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VENTURE CAPITAL FINANCING PROCESS IN INDIA: A STUDY OF SELECTED VENTURE CAPITAL FIRMS

Dr. Naseeb Ahmad[1]

[1]Sr. Assistant Professor
Department of Commerce and Business Studies,
Jamia Millia Islamia
(Central University),
New Delhi – 110025, India

ABSTRACT

The paper is attempted to analyze and understand the various issues inherent in venture capital financing process of selected venture capital firms. The study is based on primary data collected from selected venture capital firms operating in India. The paper is focused towards examining the various aspects of financing process in order to understand if the firms' investment preferences are homogenous across various categories of venture capital firms.

KEY WORDS: *Venture Capital, Venture Capital Process, Venture Capital Financing*

INTRODUCTION

The venture capital firms are concerned with the safety of their investments and possibilities of a higher return on investment. It is obvious that Venture capital firms do not blindly fund all the proposals that come across. Instead they follow a due process to appraise and select ventures. The success of a venture capital firm depends to a great deal on their ability to select proposals that may prove to be successful. The Venture Capitalist's have developed procedure and models for doing the same.

OBJECTIVES

The study undertaken is aimed to get an insight into the venture capital financing process and mechanism and to understand the investment philosophy and preferences of selected venture capital firms operating in India

METHODOLOGY

The study is based on data collected from a sample of 38 venture capital firms operating India. The sample, selected is small and non-representative. The primary data are qualitative in nature and are analyzed accordingly.

Proposal Selection Rate and Time Lag:-

It has been rightly said that time taken in making decision to finance a venture is of business essence; the entrepreneurs seeking VC funding are often quite impatient people waiting a decision from venture capitalist (VC) in no time. On the other hand, VCs have to follow a due diligence process and will have to carefully weigh the risk and return involved in a proposal, which clearly is a long and time consuming process. However, it is also the efficiency of the VCs, which determine the speed with which they appraise a proposal and arrive at a final decision. Evaluated from this point of view, the time required in VC appraisal was found to be in a range of 4 to 20 weeks. It was observed that 63.2% (24) of the firms on an average take 16-20 weeks in evaluating a proposal for investment, 34.2% (13) firms require 12-16 weeks and only one firm was quick enough to evaluate a proposal in a short period of up to 4 weeks. However in general the VCs reported that the time depends on the quality of proposals are evaluated and rejected in a short period of time whereas good and promising proposals usually requires more time for further probe.

It is often said that the VCs have difficulty in finding good proposals to fund, but it would also be wrong to assume that every business plan that they receive, would get funding. The proposal evaluation and selection criteria of VCs were found to be stringent as 68.4% (26) of the firms reported to select/ accept only 0-3% of the proposals they come across and 31.6% of the firms reported to select only 3-5% of the proposals for funding.

Table 1.1: Proposal Selection Rate and Time Lag

Time lag	Frequency	%
Up to 4 weeks	1	2.6
12 - 16 weeks	13	34.2
16 - 20 weeks	24	63.2
Total	38	100.0
Selection Rate		
0 - 3%	26	68.4
3 - 5%	12	31.6
Total	38	100.0

Proposal Selection Rate and Time Lag:-

H1: There is no significant difference between Appraisal Time and Selection Rate

The time required by VC's in evaluating the proposals and the proportion of the proposals accepted for funding were examined across the various characteristic feature of VC firms to find if there is any significant difference.

Table 1.2: Appraisal Time and Selection Rate

	X^2	C	Df	P
Firm Type				
Time Lag in appraisal	9.723[a]	0.451	6	0.137
Proposal Selection Rate(%)	7.294[a]	0.401	3	0.063
Firm Domicile				
Time Lag in appraisal (%)	5.071[a]	0.343	2	0.079
Proposal Selection Rate (%)	0.197[a]	0.072	1	0.658
Form of Organisation				
Time Lag in appraisal	7.143[a]	0.398	6	0.308
Proposal Selection Rate (%)	1.715[a]	0.208	3	0.634
SEBI Registration				
Time lag in appraisal	3.842[a]	0.303	2	0.146
Proposal selection Rate (%)	3.623[a]	0.295	1	0.057
IVCA Membership				
Time lag in appraisal	0.935[a]	0.155	2	0.627
Proposal Selection Rate (%)	0.554[a]	0.120	1	0.457
Fund Size				
Time Lag in appraisal	66.236[a]	0.797	58	0.214
Proposal selection Rate (%)	29.515[a]	0.661	29	0.439
Year of Establishment				
Time lag in appraisal	1.925[a]	0.220	2	0.382
Proposal selection rate (%)	0.093[a]	0.049	1	0.761

*** Significant at P<0.01 level of significance*

** Significant at P<0.05 level of significance*

It is observed that the Chi square values are not significant at P<0.01 level of significance and Significant at P<0.05 level of significance for Appraisal Time and Proposal Selection Rate across various features of VC firms, there by ***accepting the hypotheses,*** thus, there is no significant difference between appraisal time & different features like location, type of firm, firm domicile, form of organisation, SEBI Registration, IVCA Membership, Fund Size and Year of Establishment. However, it is found that there exist some difference in terms of appraisal time and firm domicile. It is observed that 82% (14 out of 17) domestic firm take more time(18-20 week) in taking decision, whereas foreign firms take less time(12-16 week) in taking decision by 47.61% of firms(10 out of 21 firms). Further, it found that there is no significant association between proposal selection rate & different features like location, type of firm, firm domicile, form of organisation, SEBI Registration, IVCA Membership, Fund Size and Year of Establishment. It is also noted those in terms of proposal selection rate of 0-3% is preferred by 92.86% of firms (26 out of 38). Further, it comprise of 65.38% as Private Independent firms (17 out of 26 firms). There were only 11 firms out of 38 having SEBI Membership. Out of 11 firms 10 firms indicated proposal selection rate of 90.90%, whereas 40.74% (11 out

of 27) firms who do not had SEBI membership, indicated proposal selection rate of 3-5%.

Investee Selection Mode and Preferences

It is assumed that VC firms differ in terms of mode selection of entrepreneur, as is noticed from table 1.3 that most the VC prefers direct contact (100%), followed by other entrepreneur (94.7%), referred by intermediaries (63.2%) and only 36.8% prefer reference by other entrepreneur.

Table 1.3: Investee Selection and Preference

Parameters	Always	Mostly	Rarely	Never	Rank
Mode of selection of Entrepreneur					
Direct contact by the entrepreneur	32 (84.2%)	6 (15.8 %)			1
Referred by another VC	3 (7.9%)	36 (86.8 %)	2 (5.3%)		2
Referred by another Entrepreneur		14 (36.8%)	23 (60.5%)	1 (2.6%)	4
Referred by intermediaries		24 (63.2 %)	14 (36.8%)		3

Type of firm and Investee selection:-

H2: There is no significant difference between Firm Type and Investee Selection

To test the above hypothesis Chi Square was carried out between firma type and Entrepreneur selection he results are given in table;

Table 1.4: Type of Firm & Investee Selection

Mode of selection of Entrepreneur	X2	C	Df	P
Direct contact by the entrepreneur	1.360[a]	0.186	3	0.715
Referred by another VC	13.464[a]	0.511	6	0.036**
Referred by another Entrepreneur	22.363[a]	0.609	6	0.001*
Referred by intermediaries	1.773[a]	0.211	3	0.621

*** Significant at P<0.01 level of significance, * Significant at P<0.05 level of significance*

It is noted that Chi Square values of **22.363** for referred by another entrepreneur and Chi Square value of **13.464** for referred by another VC are significant at P<0.01 and P<0.05 level of significance, hence the hypothesis is ***rejected,*** there by confirming that there exist significant difference amongst type of firm and Mode of selection of Entrepreneur, referred by another VC and another Entrepreneur. The cross tabulation shows that there are 26 Private Independent firms out which only 2 firms (8%) are rarely referred by VC, whereas all other types of firms i.e., Affiliate/Subsidiary of Bank/Fin Inst., Affiliate/Subsidiary of Non-Financial Corp, and Govt. Affiliated are always or mostly referred by VCs(100%). All most all type of firms is always or mostly referred (100%) by entrepreneur and only in the case of Govt., Affiliated firms only 50% are referred by entrepreneur.

Domicile and investee selection:-

H3: There is no significant difference between Firm Domicile and Investee selection

To test the above hypothesis Chi Square was carried out between Firm Domicile and Entrepreneur selection and the results are given in table;

Table 1.5: Firm Domicile & Investee Selection

Mode of selection of Entrepreneur	X2	C	df	P
Direct contact by the entrepreneur	0.375[a]	0.099	1	0.540
Referred by another VC	0.187[a]	0.070	2	0.911
Referred by another Entrepreneur	0.981[a]	0. 159	2	0.612
Referred by intermediaries	2.343[a]	0. 241	1	0.126

It is observed that Chi Square values are not significant at P<0.01 and P<0.05 level of significance, hence the hypothesis is ***accepted,*** there by confirming that there exist no specific association amongst firm domicile and Entrepreneur selection. Almost 100% of domestic (17 firms) and foreign firms (21firms) had indicated that they prefer Direct contact by Entrepreneur (mostly or always).

Form of organisation and investee selection:-

H4: There is no significant difference between Form of Organization and Investee selection

To test the above hypothesis Chi Square was carried out between Form of Organization and Entrepreneur selection and the findings are given in table:

Table 1.6: Form of organization and Investee selection

Mode of selection	X2	C	Df	P
Direct contact by the entrepreneur	9.120[a]	0. 440	3	0.028*
Referred by another VC	3.658[a]	0. 296	6	0.723
Referred by another Entrepreneur	13.114[a]	0.507	6	0.041**
Referred by intermediaries	0.210[a]	0.074	3	0.976

*** Significant at P<0.01 level of significance, * Significant at P<0.05 level of significance*

It is noted from the table 1.6 that Chi Square value for refer by another entrepreneur is **13.11** and Chi square Values of **9.12** for direct contact by entrepreneur are significant at P<0.01 and P<0.05 level of significance; hence the hypothesis is **accepted**, there by confirming that there exist specific preference amongst form of organization. Almost all form of organizations (100% by all firm type i.e, Partnership, LLP, Pvt. Limited Company and Public Limited Company) has almost or mostly preferred direct contact by entrepreneur. Almost 52% to 100% of the firms are rarely referred by another entrepreneur.

Year of establishment and Investee selection:-

H5: There is no significant difference between Year of Establishment and Investee selection

To test the above hypothesis Chi Square was carried out between Year of Establishment and Entrepreneur selection and the results are given in table:

Table 1.7: Year of Establishment and Investee Selection

Mode of selection of Entrepreneur	X2	C	Df	P
Direct contact by the entrepreneur	0.530[a]	0.117	1	0.467
Referred by another VC	0.168[a]	0.066	2	0.919
Referred by another Entrepreneur	2.031[a]	0.225	2	0.362
Referred by intermediaries	0.012[a]	0.018	1	0.912

It is noted that Chi Square values are not significant at P<0.01 and P<0.05 level of significance, hence the hypothesis is ***accepted***, there exist no specific preference of firm and year of establishment. 84% of the firms (32 out of 38) irrespective of year of establishment prefer direct contact by entrepreneur, 88% of the firms (21 out of 24 firms) with more than 5years of establishment, prefer direct contact by entrepreneur.

Size of fund and Investee selection:-

H6: There is no significant association between Fund Size and Investee Selection

To test the above hypothesis Chi Square was carried out between Fund Size and Entrepreneur Selection and the findings are given in table:

Table 1.8: Fund size and Investee selection

Mode of selection	X2	C	Df	P
Direct contact by the entrepreneur	29.296	0.659	58	0.453
Referred by another VC	59.015	0.780	58	0.438
Referred by another Entrepreneur	48.365	0.748	58	0.812
Referred by intermediaries	32.270	0.678	58	0.308

It is evident from the table that Chi Square values are not significant at P<0.01 and P<0.05 level of significance, hence the hypothesis is ***accepted***, there exist no specific preference for Entrepreneur Selection by firm and Fund size.

SEBI registration and Investee selection:-

H7: There is no significant difference between SEBI Registration and Investee Selection

To test the above hypothesis Chi Square was carried out between SEBI Registration and Entrepreneur Selection and the findings are given in table;

Table 1.9: SEBI Registration and Investee selection

Mode of selection	X2	C	df	P
Direct contact by the entrepreneur	1.535[a]	0.197	1	0.215
Referred by another VC	1.683[a]	0.206	2	0.431
Referred by another Entrepreneur	0.811[a]	0.145	2	0.667
Referred by intermediaries	4.777[a]	0.334	1	0.029**

*** Significant at P<0.01 level of significance, * Significant at P<0.05 level of significance*

It is observed that Chi Square value of 4.777 is significant at P<0.05 level of significance, hence the hypothesis is ***rejected***, there exist specific preference of entrepreneur selection by VC firm and SEBI Registration. There are only 28% firms having SEBI registration, 36% of SEBI registered firms(4 out of 11) are mostly referred by intermediaries, whereas VC firms not having SEBI registration are mostly referred by 74% firms(20 out of 27 Firms).

Monitoring Methods:-

The monitoring and mentoring of investee firm is an important element of VC financing process. The VCs generally prefer to be involved in decision making process and like to nurture the firms to help it grow. The various monitoring methods were ranked in a four point scale (1=Never and 4 = Always). In the study, it has been found that all the responding firms always prefer to have a representation in the board of investee firm. The other mode of monitoring was to have a regular feedback reports and statements covering the operational and financial issues. The occasional visit to the investee firm is also found to be a mode of mentoring and monitoring the progress of the investee firm and strengthening the bond of relationship.

Table 1.10: Preferred Monitoring Modes

Mode of Monitoring	Always	Mostly	Sometimes	Never
By nominating Director on the Board of the Investee	97.4	2.6		
Feedback through periodical reports/ statements	76.3	23.7		
Personal Visits	18.4	50	31.6	

It is noted from above table that monitoring mode preferred is by Nomination (97.4%), by feedback reports/statement (76.3%) and personal visit (18.4%). The personal visits are preferred sometime by 31.6% of the firms.

Table 1.11: Monitoring mode across various features of VC Firms

Monitoring Methods	X^2	C	df	P
Firm Type				
Monitoring by nominating director on the board of the investee	0.474[a]	0.111	3	0.925
Personal visits	6.382[a]	0.379	6	0.382
Feedback through periodical reports / statements	8.280[a]	0.423	3	0.041**
Firm Domicile				
Monitoring by nominating director on the board of the investee	1.269[a]	0.180	1	0.260
Personal visits	1.120[a]	0.169	2	0.571
Feedback through periodical reports / statements	0.000[a]	0.003	1	0.984
Form of Organisation				
Monitoring by nominating director on the board of the investee	0.534[a]	0.118	3	0.911
Personal visits	7.271[a]	0.401	6	0.297
Feedback through periodical reports / statements	4.473[a]	0.325	3	0.215
Year of Establishment				
Monitoring by nominating director on the board of the investee	1.761[a]	0.210	1	0.185
Personal visits	0.495[a]	0.113	2	0.781
Feedback through periodical reports / statements	4.508[a]	0.326	1	0.034
Fund Size				
Monitoring by nominating director on the board of the investee	38.000[a]	0.707	2	0.122
Personal visits	57.500[a]	0.776	58	0.494
Feedback through periodical reports / statements	29.701[a]	0.662	29	0.429
SEBI Registration				
Monitoring by nominating director on the board of the investee	0.418[a]	0.104	1	0.518
Personal visits	5.502[a]	0.356	2	0.064
Feedback through periodical reports / statements	0.110[a]	0.054	1	0.740
IVCA Membership				
Monitoring by nominating director on the board of the investee	0.747[a]	0.139	1	0.387
Personal visits	4.359[a]	0.321	2	0.113
Feedback through periodical reports / statements	0.026[a]	0.026	1	0.871

*** Significant at P<0.01 level of significance, * Significant at P<0.05 level of significance*

The monitoring methods were examined for any statistical significance across various characteristic features as mentioned in table 1.12 No significant difference has been observed on only Firm type of VC firms and monitoring mode. Almost all type of firm prefer Personal visit (100%) as a mode of monitoring.

Type of firm and monitoring mode:-

H1: There is no significant difference between Firm type and Monitoring Mode

To test the above hypothesis Chi Square was carried out between Firm type and Monitoring Mode and the findings are given in table

Table 1.12: Firm type and Monitoring Mode

Mode of Monitoring	X2	C	Df	P
By nominating Director on the Board of the Investee	0. 474[a]	0.111	3	0. 925
Feedback through periodical reports/ statements	6.382	0.379	6	0.382
Personal Visits	8.280[a]	0.423	3	0.041**

*** Significant at P<0.01 level of significance, * Significant at P<0.05 level of significance*

It is noted from the table that Chi Square value of 8.28 for personal visit as mode of monitoring and Firm Type is significant at P<0.05 level of significance; hence the hypothesis is **rejected**, there by confirming that there exist specific preference amongst firm type and monitoring methods. The 81 %(21 out of 26) Private Independent firms always prefer personal visits. None of the Govt. firm always prefer personal visit, though all the Govt. firm mostly prefer personal visits. The 100 % (4 out of 4 firms) Affiliate/Subsidiary of Non-Financial Corp firms always prefer personal visit.

Domicile and monitoring mode:-

H2: There is no significant difference between Firm Domicile and Monitoring Mode

To test the above hypothesis Chi Square was carried out between Firm domicile and Monitoring Mode and the findings are given in table:

Table 1.13: Firm Domicile and Monitoring Mode

Mode of Monitoring	X2	C	df	P
By nominating Director on the Board of the Investee	1.269[a]	0.180	1	0.260
Feedback through periodical reports/ statements	1.120[a]	0.169	2	0.571
Personal Visits	0.000[a]	0.003	1	0.984

It is noted from the table that Chi Square values are not significant at P<0.01 and P<0.05 level of significance, hence the hypothesis is **accepted**, that there exist no specific association between Firm Domicile and Monitoring mode.

Form of organisation and monitoring mode:-

H3: There is no significant difference between Form of Organisation and Monitoring Mode

To test the above hypothesis Chi Square was carried out between Form of Organisation and Monitoring Mode and the findings are given below:

Table 1.14 Form of organization and Monitoring Mode

Mode of Monitoring	X2	C	df	P
By nominating Director on the Board of the Investee	0.534[a]	0.118	3	0.911
Feedback through periodical reports/ statements	7.271[a]	0.401	6	0. 297
Personal Visits	4.473[a]	0.325	3	0.215
Any Other				

It is noted from the table that Chi Square values are not significant at P<0.01 and P<0.05 level of significance, hence the hypothesis is ***accepted***, there exist no specific association between Form of organization and Monitoring mode.

Return Expectations:-

A traditional venture capital funds are usually limited partnerships. This means that the fund managers only get to invest the money once. If they make an investment and exit for a 3 to 4 times return, they have to give the principle and gains back to the venture capital fund's investors. They don't get a chance to invest it again. From the VC partner's perspective, this effectively guarantees they have failed. Thus, Venture capital is commonly called risk capital due to high level of risk involved in such investments. The return expectations of the VCs are high commensurate with the risk factors. The level of risk varies across various stages and so the return expectations.

In the study, the respondents were asked about the return expectations in terms of Internal Rate of return (IRR) across different stages of investment. The majority of VCs (71.1%) reported to expect a return more than 40% at seed stage. In case of first/ early stage 40% of the funding.

Table 1.15: Expected Return (IRR) at Various Stages

Return Expected	Seed / Startup	First /Early Stage	Second/ Later Stage	Expansion	Turn around	PIPE	Overall
20-25%							
25-30%				1 (2.6)		1 (2.6)	
30-35%			12 (31.6)	16 (42.1)	17 (44.7)	29 (76.3)	9 (23.7)
35-40%	11 (28.9)	15 (39.5)	24 (63.2)	21 (55.3)	21 (55.3)	8 (21.1)	25 (65.8)
>40%	27 (71.1)	23 (60.5)	2 (5.3)				4 (10.5)

The expected return (IRR) at various stages reported by VC Firms is presented below

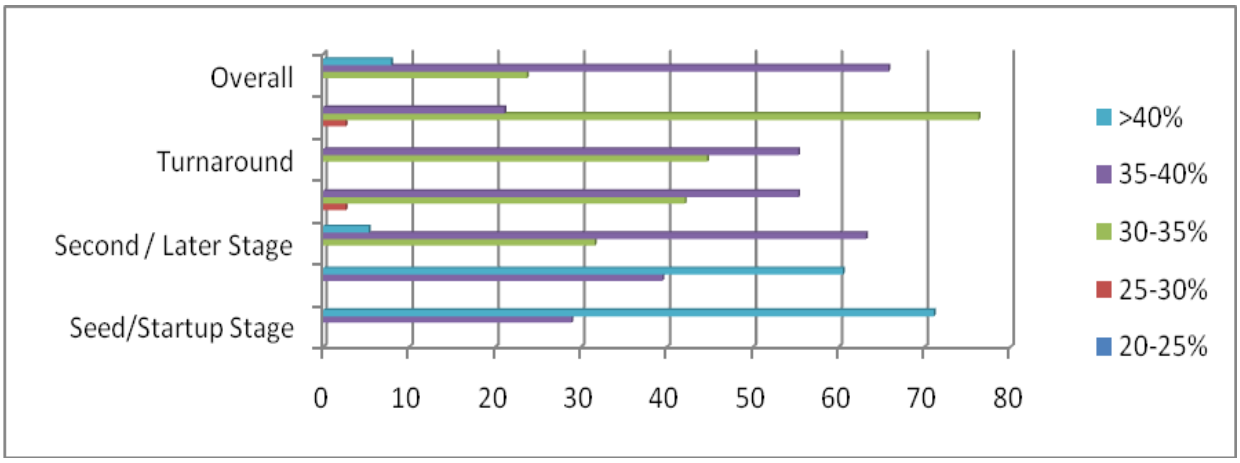

Fig 1.1 Expected Return (IRR) at Various Stages Reported by VCF

Firm type and expected return:-

H1: There is no significant difference between Firm type and Expected Return (IRR)

To test the above hypothesis Chi Square was carried out between Firm type and Expected Return (IRR) and the findings are given in table:

Table 1.16: Firm Type and Expected Return (IRR)

Stage of Funding	X2	C	Df	P
Seed / Startup	7.426[a]	0.404	6	0.059
First /Early Stage	3.953[a]	0.307	6	0.267
Second/ Later Stage	6.851[a]	0.391	6	0.335
Expansion	9.469[a]	0.447	6	0.149
Turn around	4.682[a]	0.331	6	0.197
PIPE	20.760[a]	0.594	6	0.002*
Overall	7.533[a]	0.411	6	0.274

It is noted from the table that Chi Square values of **20.760** are significant at P<0.01 level of significance, hence the hypothesis is **rejected**, and that there exist significant difference between Firm Type and Expected Return for PIPE. 50% of the Affiliate/Subsidiary of Non-Financial Corp VC firms (2 out of 4 firms) prefers 35%-40% of Return in PIPE (Private Investment in Public Enterprise). Further, 76% of the VC firms(29 out of 38) prefer Return on investment in the range of 3-%-35% in PIPE stage, only Govt affiliated firm(1 out of 2 firms) prefer a return of 25%-30% in PIPE Stage. However, 100% Govt. Affiliated firm (2 out of 2 Firms) expect 35-40% return, whereas 81 % (21 out 26 Firms) Private Independent firms expect more than 40% return on investment.

Domicile and expected return:-

H2: There is no significant difference between Firm Domicile and Expected Return

To test the above hypothesis Chi Square was carried out between Firm Domicile and Expected Return (IRR)and the findings are given below

Table 1.17: Firm Domicile and Expected Return (IRR)

Stage of Funding	X2	C	df	P
Seed / Startup	0.003[a]	0.009	2	0.955
First /Early Stage	0.225[a]	0.077	2	0.635
Second/ Later Stage	0.080[a]	0.046	2	0.961
Expansion	0.886[a]	0.151	2	0.642
Turn around	0.158[a]	0.064	2	0.691
PIPE	1.963[a]	0.222	2	0.375
Overall	0.711[a]	0.137	2	0.701

It is noted from the table that Chi Square values are not significant at P<0.01 and P<0.05 level of significance, hence the hypothesis is ***accepted***, that there exist no specific association between Firm Domicile and Expected Return.

Form of organisation and expected return:-

H3: There is no significant difference between Form of Organization and Expected Return (IRR)

To test the above hypothesis Chi Square was carried out between Form of Organizationand Expected Return (IRR) and the findings are given below

Table 1.18: Form of organization and Expected return (IRR)

Mode of Monitoring	X2	C	df	P
Seed / Startup	1.665[a]	0.205	6	0.645
First /Early Stage	3.288[a]	0.282	6	0.349
Second/ Later Stage	2.280[a]	0. 238	6	0.892
Expansion	4.382[a]	0.322	6	0.625
Turn around	3.484[a]	0.290	6	0.323
PIPE	11.583[a]	0.483	6	0.072
Overall	4.599[a]	0.332	6	0.596

It is noted from the table that Chi Square values are not significant at P<0.01 and P<0.05 level of significance, hence the hypothesis is ***accepted***, that there exist no specific association between Form of Organization and Expected Return.

Fund size and expected return:-

H4: There is no significant difference between Fund Size and Expected Return (IRR)

To test the above hypothesis Chi Square was carried out between Fund Sizeand Expected Return (IRR) and the findings are given in table 1.20

Table 1.19: Fund Size & Expected Return (IRR)

Stage of Funding	X2	C	df	P
Seed / Startup	27.466	0.648	29	0.546
First /Early Stage	31.024	0.670	29	0.364
Second/ Later Stage	55.417	0.770	58	0.572
Expansion	43.692	0.731	58	0.918
Turn around	31.259	0.672	29	0.353
PIPE	49.274	0.751	58	0.786
Overall	56.404	0.464	56	0.777

It is noted from the table that Chi Square values are not significant at P<0.01 and P<0.05 level of significance, hence the hypothesis is **accepted**, that there exist no specific difference between Fund Size and Expected Return.

CONCLUSION

It has been found that the venture capital firms follow a meticulous and systematic process to select and finance a firm. The present study reveals that on an average 16-20 weeks is being the time lag in appraising a project, while no more than 0-3% of the proposals finally gets funded by the venture capital firms, as the rest of the firms do not meet the stringent criteria. The findings in the paper are based on the perception of the entrepreneurs and investee firms with respect to the venture capital financing process.

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