# A VENTURE CAPITAL- A PARADIGM SHIFT IN INDIA

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**ABSTRACT:**

The Venture Capital (VC) business in India began in the late 1980s and is experiencing a change in the current uncertain, yet supposedly optimistic, economic environment. This study seeks, via analysis of data concerning proportions of sector contracts, total volume and the number of contracts and the increase of the number of VC businesses in 2001 and 2007, to understand the changing pattern of the VC industry in the country. These trends have also been analysed throughout the economic crisis. The results of the study could show that the country's VC projects overcame the crisis with diversification and innovation. This paradigm shift can be demonstrated by the move from initial to later funding, which means that risk capitalists have an interest in proved companies because of the precautionary attitude they have gained about risk aversion.

**Key words:** Venture capital, Indian economy, financial crisis, risk-inherent business, global investors, risk appetite, BPSL

## 1. INTRODUCTION

Indian economy is growing at an unconvincingly faster rate, albeit many of its counterparts are struggling to rebound from setbacks sprouted from recent financial land slide. The shock-absorbing capacity of Indian economy and the ability to surmount the re percussions of financial crisis, with minimum damage, manifest the investing knowledge and operating experience' (Zider, 1998) of the vibrant entrepreneurial community of India as well as abroad. Backed by resource and knowledge endowment, these new generation entrepreneurs are ready to em brace high risky business opportunities. To encourage this young talent, one important source of financing is venture capital. It is considered to be the best because it provides an opportunity to the aspiring innovators and initiates new ventures in the country. This activity leads to a long-term impact on overall growth of the economy which, in turn, fulfills the objective of creating employment opportunities, and eventually leads to an increase in the standard of living of the citizens. The booming business opportunities widen the scope of government share in the form of additional corporate tax revenue, which cannot be overlooked in a welfare oriented state like India.

Venture Capital (VC) provides capital to upcoming business which could either be a success or a failure, as it is based on the philosophy of risk-inherent lucrative ventures. Such funding is

extended to companies that haven't made any public offering. The VC is invested in companies using the equity
instrument as well. The return of capitalists depends on the growth and profit ability of the invested business. It is mainly instrumental in realizing the innovative ideas of upcoming entrepreneurs.

**1.1 A Glance to Venture Capita in India.**

The first VC company in India was recognized by the setting up of Technology Development & Information Company of India Ltd formed by Industrial Credit and tory Investment Corporation of India (ICICI) and Unit Trust of India (UTI) before 1988. The next VC company- Gujarat Venture Finance of W Limited (GVFL) was established in 1990, Nine VC institutions came up during the period of 1988-1992. It was during this phase that the concept of VC set its foothold in India. In 1995 the authority to control the VC firms / funds was given to SEBI. Along with this change in authority, new regulations came in to existence. This marked the beginning of the second phase of VC growth in India.

Of late, there has been a major shift in the pattern of investment among the venture capitalists. Due to ceaseless opportunities to flourish and become rich; they are spreading their wings to trans-boundary initiatives as well. Another reason is due to the surfacing of entrepreneurial atmosphere g from the emerging economies. The benefit of diversifying the industry and geographical risks and being able to access the foreign markets also led to the change in the investment pattern.

2. **Objectives, Hypothesis and Methodology**

The present study made an attempt to to understand different factors that underlie the status of VC investment in India and to study the paradigm shift in the VC investment in the country. The hypothesis of the study indicates that there is a paradigm shift in the VC industry in India. The study followed a chronological analysis of venture capital, covering the period between 2001 and 2007, pertaining to four important quantitative elements of VC, namely, proportion of sectoral deals, total volume investment in venture capital, number of deals and number of VC firms. The VC industry embarked on a new lease of growth phase during 2004, rebounding from the setbacks of dot.com crash in 2000. Hence we divided the analytical time-frame into two (2001-04 and 2004 -07). The first period (2001-04) was also characterized by the absence of comprehensive policy frame work pertaining to the VC industry in India.

The latter period (2004 - 07) was evidenced by an improvement in the condition of Indian VC market mainly due to the recovery of the IT sector globally and also due to the changes in the country's regulatory framework related to VC market. The opening up of venture capital, especially, to foreign venture capitalists widened the scope of VC investment in the country. The developments in the national VC scenario after 2007 are discussed separately to understand how the VC initiative was able to surpass the onset of financial crisis.

## 3. DATA ANALYSIS AND INTERPRETATION

### A. Proportion of deals in different industries

The proportion of the deals invested in the IT-ITES sector during the phase of reforms has declined compared to that of the period before reforms (refer table 1). It is clear from the data that VC investment in IT-ITES has been falling continuously, even though total amount of VC is on an upward trend. Even during the global downturn this can be the main reason for the notable growth rate. The Indian economy is not restricted only to the IT sector but has spread evenly now more equally to sectors such as biotechnology and pharmaceutical, health and medical, tourism, the auto parts, travel and tourists, retail, textiles, property and infrastructure. The Indian economy is not restricted to one sector alone:

**Table: 1 Data for proportion of deals invested in each sector per year.**

| Sector/ year | IT-ITES | MANUFACTURING | BFSI | HEALTH CARE | OTHERS | TOTAL |
|---|---|---|---|---|---|---|
| 2003 | 49.10 | 1.80 | 12.30 | 7 | 29.80 | 100 |
| 2004 | 35.20 | 14.20 | 8.40 | 16.90 | 25.30 | 100 |
| 2005 | 30 | 18 | 8 | 11 | 33 | 100 |
| 2006 | 23.10 | 15 | 16.10 | 9.80 | 36 | 100 |
| 2007 | 19.30 | 17 | 17.90 | 8 | 37.80 | 100 |
| Average % during reforms | 31.34 | 13.20 | 12.54 | 10.54 | 32.38 | 100 |
| % growth decline | 60.1 | 844.4 | 45.53 | 14.28 | 26.84 | ---- |

**SOURCE : IVCA(2008)**

**Table 2a- Tabular Analysis of volume of Investments**

| Stages | average (USD Millions) | Inference |
|---|---|---|
| Early Reforms (2001-2004) | 1016.667 | Balanced decrease |
| During Reforms (2004-2007) | 2997.25 | Initial growth 2004 continued at an increasing rate till 2006. Abrupt decline in 2007. |

**Table 2b - Data for volume of Investments per year**

| Year | Volume of Investments | % change over the previous year |
|---|---|---|
| 2001 | 1135 | 0 |
| 2002 | 1050 | -7.49 |
| 2003 | 865 | -17.62 |
| 2004 | 1363 | 57.57 |
| 2005 | 2238 | 64.20 |
| 2006 | 7460 | 233.33 |
| 2007 | 928 | -87.56 |

**SOURCE : IVCA(2008)**

**Table 3a- Tabular Analysis of number of deals**

| S. No. | Stages | Average no. Of deals | Inference |
|---|---|---|---|
| 1 | Early Reforms (2001-2004) | >81 | Steep fall |
| 2 | During Reforms (2004-2007) | >225 | Increased at an increasing rate 2005,Abrupt boost 2006 continued in to 2007 |

entertainment and media and banking and financial services. The pattern of declining shift in the IT- ITES sector continues to be followed even after the financial crisis, but many other promising sectors are on the rise.

**B. Volume of Investment**

The volume of investments during the reform stage boosted as compared to that of prior to reform stage (refer table 2a). The volume of investment in the reform phase in creased almost twice when compared to that of prior to reform stage. This occurred due to the reforms in the regulations related to the foreign VC investments which came in to force in 2004. It resulted in the encouragement of flow of foreign funds in to the Indian VC market. Another reason for this trend is due to the emerging sectors of entertainment, media, BFSI and health care.

**C. Number of deals during the period**

Indian V C market experienced the highest number of VC deals in the reform period, which is impressively on higher end comparing to previous reference period (refer table 3a). The average number of deals during the reforms was 225.75 whereas the average number of deals prior to reforms was 81.33. From the average values, the growth of the number of the deals was almost thrice in the reform phase when compared to that of previous. This growth trend has seemingly an inclination towards high growth in the reform stage, which fell abruptly during the following years (2008,2009) due to global business pessimism sprouted through financial crisis.

**Table 3b - Data for number of deals per year**

| Year | Number of deals | % change over the previous year |
|---|---|---|
| 2001 | 110 | 0 |
| 2002 | 78 | -29.10 |
| 2003 | 56 | -28.20 |
| 2004 | 71 | 26.78 |
| 2005 | 146 | 105.63 |
| 2006 | 299 | 104.79 |
| 2007 | 387 | 29.43 |

**D. Number of venture firms/funds**

The second phase maintained its growth consistency with respect to the en try of the number of venture firms as well (refer table 4a). There has been a rise in the number of firms at the rate of 35.38% in the reform stage in comparison to those during the early reforms. This rise may be attributed to the growing Indian economy, relaxation in the regulations by the Government and SEBI and development of major and minor sec tors. The movement of pattern of upcoming of VC firms is in the upward direction.

**E. Combination of investment profile in different stages of ventures**

The years 2001 to 2004 witnessed a decline in both the number of deals and the amount so invested in both the early and later stage enterprises. From the year 2004, there has been an increase in the number of deals invested in the later stage companies as compared to those invested in early stage enterprises. While the number of deals in early stage companies declined and later stage companies grew, in the year 2007, it can be seen that the amount of investment in early stage companies are more with regard to the number of deals invested in the later stage companies. It manifests that paradigm shift of concentrating early stage to later stage of investment by venture capitalists.

**Table 4a- Tabular Analysis of number of VC firm's/funds**

| S.No | Stages | Average | Inference |
|---|---|---|---|
| 1 | Early Reforms(2001-2004) | >78 | Gradual decline from the number of firms in 2000. But steady increase in the period. |
| 2 | During Reforms (2004-2007) | >106 | Steady raise (2004,2005) sharp growth (2006) continued steeply in 2007. |

**Table 4b - Data for number of VC firm's per year.**

| Year | Number of VC firms | % change over the previous year |
|---|---|---|
| 2001 | 77 | 0 |
| 2002 | 78 | 1.23 |
| 2003 | 81 | 38.46 |
| 2004 | 86 | 6.17 |
| 2005 | 89 | 3.49 |
| 2006 | 105 | 17.98 |
| 2007 | 146 | 39.05 |

**F.Government policies**

One of the main reasons for the lack of development of the VC industry in India was found to be the restrictive legal and financial framework. The Chandrasekhar Committee (2000) was appointed to identify the barriers in the growth of the VC industry in India and to suggest suitable measures for its rapid growth. The committee submitted its report in the year 2000 making a complete set of recommendations to promote the growth of in the VC industry in the country. These recommendations were accepted and implemented by the SEBI. This has played a major role in the growth of the industry, but there are certain loopholes that need to be addressed by the government with regard to regulation, taxes, etc.

**G. Risk Appetite of Investors**

The risk appetite of VC investors has seen a declining trend in the period taken t for the study, which is inferred from the fact that the number of deals, the volume of in vestment and value of deals has decreased. More importantly, it is pertinent to note that the probability of failure of early stage deals is higher than that of later stage deals. From the analysis on the proportion of deals in the different stages of VC investment, it is identified that the investment activities in later stage deals have considerably increased as compared to activity in early stage deals. This implies that the willingness to take risk by venture capitalists has declined. The global financial crisis is also seen to have had a negative effect on the risk appetite of venture capitalists.

**Survival of Venture Capital Industry in India during the Financial Crisis**

The widespread business pessimism and lack of confidence created by the financial turmoil has as adverse impact on the VC industry globally. In India, as well, the overall functioning of the VC Market declined during the financial crisis, yet there have been proofs of the market making a progressive

recovery in 2009. This part of the analysis focuses on the state of VC industry during the financial period with respect to the variables chosen Even though IT & ITES industry remained the favorite among VC investors in 2009, it accounted only for about 39% of the investments during 2009. Other sec tors are attracted investors' attention in 2009, which comprised Financial Services, Health care & Life Sciences, and Alternative Energy. Therefore the pattern of declining shift in the IT-ITES sector continues to be followed even after the financial crisis, but many other promising sectors are on the rise Following the crisis, investors became risk averse mainly due to the shortage of excess income or the fear of losing the existing of job. As a result the trend in the volume of of investment has declined as compared to the reform phase, which is in congruence with d the hypothesis of the study. On comparing the amount invested in 2009 (USD 475 Mil lion) with that of 2007 (USD 950 Million), the ed downfall of the trend in the investing pattern can be clearly seen. Therefore, it can be inferred that there has been a waning shift in the pattern of volume of investment.

Through the period of financial crisis, there occurred considerable downfall in the number of deals both in the years of 2008 and 2009. The number of deals fell from 387 (2007) to 153 in 2008, which then at again continued to fall drastically to 92 in 2009. Therefore, there has been a major shift in the pattern of number of deals becoming facilitated to the growing VC market in S the country.

The number of venture firms increased despite the financial crisis in 2008. From 146 in 2007, the number of venture firms K increased steadily to 160 in 2008. Therefore, 2 it does substantiate to say that the trend B hasn't shifted with respect to that of the reform phase. The movement of pattern of upcoming of VC firms is in the upward direction.

Number of deals in each stage in the year 2008 and 2009, the number of deals invested in by venture capitalists was 153 and 92 respectively. This is a sharp decline from the previous year's figures. This decline is ascribed mainly due to the financial crisis. The industry, however, is seen to be picking up in terms of investments in late 2009 and early 2010. The reason behind the increase in the number of deals investment in ventures during 2009-2010 was mainly due to the confidence levels of venture capitalists towards the growth of the economy and growth (2006) performance of the corporate sector even during the seemingly difficult situation.

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However, the financial crisis had an impact on the VC industry. Surveys imply a substantial "funding gap" for the financing of new and current project initiatives was created by the crisis. This may in turn have a negative impact on subsequent economic growth and development. VC finance has a significant positive effect on economic growth.

Discussion

The service sector is estimated to be the major contributor to the GDP (53.7%) of Indian economy. The service sector of India is powered by the ICT enabled industries, especially the software solution companies, banking and financial services, personalised services, retail and real estate. India has now become one of the first choice destinations not only for investment in manufacturing and trading but for sectors of research and development also, reinforcing the role of service sector in the country. A survey conducted in 2007 (Chadda), on the inter est of the venture capitalists, it was found that foreign investors are highly interested to have their funds

stakes in USA, China, India, Israel and Canada. India was found to be the second choice destination for the foreign investors.
Following the recent financial melt down, there has been a major decline in VC initiatives, due to considerable decrease in the availability of the investors in the VC market. Many investors were forced to reduce their involvement in providing funds to risky assets due to the shaken confident shot up by the US banking bubble. The analysis regarding the amount of capital invested in VC clearly states the recovery in investment activity and rising interest in the global investors towards India. It is being predicted that in 2010, there would be more of follow-on investments and exit activity with the economic recovery taking place.

The future of VC industry in the country is very promising. It has been endorsed by the collective efforts of academia, industry and the government. The initiative has already been started with the launching of 'the Power of Ideas' initiative at the Centre of Innovation, incubation and Entrepreneur ship of IIM (Ahmedabad), Science and Technology Department of the Government of India in October 2010 (Abrar, 2010). Under the project, 74 contractors from 850 short-listed applications were selected from a pool of 16000 exploratory business suggestions through a strict screening procedure. The participants underwent different facets of entrepreneurship, including corporate policy, marketing research, client acquisition, due diligence processes and the manner in which risk capitalists are approached. Hence, this initiative seems to be heralding similar additional inputs by academia, em bedded with technical knowledge and think tank, rising to the expectation of industry and economy in future.

**4. CONCLUSION AND FINDINGS OF THE STUDY**

The study found that the state of the VC industry in India during the period from 2001 to 2004 showed that even after the dot.com bubble burst, venture capitals survived with the new opportunities they took advantage of and with new innovations in the industry. The VC industry grew to a great extent during the next period of our study, 2005 to 2007, where investments were at their maximum when evaluated at the end of the year 2007. The financial crisis caused a major decline in the VC investment activity in general. Though IT-ITES sector still rules the VC market, there are other sectors which are coming up such as the Health Care, BFSI etc. despite the fact that the number of deals in the IT-ITES sector is the highest compared to other sectors, the total amount of capital invested in IT-ITES is lesser than that invested in BFSI.
A Change in regulations with the aim of accelerating the growth of the industry was also done. The Chandrasekhar Com- Abrar, P. I mittee which was appointed by SEBI in the year 2000 made recommendations for this purpose and these were implemented by the SEBI. The regulations related to the amount of fees to be paid by VC firms were again amended in the year 2006. Other recommendations with regards to the Government, Clark, P RBI, CBDT are being pursued by the SEBI. The risk appetite of venture capitalist has also seen a major shift because of various reasons such as the decrease in the amount available for investment which has, in turn, affected the value and number of deals in vested in. Investors are also found to prefer investing

in less risky investments such as deals of companies in their later stages. This changes the very meaning of VC investment which was initially said to be "unsecured risky financing" for high and new technology-based enterprises. Chrysler, provider In 2009, a significant rebounds in investment and increased interest (including global investors in potential markets such as India, show a picture of the sector's expansion. GIVCA's director Sudhir Sethi, and IDG Ventures President, Managing Director India is quite hopeful about the major successive investments in companies, which have raised a number of rounds in the last two to three years and the growth in exit activities in the near future as global economic recovery is progressing.

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