VENTURE CAPITAL: THE INDIAN SCENARIO

Dr. A. Amruth Prasad Reddy*

Dr. M. Venkata Subbaiah**

ABSTRACT

Every human behaviour is positive, that is, goal-directed, backed by true-will. There is a passion and commitment to start their own venture and be on their own, provided there is high reward associated with high-risk new business projects. The internet and telecom revolutions are affecting life styles, personal interactions, societies and businesses in profoundly many ways. The changes in turn are being fueled by globalization, technology, knowledge and intellectual property. However, for a substantial number of technocrats who seek to capitalize on their strengths and business opportunities, starting-up a new venture is a distant dream. There are a number of critical factors that contribute to its success or failure of new business. Experience, integrity, prudence and a clear understanding of the market are among the most sought after qualities of a promoter. Besides these, there are other external factors which lie beyond the control of the entrepreneur. Prominent among them are the timely infusion of funds, technical skills, cost competitive manpower,etc. This is where the 'venture capitalist' comes in with money, business sense and a lot more. Two-tier institutional structure- central and state levels – evolved after independence in India to provide long-term finances to industry. The notable deficiency in the structure of lack of provision of VC to new industrial units. To correct this deficiency VC evolved in India in three phases: In the first phase (1973-1994) the need for VC was recognized in India. This phase witnessed inauguration of risk capital foundation by IFCI, creation of venture capital fund by IDBI, development of VCCs, tax concessions to VCCs/VCFs by the government and formation of venture capital association.

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*Asst. Professor, Dept. of Business Administration, Yogi Vemana University, Kadapa-516003, YSR District, Andhra Pradesh,India

**Professor, Bangalore Institute of Management Studies, Bangalore, Karnataka,India

The landmarks in second phase (1995-99) were establishment of clear guidelines to VCFs by SEBI. In the third phase, (which started in 2000) in addition to some overseas VCFs also entered into Indian industry.It is against this backdrop, the present paper is designed to provide a comprehensive picture of venture capital industry in India, tracing out its evolutionary stages in abroad as well as in India. Reliable estimates of magnitudes of venture capital are difficult because of two primary reasons: firstly, all that is reported under venture capital is difficult to be verified for its validity; and secondly, under defined rules venture capital transactions fall outside official statistical system leading to under-reporting.

INTRODUCTION

Between taking-up a job for salary and starting their own risky business venture, many educated youth prefer the former which, they think, will give them comfortable existence. Besides, people have become risk-averse, conditioned by their direct and indirect experiences. What is needed at present is change in the mindset at a faster rate never before seen in history. Every human behavior is positive, that is, goal-directed, backed by true-will. There is a passion and commitment to start their own venture and be on their own, provided there is high reward associated with high-risk new business projects. The internet and telecom revolutions are affecting life styles, personal interactions, societies and businesses in profoundly many ways. The changes in turn are being fueled by globalization, technology, knowledge and intellectual property.[1]

However, for a substantial number of technocrats who seek to capitalize on their strengths and business opportunities, starting-up a new venture is a distant dream. There are a number of critical factors that contribute to its success or failure of new business. Experience, integrity, prudence and a clear understanding of the market are among the most sought after qualities of a promoter.[2] Besides these, are other external factors which lie beyond the control of the entrepreneur. Prominent among them are the timely infusion of funds, technical skills, cost competitive manpower,etc. This is where the ‘venture capitalist’ comes in with money, business sense and a lot more.

AIM OF THE PAPER

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

CONCEPT

Venture capital financing means providing a proper mix of medium and long-term investments in high-risk industrial projects with high reward possibilities. It may be at any stage of implementation of the project or its production cycle viz., to start-up an economic activity or an industrial or commercial project or to improve a process or a product in an enterprise associated with both risk and reward. Medium-term refers to a period ranging between 3-5 years and ‘long-term’ covers a period of 5-15 years.[3]

VISION OF VENTURE CAPITAL

The vision of venture capital is focused on new projects, seed capital, technology and innovation. It aims at:[4]

- Fueling ambitions and dreams;
- Breathing life into promising business ventures;
- Charting the course of incisive business ideas;
- Providing foresight with a free sense of direction;
- Helping in building enterprise vision; and
- Guiding smoothly over rough passages;
- Partnering enterprises on to script thrilling success;

- Complementing acumen and enterprise with a steady flow of resources;
- Inspiring enterprises to script thrilling success; and
- Plotting venture capital finances are plotted on a firm life-cycle curve.

ORIGINS OF VENTURE CAPITAL IN ABROAD

Period of venture capital development can be divided into two sub-periods: prior to 1980 and post-1980. In the first sub-period venture capital was really a cottage industry in its rudimentary form. Before 1980 there were two venture capital investments in Massachusetts – the Saugus Ironworks in 1645 and the Middlesex Canal in 1789[5]. Prior to 1980s individuals and families were the main sources of venture capital.

It was John Witter who used the term ‘venture capital’ in 1939 while addressing the Investment Bankers Association of America[6]. Through 1930s to 1950s, there were intensive discussions in USA and UK as to lack of investment in small business, although there was a little agreement about what types of small businesses should be given funds and what would be the vehicles for providing finance to them.

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

Entrepreneurial finance has a long history in US going back to financing rail roads in1800[7], and later to industrial revolution. Prior to World War II there were wealthy American families investing in new promising firms. Soon after the war these families started hiring professional managers to discover, evaluate and invest in high-growth potential small firms. By providing start-up capital to companies, Eastern Airlines and Xerox[8] became household names. In fact, the first entrepreneurial bank founded by Brother Pereire in 1852 operated with a concept, ‘creative finance’[9]. Thus, venture capital firm is a US organizational innovation. Three role models in venture capital industry in USA are: American Research and Development Corporation (ARDC), Minute Maid Juice, and Eastern Airlines[10].

INDIAN SCENARIO

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

Venture Capital Development in India: First Phase (1973-94)

The first phase began with the government of India when the need for venture capital financing was first highlighted in 1973 by the government appointed committee on Development of Small, and Medium Enterprises(SMEs) under the Chairmanship of R.S.Bhatt, drew attention to the problems of new entrepreneurs and technologies in setting-up industries[11]. Thereafter, though some public sector funds were set-up but the activity of venture capital did not gather momentum as the thrust was on high-technology projects funded on a purely financial rather than a holistic basis.

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

In 1975 venture capital financing was introduced in India by the All-India Financial Institutions with the inauguration of 'Risk Capital Foundation (RCF)' sponsored by Industrial Finance Corporation of India (IFCI) to supplement "promoters' equity" with a view to encouraging technologists and professionals to promote new industries[12]. During 1976 the seed capital scheme was introduced by Industrial Development Bank of India (IDBI). The announcement of National Technology Policy Statement in 1983 by the Central Government setting guidelines towards technological self-reliance through commercialization and exploitation of technologies developed in the country, had established the need for venture capital. Till 1984 the concept of venture capital was known in the form of "Risk Capital and Seed Capital"[13]. In addition to IFCI and IDBI the Industrial Credit and Investment Corporation of India Limited (ICICI), another all

India financial institution, also took decision in 1984 to allocate funds for providing assistance in the form of venture capital to economic activities involving both risk and high-profit potential.[14]

Government Created and IDBI-Administered Venture Capital Fund

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

Programmes for Application of Commercial Technology (PACT) of USAID

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

Development of Venture Capital Companies (VCCs) in India

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

Company of India Limited (TDICI) which took over venture capital operations of ICICI on 1.7.1988.

The necessity of venture capital institutions was also echoed by the then Finance Minister, N.D. Tiwari, in his budget speech 1988-89, referring to the need for introducing venture capital to help new entrepreneurs develop. He said, "we have one of the largest pools of scientific and technical manpower. Yet many of our young and new entrepreneurs find it difficult to raise equity capital because of the risks involved. Allowing venture capital companies to undertake high-risk equity financing, in anticipation of future capital gains''[15] can solve this problem. The Finance Minister gave concessional treatment for capital gains to be made by VCCs/VCFs, in the wake of the failure of many new companies during 1985-86 boom which practically failed to come to the level of satisfaction of investors. He declared that it had been decided to formulate a scheme under which VCCs/VCFs would be enabled to invest in new companies and be eligible for the concessional treatment of capital gains available to non-corporate entities[16]. It is increasingly realized that the companies should first go to venture capital fund for their financial requirements before they go to public for raising needed funds.

Guidelines for Venture Capital Financing

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

Financing of Venture Capital :Tax Concessions to VCC/VCF

In January 1989, the working group on the Development of the Capital Market, set-up by the Planning Commission under the chairmanship of Mr. Abid Hussain, made relevant observations on organization and financing of venture capital industry in India. The budget proposals of 1989-90, recognized the importance of risk capital needs of projects upto Rs.10 crores promoted by technocrats possessing untried and improved technology. The proposals extended concessional treatment of 20 per cent tax on long-term capital gains arising to such venture companies on eventual sale of equity shares in the assisted companies. The clause II of budget speech of 1989-90 stated "in furtherance of the announcement made by the finance minister in his budget speech of 1988-89, that a scheme to obviate the difficulties faced by new entrepreneurs in raising equity capital would be framed, it has been decided to formulates a scheme for setting-up VCCs/VCFs to extend venture capital assistance to undertakings where the risk element is comparatively high and the entrepreneurs are relatively new and non-affluent". With a view to help the growth of VCC/VCF, by amending section 48 of the Income Tax Act, it is proposed to provide that the VCCs in respect of the capital gains on sale of shares of venture capital undertaking will get a deduction at "the same rate as available to non-corporate tax payers". This amendment will take effect from 1st April, 1990 and will accordingly apply in relation to the assessment year 1990-91 and subsequent years[17].

Over the Counter Exchange of India (OTCEI) and VCCs

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

Indian Venture Capital Association(IVCA)

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

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

The second phase was heralded in by the SEBI committee on Venture Capital Industry under the chairmanship of Mr. K.B. Chandrasekhar which laid down clear guidelines for venture capital funds for opening-up the industry. In 1998, only 8 domestic venture capital funds were registered with SEBI[18]. Year 1999 was a year of rapid growth for venture capital industry in India when 12 new venture capital funds were registered with SEBI, taking the total to 20. Foreign venture capital funds like Draper International and Walden Nikko India Management Company Limited, among the more active funds, have chosen not to register themselves with SEBI, due to its constricting guidelines. In the year 2000 SEBI registered 13 more venture capital funds, which increased their number to 33.[19]

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

The third phase witnessed the introduction of new set of rules having a salutary effect on the venture capital industry. However, the dot com bust and global economic slowdown saw the plight of many venture capital firms. Though 2001 was a relatively bad year, investments in venture capital continued at the same level. In 2002, India became the second most active venture capital market among 10 major Asia-Pacific economies in terms of the total investment.[20] During 2001-03, the VCs and Private Equitys started investing less money and in more mature companies in an effort to minimize the risk. For example:

- The average deal size more than doubled from USD4.14 million in 2000 to USD8.52 in 2001
- The number of early stage deals fell sharply from 142 in 2000 to 36 in 2001
- Later stage deals and Private Investments in Public Equity (PIPEs) declined from 138 in 2000 to 74 in 2001
- Investments in internet-related companies fell from USD576 million in 2000 to USD49 million in 2001.

This decline broadly continued until 2003. since India's economy has been growing at 7 per cent - 8 per cent per annuam, and since some sectors, including the services sector and the high end manufacturing sector, have been growing at 12 per cent – 14 per cent a year, investors renewed their interest and started investing again in 2004. The investments made in 2004 were USD1.65 billion as against USD 1.16 billion in 2000 by an increase of almost 42 per cent. These investments reached USD 2.2 billion in 2005 and USD 7.5 billion in 2006, a number that is more than six times the amount invested in 2000.

PROGRESS OF VENTURE CAPITAL INVESTMENT IN INDIA

The venture capital investment in India till the year 2001 was continuously increased and thereby drastically reduced up to 2003.

Table 1

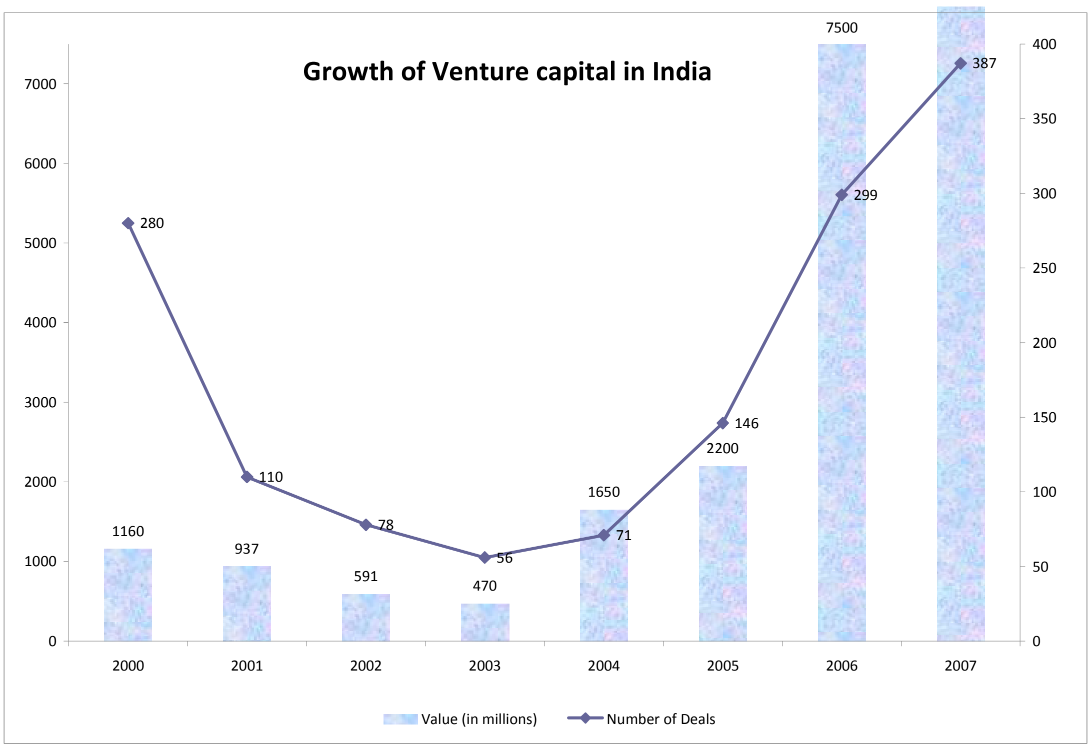
Growth of Venture capital in India

(amount in US dollars)

Year	Number of Deals	Growth	Value (in millions)	Growth
2000	280	--	1160	
2001	110	(-) 60.71	937	(-) 19.22
2002	78	(-) 29.09	591	(-) 36.92
2003	56	(-) 28.20	470	(-) 20.47
2004	71	26.78	1650	251.06
2005	146	105.63	2200	33.33

2006	299	104.79	7500	240.90
2007	387	29.43	14234	89.79
Total	1427		28742	

Source: Secondary data



The above table shows that there was a tremendous growth by almost 251 per cent in 2004, and 89.79 per cent in 2007. In absolute terms, the number of deals and the value to investments were 280 and USD 1160 million in 2000, which were increased to 387 and USD 14234 million in 2007 respectively.

STAGE-WISE INVESTMENT

The stage wise investment of venture capital is shown in Table 2.

Table 2

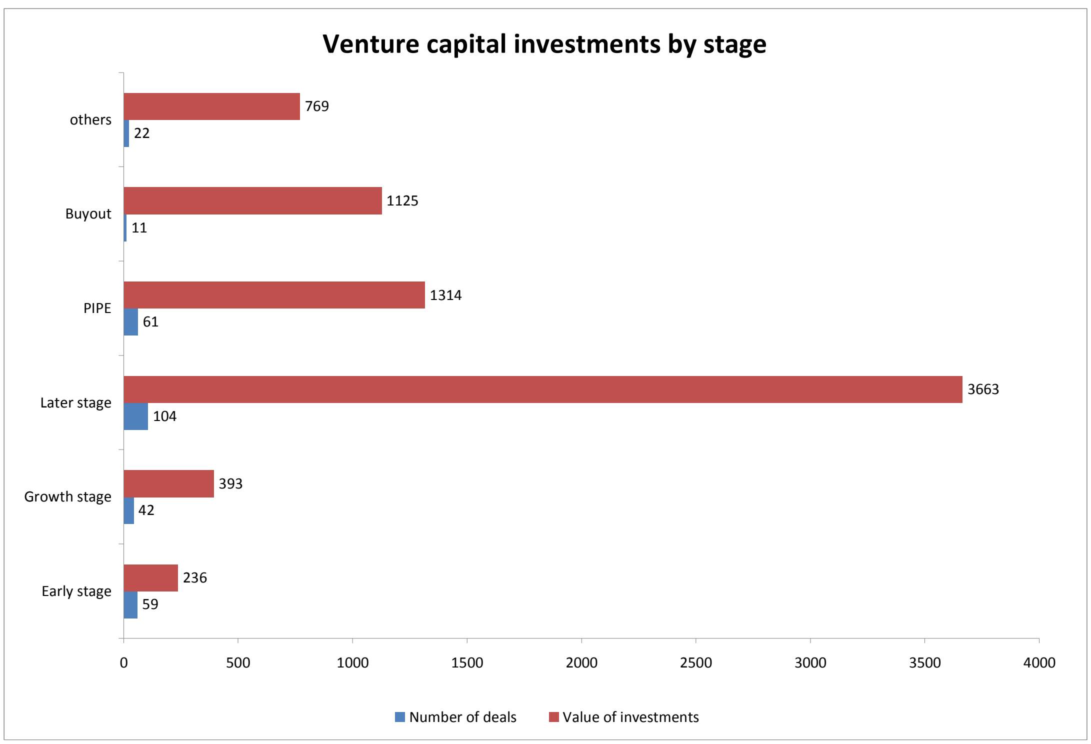
Venture capital investments by stage

(US dollar million)

Stage	Number of deals	Value of investments
Early stage	59	236
Growth stage	42	393
Later stage	104	3663
PIPE	61	1314
Buyout	11	1125
others	22	769
Total	299	7500

Source: Secondary data

In 2006 the later stage plays first with USD 3663 million following by PIPE, Buyouts etc. Further noticed that the later stage attracted 104 deals of the total 299 deals in 2006. This indicates the importance of later stage finance in India.



CITY WISE INVESTMENT

The major top cities in India were attracted the venture capital investment is shown below:

In case of city wise investment, it appears that Mumbai has attracted USD 5995 million as venture capital, which plays first in India, followed by Delhi, Hyderabad,

Table 3

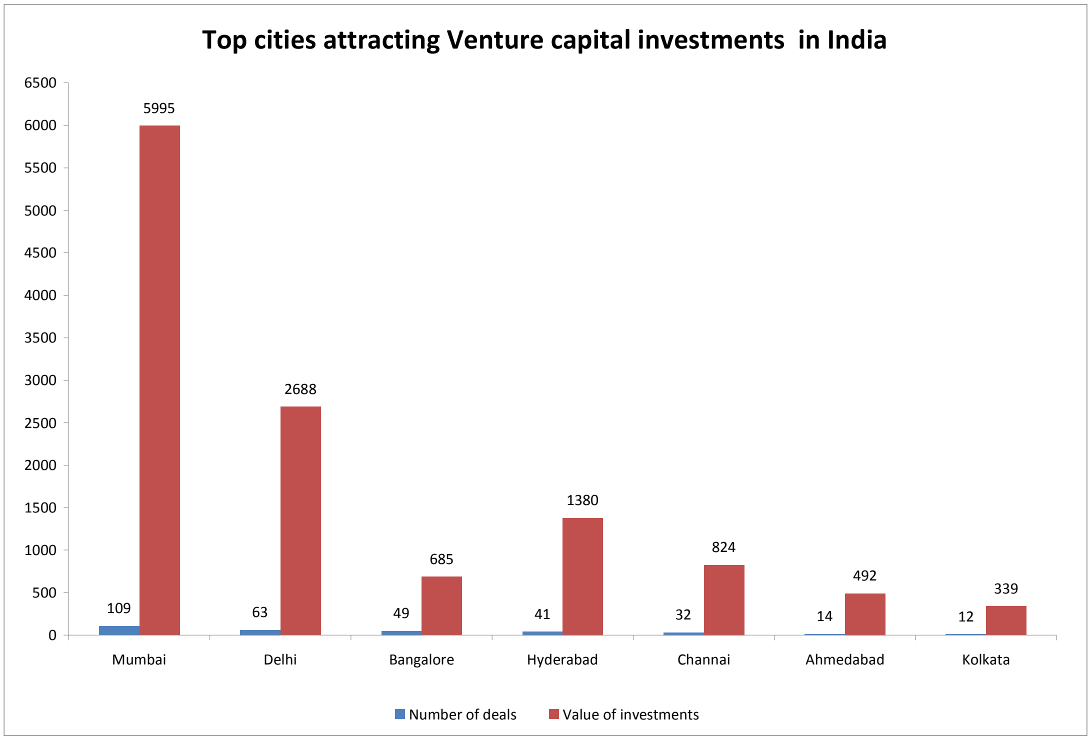
Top cities attracting Venture capital investments in India:2007

(amount in US dollars)

Cities	Number of deals	Value of investments
Mumbai	109	5995
Delhi	63	2688
Bangalore	49	685
Hyderabad	41	1380
Channai	32	824
Ahmedabad	14	492
Kolkata	12	339

Source: Secondary data

Chennai and Bangalore. In terms of numbers, as seen from the above Table and Chart that 109 deals were financed in Mumbai city, followed by Delhi, Bangalore and Hyderabad with 63, 49 and 41 deals respectively.



SECTOR - WISE INVESTMENT

The industry wise venture capital investment in 2007 is shown in Table 4. Indian venture capital activity is characterized by major investment going to banking and

Table 4

Venture capital investments by industry in India: 2007

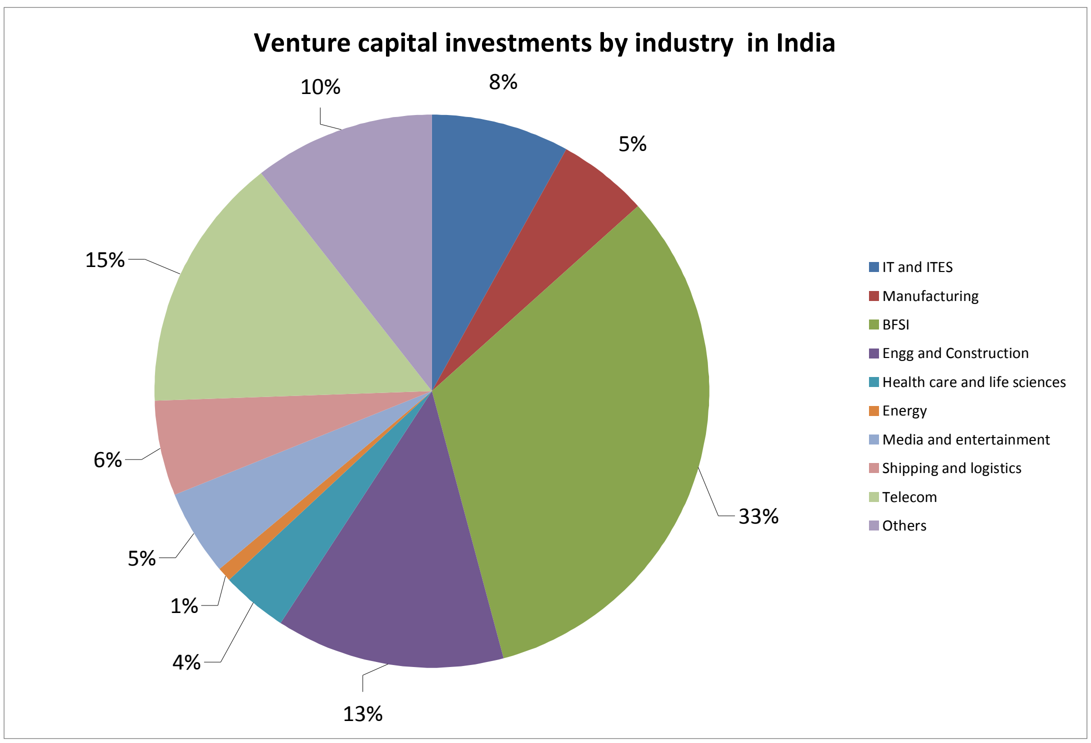
(amount in US dollars)

Sectors	Value of investments
IT and IT Enabled services (ITES)	988
Manufacturing	638
BFSI	3979
Engg and Construction	1628
Health care and life sciences	478
Energy	101

Media and entertainment	616
Shipping and logistics	685
Telecom	1839
Others	1284

Source: Secondary data

financial services industries (BFSI) , plays first rank in venture capital attraction with USD 3979 million and Engineering and construction plays second with USD 1628 millions.



THE EXIT SLOWDOWN OF VENTURE CAPITAL IN INDIA

The proverbial IPO window lifts, falls, then lifts again. Veteran venture capitalists have lived through such cycles, but few have seen the window shut a completely as it did in 2007.

In the second quarter of 2008 there were zero VC-backed exits- on the heels of five in the previous quarter, which raised a thin USD 283 million. In the first half of 2007, by comparison, 43 VC-backed IPOs collected USD 6.3 billion. When the last VC-backed IPO shutout hit, in 1978, "styain' alive" topped the charts and space invaders ignited the video game market. The country was mired in recession and wading into its second oil crisis.

Nearly two months into third quarter 2008, the window nudged open for two cleantech debuts – desalination company energy recovery and solar cell equipment supplier GT sola – suggesting that cleantech IPOs may very well lead an IPO recovery. When the window does reopen, it may reveal an altered VC landscape, one shaped partially by the exit slowdown.

CONCLUSION

In the background of lack of investment in new small business and increased awareness of the need for promotion of SMEs, small business investment company came into existence in America. This was the beginning of VC abroad. Seeing greater promise for commercial application developed by MIT, ARDC was formed. Number of SBICs established in America to leverage their private capital by borrowers from the federal government at lower interest rates. Two-tier institutional structure- central and state levels – evolved after independence in India to provide long-term finances to industry. The notable deficiency in the structure of lack of provision of VC to new industrial units. To correct this deficiency VC evolved in India in three phases: In the first phase (1973-1994) the need for VC was recognized in India. This phase witnessed inauguration of risk capital foundation by IFCI, creation of venture capital fund by IDBI, development of VCCs, tax concessions to VCCs/VCFs by the government and formation of venture capital association. The landmarks in second phase (1995-99) were establishment of clear guidelines to VCFs by SEBI. In the third phase, (which started in 2000) in addition to some overseas VCFs also entered into Indian industry. In the second quarter of 2008 there were zero VC-backed exits- on the heels of five in the previous quarter, which raised a thin USD 283 million. In the first half of 2007, by comparison, 43 VC-backed IPOs collected USD 6.3 billion. When the last VC-backed IPO shutout hit, in 1978, "styain' alive" topped the charts and space invaders ignited the video game market. The country was mired in recession and wading into its second oil crisis.

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