VENTURE CAPITAL FINANCING STRATEGY FOR INDIAN MICRO SMALL MEDIUM ENTERPRISE's

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Abstract

Venture Capital is emerging as an important source of finance for small and medium-sized firms, especially for starting the business and business expansion. An entrepreneur usually starts the business with his own funds, and those borrowed from banks. It is during expansion that they find it difficult to raise funds. SMEs have traditionally been dependent on Bank finance for expansion and working capital requirements. Venture capital is a means of equity financing for rapidly-growing MSMEs. Venture capitalists provide funds after carefully scrutinizing projects. Their main aim is to earn higher returns on their investments, but their methods are different from traditional lenders. They take active part in the management of the company as well as provide the expertise and qualities of good bankers, technologists, planners and managers. The paper highlights the benefits & future prospects of venture capital. Venture or Risk capital funding is ideal for newly emerging ventures like bio-tech, food processing, IT, pharmaceutical and other knowledge based sectors in India is creation of venture capital funds to meet the equity requirements of these units

in the initial phase of their working and the knowledge sector including BPO, KPO, Life sciences, on-line business, technology-enabled design and manufacturing as well as in emerging areas of nano-technology and environmental technology.

KEYWORDS: *Micro, Small and Medium Enterprises (MSMEs); Venture capital (VC); Equity financing; Debt financing & SEBI*

INTRODUCTION

The Indian MSME sector is incredibly heterogeneous in terms of size of the enterprises, variety of products and services produced and levels of technology employed. As per the Micro, Small and Medium Enterprises Development Act of 2006, enterprises with the capital investment (plant, machinery and equipment) levels within 10 crore INR (for services worth 5 crore INR) qualify as MSMEs. The MSME sector contributes in a significant way to the growth of the Indian economy with a vast network of over 32 million units, creating employment of about 70 million, manufacturing more than 6000 products, contributing about 45% to manufacturing output and about 40% of exports, directly and indirectly. It is an acknowledged fact that the MSME sector can help realize the target of the proposed National Manufacturing Policy of raising the share of the manufacturing sector in GDP from 16% at present to 25% by the end of 2022. Venture capital means funds made available for startup firms and small businesses with exceptional growth potential. Venture capital is money provided by professionals who alongside management invest in young, rapidly growing companies that have the potential to develop into significant economic contributors. Generally, venture capital is financing for new and rapidly growing companies, Purchase equity securities, Assist in the development of new products or services, Adding value to the company through active participation.

Micro, Small and Medium Enterprises (MSMEs) play a significant role in the economic growth and create jobs in the economy. Despite high enthusiasm and inherent capabilities to grow, they have traditionally been facing some constraints - including lack of adequate & timely finance. While bank assistance in itself takes reasonably long time, expecting equity contribution from investors is a much bigger challenge. At the same time, customers, suppliers, channel partners and lenders need authentic information & evaluation of MSMEs in order to establish business relations / take exposures. The Micro, Small & Medium Enterprises (MSME) sector is a critical component of India's growth story, making significant contributions to GDP, employment and exports. MSMEs contributed around 37.5% of India's GDP in 2012-13, a number which has remained steady over the past three years. Of this, around 30% of the GDP is contributed by the services sector and the remaining by the manufacturing sector. This translates to a gross value added of 20.56 lakh crore. Of the aggregate gross value added, 71.2% was contributed by the services sector and 18.8% by the manufacturing sector.

TABLE 1: Share of MSME Sector in Total GDP (%)

YEAR	**2010-11**	**2011-12**	**2012-13**
Manufacturing Sector MSME	7.39	7.27	7.04
Service Sector MSME	29.30	30.70	30.50
TOTAL	**36.69**	**37.97**	**37.54**

The above table indicates that share of MSME Sector in Total GDP (%) Year 2010-11 2011-12 2012-13 as the Manufacturing Sector MSME is decreased from the 2010-2011 to 2012-2013 and the Service Sector is increased in all the years.

TABLE 2:

YEAR	2010-11	2011-12	2012-13
Manufacturing Sector MSME	3.63	3.82	3.86
Service Sector MSME	14.43	16.11	16.70
TOTAL	**18.06**	**19.93**	**20.56**

The above table shows that estimate of gross value added of MSME in manufacturing and servicing sectors (in lakh crore) is gradually increase in the years.

The concept of venture capital was formally introduced in India in 1987 by IDBI. The government levied a 5% on all knowhow import payments to create the venture fund. ICICI started VC activity in the same year. Later on ICICI floated a separate VC company – TDICI. In order to provide financial support to such entrepreneurial talent and business skills, the concept of venture capital emerged. Venture capital is a means of equity financing for rapidly-growing private companies. Finance may be required for the start-up, expansion or purchase of a company. Venture capitalists comprise of professionals in various fields. They provide funds (known as Venture Capital Fund) to these firms after carefully scrutinizing the projects. Their main aim is to earn higher returns on their investments, but their methods are different from the traditional moneylenders. They take active part in the management of the company as well as provide the expertise and qualities of a good bankers, technologists, planners and managers.

Venture / Risk capital is often a more appropriate financing instrument for high-growth-potential and start-up SMEs. However, the ability of SMEs (especially those involving innovations and new technologies) to access alternative sources of capital like angel funds/risk capital needs to be enhanced considerably. Although SMEs commonly use traditional debt, this type of financing is often not accessible for fast-growth and start-up firms. During their initial phase, firms need finance to study, assess and develop an initial concept (seed phase) or for product development and initial marketing (start-up phase). At this stage, firms may be in the process of being set up or may exist, but have yet to sell their product or service commercially. High-growth firms usually develop an idea, concept or product that requires an incubation period before generating revenues and profits. Firms, typically, look for venture capital to provide them with the financing they need to expand or break into new markets and grow faster. Thus, the ability of SMEs (especially those involving innovations and new technologies) to access alternative sources of capital like angel funds/risk capital needs to be enhanced considerably. The Government of India, in terms of the recommendations of the PM's Task Force on MSMEs, is already looking at removing the fiscal/regulatory impediments to the use of such funds by the MSMEs.

Venture / Risk capital funding is ideal for newly emerging ventures like bio-tech, food processing, IT, pharmaceutical and other knowledge based sectors in India is creation of venture capital funds to meet the equity requirements of these units in the initial phase of their working and the knowledge sector including BPO, KPO, Life sciences, on-line business, technology-enabled design and manufacturing as well as in emerging areas of nano-technology and environmental technology. 19. Angel investors (i.e. investors who typically invest their own funds, unlike venture capitalists, who manage the pooled money of others in a professionally-managed fund) are increasingly becoming another alternative source of funding for SMEs in India. Entities such as Indian Angel Network, Mumbai Angels, The Chennai Angels, Nadathur Holding and Investment, etc. are well known investors who are keen on helping early stage companies with funding and mentoring. However, in the recent past, bankers have curtailed lending to SMEs due to the greater risk of non-performing assets (NPAs) in a downturn. Thus, even though many SMEs have profitable

projects and expansion plans, they find it difficult to get finance for their projects, as bankers may not be willing to fund high risk projects. In order to provide financial support to such entrepreneurial talent and business skills, the concept of venture capital emerged. Venture capital is a means of equity financing for rapidly-growing private companies. Finance may be required for the start-up, expansion or purchase of a company. Venture capitalists comprise of professionals in various fields. They provide funds (known as Venture Capital Fund) to these firms after carefully scrutinizing the projects. Their main aim is to earn higher returns on their investments, but their methods are different from the traditional moneylenders. They take active part in the management of the company as well as provide the expertise and qualities of a good bankers, technologists, planners and managers.

OBJECTIVES

• To focus on the development of Venture Capital in India.

• To study the benefits and future prospects of Venture Capital in MSME's in India.

• To study the steps and methods in Venture Capital Financing in India suitable to MSME's.

VENTURE CAPITAL FOR MSMES IN INDIA

Venture capital (VC) is financial capital provided to early-stage, high-potential, high risk, growth startup companies. The venture capital fund makes money by owning equity in the companies it invests in, which usually have a novel technology or business model in high technology industries, such as biotechnology, IT, software, etc.Venture Capital is one source of non-bank financing, which is quite prevalent in developed financial markets for small or start up firms.

VENTURE CAPITALISTS:

Venture capitalist is a person or investment firm that makes venture investments, and these venture capitalists are expected to bring managerial and technical expertise as well as capital to their investments. A venture capital fund refers to a pooled investment vehicle (often an LP or LLC) that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans. Venture capital firms typically comprise small teams with technology backgrounds (scientists, researchers) or those with business training or deep industry experience.

NEED OF VENTURE CAPITAL

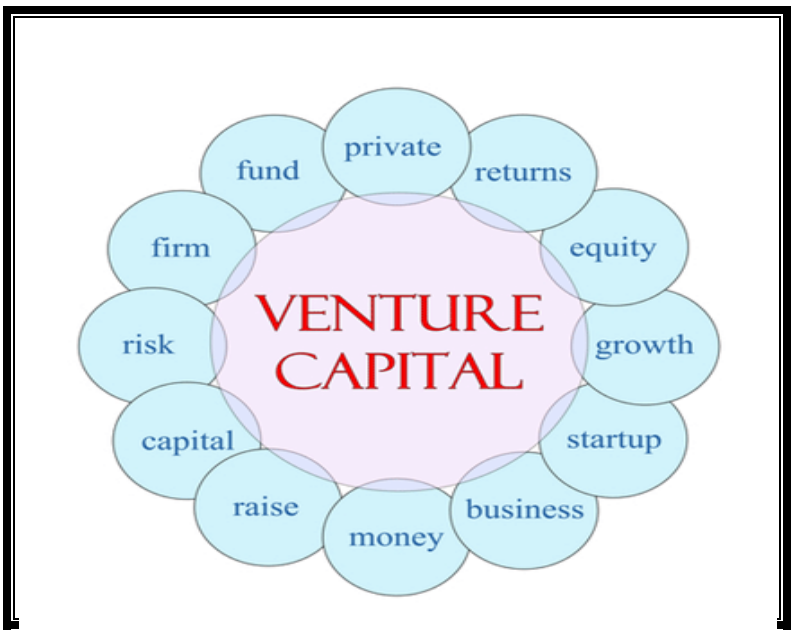
- There are entrepreneurs and many other people who come up with bright ideas but lack the capital for the investment. What these venture capitals do are to facilitate and enable the start up phase.
- When there is an owner relation between the venture capital providers and receivers, their mutual interest 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.

Venture Capitalists in India traditionally, have shied from the MSME sector. The non-corporate structure and small size of majority of MSMEs in India makes the Venture Capitalists and Private Equity Players reluctant to investing in them due to higher transaction costs and difficulties in exits out of such investments. However, the VC scenario in India is rapidly changing. Alternative funding like VC is picking up in the India, including in the MSME sector. Moreover, the VCs are expanding their reach into areas besides the traditional VC sectors like Information Technology (IT); nowadays interest in sectors like clean energy, healthcare, pharmaceuticals, retail, media, etc. is also growing. In recent years, the government controlled financial institutions have initiated positive and progressive measures to provide MSMEs access to funds at a reasonable and affordable costs and without any usual hurdles. Venture capital funding institutions have been floated to induct fund at low cost, share the risk and to provide management and technology upgradation support to these enterprises. Government-funded schemes exist at both the national and the state levels. They tend to be relatively small — they typically do not exceed US$ 5 million. The Small Industries Development Bank of India (SIDBI) is the main public financial institution involved in VC funding operations. SIDBI operates through wholly owned subsidiary, SIDBI Venture Capital Limited (SVCL). It co-finances state-level funds, and sometimes co-invests with private sector VCs on a case-by-case basis.

Some new VCs are also operating at the SME level, such as Helion Venture Partners, Erasmic Venture Fund (Accel India Venture Fund), Seed Fund, and Upstream Ventures. While technology remains the most sought after investment fields, interest has been shifting from internet companies to other types of operations especially ICT enabled services and bio-technology. A few VCs also operate at the early-stage, including Erasmic Venture Fund, Seed Fund, Infinity Venture, IFI sponsored facilities such as Swiss Tech VCF, and the government schemes such as SIDBI VC and Gujarat VF. Early stage VCs seek smaller deals, typically in the US$ 1 - 3 million range. However, they rarely go below the half million dollar mark, where there is a strong appetite for financing, but very few opportunities. Possible sources of smaller investments are represented by local public-sector facilities, business angels, business incubators funds, and isolated cases of seed VCFs, such as the micro venture schemes like Aavishkaar India Micro Venture Capital Fund (AIMVCF).

Venture Capital is the most suitable option for funding a costly capital source for companies and most for businesses having large up-front capital requirements which have no other cheap alternatives. *Software and other intellectual property* are generally the most common cases whose value is unproven. That is why; Venture capital funding is most widespread in the fast-growing technology and biotechnology fields.



BENEFITS OF VC OVER OTHER FUNDING METHODS

- Venture Capital injects long term equity finance which provides a solid capital base for future growth.
- The venture capitalist is a business partner, sharing both the risks and rewards. Venture capitalists are rewarded by business success and the capital gain.
- The venture capitalist is able to provide practical advice and assistance to the company based on past experience with other companies which were in similar situations.
- The venture capitalist also has a network of contacts in many areas that can add value to the company, such as in recruiting key personnel, providing contacts in international markets, introductions to strategic partners, and if needed co-investments with other venture capital firms when additional rounds of financing are required.

SEBI RULES AND REGULATIONS FOR VENTURE CAPITAL IN INDIA

- A venture capital fund may be set up by a company or a trust, after a certificate of registration is granted by SEBI on an application made to it. On receipt of the certificate of registration, it shall be binding on the venture capital fund to abide by the provisions of the SEBI Act, 1992.
- A VCF may raise money from any investor, Indian, Non-resident Indian or foreign, provided the money accepted from any investor is not less than Rs 5 lakhs. The VCF shall not issue any document or advertisement inviting offers from the public for subscription of its security or units
- SEBI regulations permit investment by venture capital funds in equity or equity related instruments of unlisted companies and also in financially weak and sick industries whose shares are listed or unlisted
- At least 80% of the funds should be invested in venture capital companies and no other limits are prescribed.
- SEBI Regulations do not provide for any sectoral restrictions for investment except investment in companies engaged in financial services.
- A VCF is not permitted to invest in the equity shares of any company or institutions providing financial services.
- The securities or units issued by a venture capital fund shall not be listed on any recognized stock exchange till the expiry of 4 years from the date of issuance
- A Scheme of VCF set up as a trust shall be wound up when the period of the scheme if any, is over
- If the trustee are of the opinion that the winding up shall be in the interest of the investors
- 75% of the investors in the scheme pass a resolution for winding up or,
- If SEBI so directs in the interest of the investors.

INSTITUTIONS OFFERING VC/ PE

Some venture capital firms, institutional investors and banks who provide venture capital to MSMEs are as follows Venture Capital Funds which are promoted by development finance institutions controlled by state government, overseas venture capital funds & also promoted by private sector companies. Some of the famous examples are:-

- **HYDERABAD INFORMATION TECHNOLOGY VENTURE ENTERPRISES LIMITED (HITVEL)**

  HIVE Fund contributed by Small Industries Development Bank of India, A.P Industrial Development Corporation Ltd., and A.P Industrial Infrastructure Corporation Limited. HITVEL is the asset management company under Srei Venture Capital Limited, which is the subsidiary of Srei Infrastructure Finance Limited. HITVEL has successfully completed several early stage investments in various Information Technology companies in the country. Its fund HIVE II focuses on targeting the IT ITES Sector in India.

- **KERALA VENTURE CAPITAL FUND PRIVATE LIMITED**

  The Kerala Venture Capital Fund Pvt. Ltd. is functioning as the asset managing company of the Kerala Venture Capital Fund. Its main function is to manage the venture capital. The fund which

was registered on September 14th, 1999, has eight active Director/Partners. The fund is currently Strike off Status.

- **GUJARAT VENTURE FINANCE LIMITED (GVFL)**

  GVFL is regarded as the pioneer of Venture Capital in India. It works as an independent, autonomous Board managed venture finance company in Gujarat. Founded at the initiative of World Bank, GVFL has encouraged and supported innovative ideas and entrepreneurs in the past. One feature which distinguishes GVFL from all other VCs is its broad spectrum support to its funded entities that ranged from governance support to strategic support. Over the last twenty years, the fund has spawned 7 funds which have supported 81 companies. GVFL focuses on providing venture capital to technology oriented startups.

- **PUNJAB INFOTECH VENTURE FUND**

  Founded in 1999, this Chandigarh based Fund is a Venture Capital Fund managed by Punjab Venture Capital Limited. The fund provides startup, growth and seed capital to startups in India. The fund invests in small and medium enterprises, primarily in the Software and Information Technology Sectors. The size of the fund is estimated to be $4 million.

OVERSEAS VENTURE CAPITAL FUNDS

This group comprises of Venture Capital funds from outside India. Some of the Examples are as follows –

- **BTS INDIA PRIVATE EQUITY FUND LTD**

  This Switzerland based Private Equity fund specializes in buy outs, mid stage, late stage and expansion stage investments. Founded in 2006, the fund prefers to invest in companies based in India. It invests in small and medium sized businesses. The fund does not invest its resources in early stage enterprises as it prefers enterprises that have established themselves over a period of two to three years. The fund seeks to invest in manufacturing, technology enabled services, telecommunications, packaging, pharmaceuticals and life sciences, textiles, healthcare and services.

- **WALDEN INTERNATIONAL INVESTMENT GROUP**

  It focuses its investments on opportunities in early stage and expansion stage companies. The group invests in companies across Emerging Technologies, Semiconductors, Software and IT services and Internet & Digital Media sectors. It helps companies in finding business resources, talent and market beyond their domestic terrain. The group has a very powerful and unique network of corporate, government and personal relationships across the world. They help the companies in accessing the right people in potential strategic partners that can make a huge difference in the growth of their companies. They are long term investors and seek to invest in companies that have a potential of making it huge in their markets.

- **SEAF INDIA INVESTMENT AND GROWTH FUND**

  SEAF started in the year 1989 as the CARE Small Business Assistance Corporation (CARESBAC), a single member non-governmental organization owned by the international relief and development organization, CARE. CARESBAC finally became SEAF in 1995 after it spun out of CARE. The fund has invested in a diversified range of India based companies with sustainable competitive advantages and high growth potential. It primarily invests in fast growing and dynamic sectors like media and entertainment, information & technology, life sciences and healthcare etc.

Promoted by Private Sector Companies-

This category consists of Venture Capital funds promoted by Private Sector Companies. Some Examples are:-

INFINITY VENTURE INDIA FUND

The fund seeks to invest in technology and related companies. Founded in 1999, it is the country's first institutionalized fund that brought Indian entrepreneurs and overseas entrepreneur together. It closed fund raising in 2000 and has invested in about eighteen companies. Most of these investments have been in Series A or Seed fund. The Fund follows a research based methodology in order to identify potential investment areas and understand emerging markets/technologies.

IL&FS TRUST COMPANY LIMITED (ITCL)

Founded in the year 1995, ITCL is a part of IL&FS Group. It holds a Debenture Trustee license from SEBI. It is one of the largest Independent corporate Trustees in the country which offers Fiduciary and Trusteeship services to Governments, Infrastructure and Financial Services sector, High net worth individuals and Families. As of March, 2014, ITCL has administered over INR 445,600 crores in assets under a gamut of Corporate and Family Office Trusteeship services from its offices in Mumbai, Delhi, Kolkata, and Bangalore. It clients include Financial Institutions, Governments and their agencies, Corporations and all other entities that access credit markets and debit capital.

CONCLUSIONS

The role of venture capital on growth of MSME is real and practical which reaffirms the correlation between changing needs of entrepreneurs and venture capitalists which also lead to SME development and poverty alleviation where as MSMEs are widely recognized as powerful engines of innovation and productivity. SMEs are underserved by the investment community in emerging markets have trouble attracting capital for a number of reasons. First, transaction costs of monitoring SME-sized investments are higher which increases the perceived risk. Many entrepreneurs in India has lack the collateral for debt financing, which makes equity investment an even more attractive tool. Considering the high risk involved in the venture capital investments complimenting the high returns expected, one should do a thorough study of the project being considered, weighing the risk return ratio expected. One needs to do the homework both on the Venture Capital being targeted and on the business requirements.

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