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VENTURE CAPITAL FINANCING IN INDIA: AN ANALYSIS OF PROBLEMS AND PROSPECTS

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ABSTRACT
The capitalist often tussle to find start-up capital which is not easily either available or focused on service businesses with lower risk and early recovery of revenue. To overcome this financing hurdle, the government are taking number of tactics to provide required access to infrastructure. The capitalist incline to be innovative and will also aid to produce solution to India's myriad social problems comprise of high- quality education, affordable health care, energy and waste management, and financial inclusion. Venture capital is emerging a main source of finance especially for newly start-up innovative business model where higher risk factor is associated with it. In the present study authors aims to describe intricacies of venture capital fund, issues and challenges associated with it from 1970- 2017 by using secondary data. The study showed that there were so many fluctuations in VCF's due to several reasons like regulatory pattern, higher risk, complexity in understanding the phenomenon and other issues associated with it.

KEYWORDS: *Venture Capital, Finance, Start- Up, Innovative Business and Financial Inclusion.*

1.0 INTRODUCTION

Setting up a business is a formidable task. There are plenty of challenges that an entrepreneur has to face. Raising start-up capital for a business venture has always been a bigger challenge for aspiring entrepreneur. Venture Capital has long been a significant source of funding for entrepreneurs and start-ups. Venture Capital is the financial assistance provided to start-up companies, which are potentially capable for achieving growth over a period of time and sustain the growth in the long run due to their distinct and unique business model. Venture capitalists and Venture Capital funds earn money by investing in these companies by way of owning a part of their equity capital. Venture capital is of much importance to the start-ups because they lack credibility and do not have access to capital markets. VC funds identify their growth potential and provide financial assistance for nurturing and successful execution of the business ideas of these start-ups.

Venture Capital has been in existence all over the world since a long time. In Indian context, it has an equal importance. Today, Indian economy is seen as an economy that has tremendous opportunities, yet it comprises of many industries that have reached their saturation point. Industries such as Information technology and Telecom are already saturated due to intense competition. This has limited the scope of growth. An increase in the number of saturated sectors in the economy and limited opportunities in the market has made way for new innovative ideas and business strategies to take place of the old ones.

There are typically six stages of VC Financing- Seed Funding, Start-up, First round (growth), second round, Expansion, Exit of Venture Capitalist. Venture

Capitalists look for only those business ventures which fit their investment criteria, after completing extensive due diligence. VCs may have different approaches to analyse their investments in a particular venture. A venture capitalist may ask prospective business for information regarding their product and services, their business model, operations and most importantly, the management of the company.

1.1 Private Equity vs. Venture Capital

Venture capital can be considered as a segment of private equity. The difference between private equity and venture capital can be understood in simple terms as private equity investors prefer fairly mature companies to invest in, which maybe underperforming or undervalued, with the goal of improving their profitability and getting a return on their investments. Venture capital, on the other hand, targets early stage and high potential companies which can expand quickly over a period of time, with the objective of nurturing them and help them to grow rapidly.

In other words, private equity is the capital that is invested in private companies i.e. those companies whose shares or units are not traded publicly, whereas, in the case of venture capital, the Venture Capitalists investing in the company may take the company to the public and raise more funds. The venture capitalists then sell their stake in the company at higher prices, thus exiting the company.

2.0 PRESENT STATE OF KNOWLEDGE

To develop better understanding with Venture Capital Financing, the researcher presented review of available literature categorically.

A) Venture Capital and Total Factor Productivity

Chemmanur et al. (2011) examined the relationship between the use of venture capital and Total factor productivity growth, and they found that companies financed by venture capital already had higher TFP growth in the years prior to obtaining venture capital. Moreover, they observed that obtaining venture capital financing was associated with continued higher TFP growth. Other authors highlighted the relationship between venture capital and innovation, for example Hellmann and Puri (2000) showed that the firms more likely to obtain venture capital financing were the ones using innovation strategies. Also, they showed that venture capital backed companies brought their products on the market faster. This effect was more significant for innovator companies, where time to reaching the market is likely to be of greater strategic importance. Puri and Zarutskie (2011) found that venture capital investors fund companies with no initial revenues but only if they demonstrate stronger growth potential. Lindsey (2008) also examined the relationship between venture capital financing and the formation of strategic alliances. The author showed that companies that have a common venture capital investor are more likely to form strategic alliances. Moreover, such alliance formation is associated with better exit performance. Apart from the analysis of how venture capital impacts innovation it is important to examine how venture capital impacts the new value creation, such as new entry on the markets, employment, and company growth. Hirukawa and Ueda (2008) found no significant relationship between the use of venture capital and an industry's total factor productivity (TFP) growth, although they did find a positive relationship between venture capital and labour productivity.

B) Venture Capital Financing and Start-ups

Samila and Sorenson (2011) using panel data examined the relationship between venture capital financing and the number of start-ups, employment and income. As a result, they found a positive relationship between venture capital financing and all these variables across a variety of model specifications. Also, they showed that increases in venture capital investments determined the increase of new business creation. Following the same line of thinking Popov and Roosenboom (2008) found that higher levels of venture capital investment were associated with more entry on the market, especially in industries with high investments in research and development. Also, they demonstrated the existence of a positive correlation between venture capital, new entry on the market and employments growth. Other researches sustain these findings, for example Chemmanur et al. (2011) found a positive effect of venture capital on company productivity.

Davila et al. (2003) and Engel and Keilbach (2007) also found a positive effect of venture capital on employment. So it can be observed that the specialized literature consistently finds a positive relationship between venture capital financing and other measures of economic value creation. Puri and Zarutskie (2011) showed that venture capital backed companies grow faster at every stage of the investment cycle, both before and after the receipt of venture capital. Winton and Yerramilli (2008) and Ueda (2004) compared venture capital financing with bank financing showing that venture capital investors have better ability to monitor the firm's activity, but on the other hand they demand higher returns. In contrast, banks are less skilled at monitoring, but demand lower returns from entrepreneurs because they themselves face lower funding cost by exposing themselves to liquidity shocks. Venture capital financing is optimal only if firms face highly risky and positively skewed project cash flows, with low probability of success, low liquidation value, and high returns if successful, and if they face highly volatile cash flows across two continuation strategies.

C) Venture Capital Financing, Buyout and Relation With Patent :

Metrick and Yasuda (2009) inferred that one reason why BO funds tend to perform better than VC funds is that the former are more scalable, leading to significantly higher revenue per investment professional. However, there are also contradictory views about optimal PE fund sizes, indicating that too large funds may underperform relative to their smaller peers. Walske and Zacharakis (2009) showed that nascent VC firms founded by managers having prior venture capital or senior management experience were more likely to raise subsequent funds. Following the reasoning that experience has a strong impact on performance, there is an expectation that the returns from a subsequent fund will be in line with, or better than, the previous fund's return.

Mann and Sager (2007) showed that companies that had more patents obtained more venture capital investments. They also found that venture capital backed companies with more patents obtained higher valuations, especially in earlier rounds. To support this idea, Kortum and Lerner (2000) provide a systematic assessment of the fact that venture capital promotes innovation, examining the relationship between venture capital financing and patenting. By analysing firms of US manufacturing industries, they found that venture capital financing was associated with sectors that have higher contemporaneous patent production. Having more patent applications increases the chances of the company obtaining venture capital financing (Engel and Keilbach, 2007).

The Indian economy is indeed in need of long term capital. In the last few years, Private equity investment remained one of the major sources to meet this requirement. The economic downturn since 2008 has lowered public sentiments. As a result, raising public money remains a concern for Indian industries. Rising inflation over a last few years also has significantly reduced the disposable income of the general public for investment in public equity.

Currently, Ease of Doing Business is one of the important initiatives run by the Government and is crucial to the success of various initiatives such as Make in India, Start-up India, Digital India, etc. In the current global environment, where capital is scarce and there are countries competing for attracting the same capital, it is important to make India an investor-friendly destination. Venture capital is one of the major sources of finance for start-ups which comes with the innovative ideas and supports the initiatives taken by the government. Concerned with this problem, the researcher needs to study intricacies, challenges and pertinent issues faced by a venture capitalist.

3.0 OBJECTIVES OF THE STUDY

- To study the intricacies of venture capital fund.
- To describe the issues and challenges faced by venture capitalist.

4.0 RESEARCH METHODOLOGY

In the concerned study researchers used the secondary data over the period from 1970-2017. The Secondary data has been collected from various research papers, working papers, journals, articles related to concerned problem and through websites.

5.0 RESULTS AND DISCUSSION

5.1 Intricacies of venture capital financing in India:

Venture capital plays an essential role in the growth and advancement of innovative entrepreneurship in India. Before 1997, private equity (PE) market was very narrow and mostly grounded in official funding from the government and international agencies like IMF and World Bank etc. The PE expansion was recognized at the time of dotcom boom with entry of foreign institutional investors (FIIs) (Adilakshmi and Jampala, 2007). After IT bubble in the year 2000, the seed stage funding declined and again it started recovering during 2004.

In India, Evolution of venture capital dates in the early 70's when Government of India (GOI) appointed a committee under the chairmanship of Shri R.S.Bhatt, suggested the ways to fill a gap in conventional financing available for start-up companies with innovative technologies and also recommended to start the venture capital financing in India. It was first started in 1975 with the setup of Industrial Finance Corporation of India (IFCI) sponsored Risk capital foundation (now known as IFCI Venture capital Fund Ltd.).

In 1976, a scheme announced by the Industrial Development Bank of India (IDBI) which popularly known as Seed Capital scheme and by the year 1984, it took the form of risk and seed capital (Chary, 2005). A venture capital fund was set up 1985 for providing equity capital for projects attempting commercial applications of the indigenous technology by GOI (Nigam, 2001). But it got the statutory recognition when fiscal budget 1986-87 was introduced and 5 per cent cess levied on all know how import payments to create a pool of funds for venture capital activities initiated by IDBI (Pandey, 1996). IDBI introduced venture capital fund scheme for financing ventures seeking development of indigenous technologies or adoption of foreign technologies to wider domestic application. Correspondingly, ICICI in association with unit trust of India formed a venture capital subsidiary technology development and Information Company of India (TDICI) for financing technology oriented innovative companies.

In November 1988, government of India decided to institutionalize venture capital industry and formulated first comprehensive guidelines governing the venture capital fund which is popularly known as controller of capital issues for venture capital implemented by controller of capital issues. These guidelines were very restrictive and following a very narrow definition of VC (Varshney, 2006). Even under these guidelines, only national level financial institutions and scheduled commercial banks were allowed to set up VC funds (Ramesh and Gupta, 2005). An advisory committee headed by Dr. Ashok Lahiri reported in its report Technology Innovation and Venture Capital that internationally venture capitalists willing to take high risk in the expectation of high return on investment. Further, these guidelines required to invest venture capital in a n innovative technologies done by first generation entrepreneur (Verma, 1997).

Following these guidelines venture capital became more risky and unattractive source of capital. Continuing with the period of 1989 world bank started awareness programme for venture capital and started venture capital investment in India with initial investment of $45 million through these selected institution that is TDICICI (ICICI), GVFL, Canbank Venture Capital Fund, APIDC, RCTC (presently as IFCI Venture Capital Funds) and ILF (presently as Pathfinder) (Varshney, 2006). In the period of 1991 Liberalisation, Privatisation and Globalization (LPG) policy were introduced, following this structural change controller of capital issues get abolished in 1992 and all regulatory authorities and power handed over to Securities Exchange Board of India (SEBI, 1992) by the end of 1996 through government notification (Bowonder and Mani, 2002).

The Indian venture capital community enacted in 1993 with the incorporation of the Indian venture capital association (IVCA) headquartered in Bangalore with some domestic venture capital funds. Thereafter, in 1995 government of India issued guidelines for overseas venture capital investment in India (Report of K.B.Chandrashekhar Committee on Venture Capital, 2000). As a result availability of foreign funds increased as foreign venture capital firm entered in India for investment.

In 1996, government announced the regulate VC Industry guidelines to regulate the VC industry. Though there were many shortcomings these guidelines were the starting point. In 1997, IT boom in India made VC Industry more significant. Due to symbiotic relationship between VC and IT industry, VC got more prominence as a major source of funding for the rapidly growing IT industry. Indian VC's which were so far investing in all the sectors changed their focus to IT and telecom industry. During recession 1999 - 2001 wind out of VC industry. Most of the Venture Capitalists either closed down or wound-up their operations. Almost all of them changed their focus to existing successful firms for their growth and expansion. Currently, just a few firms are taking the risk of investing into the start-up technology based companies. VC firms also got engaged into funding buyouts, privatisation and restructuring (Dr. Reddy Narayana T. & Dr. Reddy Viswanatha C.).

The Government of India constituted a SEBI committee headed by K. B. Chandrasekhar to make recommendations to facilitate the growth of VC industry in India. This committee submitted its report in July 2000 with the following salient recommendations, all of which were accepted and implemented: 1. SEBI should be the nodal regulator for VC funds in India providing a smooth, single window, problem-free regulatory framework for quick and efficient flow of money into VC funds in India. 2. Tax pass-through status should be granted to all regulatory compliant VC funds, similar to that which is provided to mutual funds, ensuring that at the "pool-level" (VC Fund) profits are tax exempt. Foreign venture capital investors (FVCI) should also be registered with SEBI. This registration should enable them to have the same facilities as the foreign institutional level of easy investments and disinvestments without any FIBP/RBI approvals. In the present phrase government of India introduced so many tactics to attract foreign capital like start up India, Make in India as a result of this strategies it is evident that FDI has been increased in various sector of India by 14 per cent in term of real GDP.

5.2 Issues and challenges faced by Venture Capital financing:

There are certain pertinent issues of venture capital financing in India which synonymously are the issues of private equity as well are as follows:

- **Product risk:** the product risk concerned with little and no track records in the market as they have high rate of obsolescence.
- **Entrepreneur risk:** another issue related to the venture capital financing is that it is very difficult to assess information of new management and new established business without prior track record.
- **Concentration risk:** Concentrating on small market which may be based either on product bases or on geographical basis, raises risk for sectorial downturn
- **Technology risk:** It is very difficult to assess new technology for small set of products.
- **Duration risk:** there is longer payback period for funding is needed
- **Asset risk:** there is high percentage of obsolete fixed assets, along with high fraction of man power, there is lack of collateralized assets, which is one of the issue concerned with venture capital financing.
- **Small deal size:** This is not found economical by most investors.

Apart from above issues there are some challenges which have to be faced by venture capitalist as obtaining private equity or venture capital is of challenging in nature. Firstly, the private equity investor may replicate the business idea that he was presented with and pass it on to another established company where he holds ownership stakes. Secondly, Private equity investors may use the company to further the cause of other companies where they have larger investments. For example, he may force or influence the company into supplying materials to another company at below-market prices. Thirdly, Performance-oriented private equity investors may withdraw their funds if the company does not perform in accordance with the required returns. Lastly, since there is no market valuation for the stake in the company's shares, the company may be 'under-valued' by private investors with strong bargaining power. This is especially so if the management of the company has comparatively less information.

6.0 CONCLUSION

Indian economy is on ever-increasing growth curve despite problems related to downturn in global economy. The capitalist often tussle to find start-up capital which is not easily either available or focused on service businesses with lower risk and early recovery of revenue. To overcome this financing hurdle, the government are taking number of tactics to provide required access to infrastructure. The capitalist incline to be innovative and will also aid to produce solution to India's myriad social problems comprise of high- quality education, affordable health care, energy and waste management, and financial inclusion. Venture capital is emerging a main source of finance especially for newly start-up innovative business model where higher risk factor is associated with it. The study concluded that instead of having multiple regulatory mechanisms, a single window regulatory mechanism must be developed. SEBI's regulations, DFI's regulations, regulations for private equity financiers, regulations for domestic financiers, regulations for venture financiers in India backed by international financiers should be brought into single platform. By this there were so many fluctuations in VCF's reasons like regulatory pattern, higher risk, complexity in understanding the phenomenon etc. this study make emphasis on lack of corporate governance practices and lack of sensitivity among entrepreneurs and investors. So, there is need to develop a model code of conduct for entrepreneurs and investors for their win-win association.

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