE number of investments in 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>

Source: Secondary Data

1.12 Benefits of Venture Capital Fund

i. Benefits received by 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. Benefits received by 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 broker’s 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 form maintenance of share registry cell, stock exchange listing fee, expenditure on printing and posting of annual reports etc., and 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. **Benefits received by 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.

1.13 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

1.13.1 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 potential entrepreneurs.

1.13.2. Screening: Venture Capital is a service industry, and VCFs generally operate with small staff. VCFs, before going for an in-depth analysis, carry out initial screening of all projects on the basis of some broad criteria.

1.13.3. 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.

1.13.4. 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, specifying 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.

1.13.5. 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 Venture Capitalists 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.

1.13.6. 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.
Table 1.3: Venture Capital Investment Process

<table>
<thead>
<tr>
<th>Stage</th>
<th>New Request</th>
<th>Active Request</th>
<th>Project</th>
<th>Approved Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. / year</td>
<td>300</td>
<td>100</td>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>Time to respond</td>
<td>&lt; 5 days</td>
<td>&lt; 14 days</td>
<td>1 – 2 months</td>
<td>2 weeks</td>
</tr>
<tr>
<td>Actions</td>
<td>first analysis; initial issue identification</td>
<td>visit to company and management; issue identification; initial upside analysis</td>
<td>in depth company analysis; market/technology; upside factors; syndication</td>
<td>term sheet; contracts</td>
</tr>
<tr>
<td>Outcome</td>
<td>Fact Sheet</td>
<td>Project Proposal</td>
<td>Investment Proposal</td>
<td>Deal</td>
</tr>
</tbody>
</table>

Source: Gilde Investment Management

1.14 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:

1.14.1 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 the 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.

1.14.2 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.

1.14.3 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.

1.14.4 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 divided 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.

1.15 Disinvestment Mechanisms (Exit of venture capital)

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 (Vandana Panwar, 2009).

1.15.1 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.

1.15.2 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 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 VCFs 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.

1.15.3 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 has 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.

MANAGEMENT OF VENTURE CAPITALISTS PORTFOLIO

It is uncommon to find investors investing their savings in a single security. Instead, they tend to invest in a group of securities. Such a group of securities is called a portfolio. Creation of a portfolio helps to decrease risk without sacrificing returns. Portfolio management deals with the analysis of individual securities as well as with the theory and practice of optimally combine securities into portfolios.

1.16 Portfolio Management

An investor considering investment in securities is faced with the problem of choosing from among a large number of securities. Investors’ choice depends upon the risk-return characteristics of individual securities. The investors face an infinite number of possible portfolios or groups of securities. The risk and return characteristics of portfolios differ from those of individual securities combining to form a portfolio. The investors try to choose the optimal portfolio taking into consideration the risk-return characteristics of all possible portfolios.

As the economic and financial environment keeps shifting, the risk-return characteristics of individual securities as well as portfolios also change. This calls for periodic review and
revision of investment portfolios of investors. Portfolio management comprises all the processes involved in the creation and maintenance of an investment portfolio. It deals specially with five phases of portfolio management. It also makes use of analytical techniques of analysis and conceptual theories regarding rational allocation of funds. Portfolio management is a multifaceted process which tries to make investment activity more rewarding and less risky.

1.17 Phases of Portfolio Management

Portfolio management is a process encompassing many activities aimed at optimizing the investment of one’s funds. Five phases can be identified in this process:

1. Security Analysis
2. Portfolio Analysis
3. Portfolio Selection
4. Portfolio revision
5. Portfolio evaluation

1.17.1 Security Analysis- It is the first phase of the portfolio management process. This step consists of examining the risk-return characteristics of individual securities. An essential strategy in securities investment is to buy underpriced and over priced securities. There are two option approaches to security analysis, namely fundamental analysis and technical analysis.

1.17.2 Portfolio Analysis- this phase of portfolio management consists of identifying the range of possible portfolios that can be constituted from a given set of securities and calculating their return and risk for additional analysis.

1.17.3 Portfolio Selection- the goal of portfolio construction is to produce a portfolio that provides the highest returns at a given level of risk. Portfolios having these characteristics are known as a proficient portfolio. The inputs for portfolio analysis can be used to identify the set of efficient portfolios. From this set of efficient portfolios, the optimal portfolio has to be selected for investment. Harry Markowitz’s portfolio theory provides both the conceptual framework and the analytical tools for determining the optimal portfolio in a disciplined and objective way.

1.17.4 Portfolio Revision - may also be necessitate by some investor-related changes such as accessibility of additional funds, change in risk attitude, need of cash for
other alternative use. It has to be done scientifically and objectively so as to ensure the optimality of the revised portfolio.

1.17.5 Portfolio Evaluation – The objective of constructing a portfolio and revise it periodically is to earn maximum returns with minimum risk. It is the process which is concerned with assessing the performance of the portfolio over a choose period of time in terms of return and risk. This involves quantitative measurement of actual return realized and the risk born by the portfolio over the period of investment.

1.18 Venture Capitalists’ Portfolio Management

The investment process for the management of a portfolio of venture capital funds describe the system or method used by the fund manager to generate profits from a source of returns. The most suitable process for a given manager depends on his/her objectives and tolerances for risks. This means that trade-offs are unavoidable.

The main question to address in the investment process are the relevance of strategic asset allocation, the importance of selecting superior fund managers, the management of the right level of diversification, and the management of commitments for putting capital effectively to work. In modern portfolio theory the diversification of a portfolio within the mean-variance framework makes it possible to simultaneously enhance expected returns and reduce risks.

1.19 Portfolio Investment Process Description

The challenge of managing the investment Programe is generally characterized by the trade-off between the return drivers “selection” and “putting capital to work”. Being selective and only investing in few funds of top quality would maximize the expected returns, ignoring the undrawn commitments; being highly diversified would smooth the cash flows and therefore would allow a nearly full investment in venture capital, generating a higher total return at the expense of potentially losing extreme positive returns.

Typical investment objectives are to increase total portfolio return or to reduce total portfolio risk, or a mixture of both. For the management of a venture capital fund portfolio, we need to design an investment process that can deal with uncertainty as much as it addresses risk.
Source: Beyond the J-curve by Thomas meyer and Pierreyves Mathonet

1.19.1 Portfolio objectives

The preliminary point of the investment process is the definition of the portfolio objectives. These objectives will be set by, or need to be agreed with, the mandatory. Identifying trends in the market and how much money can be profitably invested is vital for the investment strategy and for target setting. The portfolio construction requires the identification of attractive segments and the best strategies. As with the structuring of funds, it is significant that the investment Programe manager also receives the proper incentives and that his/her interests are aligned with those of the mandatory. The effect of this analysis is a formalization of portfolio objectives.

1.19.2 Portfolio design

Based on these objectives, the Programe is prepared and the portfolio is designed. Modern portfolio theory provides the theoretical basis for investors’ acceptance of alternative assets in
general. The best practices for structuring portfolios of venture capital funds, namely the top-down, bottom-up and core-satellite approaches, and the rationale for naïve diversification.

1.19.3 Liquidity management and valuation

Liquidity management as one of the key in performance drivers, and link between the need to reliably project cash flows for resource optimization and the ability to fairly value the portfolio. Fair valuation is the by-product of a well-run portfolio management, rather than the end in itself often perceived.

1.19.4 Fund cash flows and valuation modeling process

Chart 1.4: Fund cash flows and valuation modeling process

Source: Beyond the J-curve by Thomas meyer and Pierreyves Mathonet

1.19.5 Monitoring

For a limited partner, monitoring is not only connected to the specific fund investments, but also needs to consider the overall composition of the relationships managed. On an ongoing basis limited partners need to monitor the composition of their portfolio, including identifying trends within the private equity markets and tracking their peer group’s allocations to venture capital.
Analyzing concentration across all partnerships in the portfolio, e.g. by industry, stage, geography, groups, vintage years and cross-holdings between funds, provide relevant insights. Stress tests can give early warnings signals and increase the transparency of the portfolio. Track overall commitment level, contributions and distributions, return on investment to date or expected returns on investment are also important for portfolio management.

1.19.6 Actions and Implementation

Co-investing, secondary transactions and restructuring of funds are ways of actively managing the portfolio. The main purpose of fund restructuring is to stop value destruction rather than creating an upside.

1.20 Risk Management

The approach to risk management for a portfolio of venture capital funds rests on the pillars measurement, control and mitigation.

1.20.1 Risk-measurement framework

When discussing return expectations and risk of any investment, the starting point is a proper valuation of an asset. There is a difference between an accounting rule-based valuation approach and the economic substance of a fund. Modeling the economic reality as closely as possible is key to efficient management. Typically funds are valued by valuing every singly portfolio company individually, aggregating these valuations to a portfolio value and, finally, by calculating the investor’s respective share in the fund.

1.20.2 Risk control

Theoretically, risk can be controlled quantitatively, by adjusting the returns for risk in the way that the financial markets price risk. However, there is no efficient risk-adjusted pricing for primary venture capital fund investing, as risks in this asset class are not well understood. The lack of data, the blind pool nature of the investments, and the fact that the whole universe is one of the highest risk categories make differentiation and quantification of risks difficult. For buy-and-hold investments, the quality of the asset determines the returns to the investor.
1.20.3 Risk mitigation

In principle, one can mitigate risks by choosing to avoid, to support, to control or to transfer them. Risk avoidance, or significant changes in investment proposals with special contract provisions, is the most commonly used approach in venture capital. By rigorously weeding out inferior proposals, investors hope to minimize risks.

Many risks in venture capital need to be assumed. A possible adverse impact can be mitigated through diversification or controlled through monitoring. On the fund portfolio level, risk transfer mechanisms, such as overdraft facilities, etc., are used in the context of the liquidity management, as this is mainly related to “traditional” instruments. Securitization is another risk transfer mechanism however; this is a financial engineering technique that is generally only applicable on a portfolio of funds level. For the venture capital investments themselves, a risk transfer is difficult to implement.

1.21 Venture Capital Risk

The inherent risks of entrepreneurial start-up firm’s decreases as these ventures grow as described in the following table.

As indicated in below table, the risk profile of the various stages is different. It is apparent that venture capital funds and business angels are instrumental in helping entrepreneurs realize their concepts and in creating and developing companies. This is especially true of cases which either because of a concept’s lack of maturity, or of a company’s critical development phase or targeted sector, may represent an unacceptable risk for a bank to lend. The venture capitalists need to have a sufficient expertise in high-technology sectors to be able to back start-ups. In supporting an early-stage investment a venture capital fund will accept the risk and intervene by taking equity participation, thus becoming part-owner of the concept or company. In so doing, the venture capital fund agrees to no security for its investment and demands no interest payments, instead it expects to achieve a return on its investment by the concepts or company’s eventual success and the consequent growth of the capital invested.
Table 1.4: Stage of investments and associated risks

<table>
<thead>
<tr>
<th>Start-up and early-stage investment Characteristics</th>
<th>Later-stage and MBO characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>• An idea</td>
<td>• Established business</td>
</tr>
<tr>
<td>• No income, only uncertain costs</td>
<td>• Predictable cash flow</td>
</tr>
<tr>
<td>• Customers and competitors unclear</td>
<td>• Customers and competitors known</td>
</tr>
<tr>
<td>• Commonly high-technology</td>
<td>• Proven technology</td>
</tr>
<tr>
<td>• One person or team with “Vision”</td>
<td>• More experienced management team</td>
</tr>
<tr>
<td>• Complex due diligence</td>
<td>• Due diligence</td>
</tr>
<tr>
<td>• Pricing very difficult</td>
<td>• Pricing possible</td>
</tr>
<tr>
<td>• “Hands-on critical”</td>
<td>• “Hands-off” venture capital style</td>
</tr>
<tr>
<td>• Illiquidity</td>
<td>• Potential liquidity</td>
</tr>
<tr>
<td>• Research &amp; monitoring costs/deal size ratio high</td>
<td>• Research &amp; monitoring costs/deal size ratio low</td>
</tr>
<tr>
<td>• Historically poor rates of return in Europe</td>
<td>• Historically favorable rates of return in Europe</td>
</tr>
<tr>
<td>• More investments needed to spread fund risk</td>
<td>• Fewer investments needed to spread fund risk</td>
</tr>
<tr>
<td>• Smaller deal sizes so more investment needed to invest total VC fund</td>
<td>• Larger deal sizes so fewer investment needed to invest total VC fund</td>
</tr>
<tr>
<td>• Long-term investment horizon</td>
<td>• Short-term investment horizon</td>
</tr>
<tr>
<td>• Outright failure frequent</td>
<td>• Outright failure rare</td>
</tr>
</tbody>
</table>

Source: http://www.bei.org/attachments/pj/vencap.pdf

1.22 Portfolio Design Framework

Modern Portfolio Theory

...it is almost impossible to use standard risk-return optimization models to determine the “right” allocation to venture capital because of the difficulty in estimating the correct risk premium for venture capital and the appropriate correlation with other asset classes.

Helen Steers (2002)

1.22.1 Bottom-up approach

As venture capital is characterized by a high spread between top-quartile and lower-quartile funds performance, investing in the asset class only makes sense with good selection skills. Therefore, generally, investors do follow a bottom-up approach, as it is widely believed that the quality of the fund management team is the over-riding criterion, much more important than sector or geographical diversification. The starting point of a bottom-up approach, also called “screening technique” is the identification of suitable investments, followed by an
intensive analysis and due diligence in order to rank the funds by their attractiveness. Then, the best funds are selected in order to invest all the capital allocated to venture capital.

The bottom-up approach has several attractive features. This approach, which is the most widely used, is simple, easy to understand and robust as it depends solely on ranking. It enhances the expected performance by concentrating the portfolio in the highest “alpha” funds, while it controls for risk by including a sufficient number of funds and by avoiding concentration in any single fund. However, the bottom-up approach is not without problems. As it is very opportunistic, it can lead to an unbalanced portfolio, carrying considerably more risk than expected.

**Chart 1.5: Bottom-up approach**

![Diagram of bottom-up approach](image)

*Source: Beyond the J-curve by Thomas meyer and Pierreyves Mathonet*

### 1.22.1 Top-down approach

The top-down approach gives priority to the choice of sectors, countries, fund styles or trends as opposed to individual fund selection. It could be argued that investors that follow a top-down approach put a stronger emphasis on managing the strategy, the asset allocation and the diversification of their portfolio.

The top-down approach takes the “big picture” as the starting point. One analyses the macroeconomic conditions, and then determines the strategic asset allocation, i.e. the combination of industry sectors, countries and fund style that will benefit most under the likely scenarios. Main criteria that are evaluated are the political, economic and currency risks, but also the extent to which the market has accepted equity as a form of financing and investment, and the degree to which the environment is conducive to entrepreneurial activity.

**Chart 1.6: Top-down approach**

![Diagram of top-down approach](image)

*Source: Beyond the J-curve by Thomas meyer and Pierreyves Mathonet*
1.22.3 Mixed approach

As together pure bottom-up and pure top-down approaches are not without problems, most investors follow a combined approach. Indeed, even a strong believer in the top-down approach would rarely invest in funds that are not of high quality just to fulfill its target allocation. Likewise, no “fund picker” would commit all its money to a single sector just because it has the opportunity to invest in outstanding teams. Investors are conscious of the importance of diversification, but instead of diversifying on the base of the correlation among the different asset classes, an approach that heavily relies on past information; they define their target allocation on the basis of the investment strategies of the funds where they invest. On the whole it is a top-down approach where the capital is allocated equally to the different asset classes without taking any view on their future evolution.

**Chart 1.7: Mixed Approach**

![Diagram showing mixed approach: top-down strategy research-based, fund manager research-based, diversification-risk control, selection skill-superior return]

*Source: Beyond the J-curve by Thomas meyer and Pierreyves Mathonet*
1.22.4 Portfolio Monitoring

Detailed asset allocations promote efficient diversification and eliminate the problems associated with random fund selection, but generally it is problematic to obtain equal weighting and at the same time be represented in key market segments.

1.23 Efficiency of Venture Capitalists Portfolio Management

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

Venture capital has emerged as a vital and leading source of financing today for entrepreneurial and early stage businesses. Several companies in India that received VC funding include Biocon, Ola, Uber, Bigbasket, Shoppers’ stop etc., VC backed firms add to the economy through the creation of jobs, an exceptional growth rate, their heavy investments, and their international expansion (Romain and Potterie, 2004).

This research provides information on how venture capitalists contribute to the portfolio companies in value creation and to improve their efficiency that they have invested in, investment evaluation criteria they adopt for decision making, risk return relationship of venture capital, success and failure factors of portfolios.

\textsuperscript{21} Report of K.B. Chandrasekhar Committee on Venture Capital