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A DESCRIPTIVE STUDY OF VENTURE CAPITAL AS A SOURCE OF FINANCE

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ABSTRACT

This paper describes and examines Venture Capital (VC) as an excellent Source of finance with its impact on the development of new firms. The paper is based on secondary data, where many secondary data sources were used by the researcher to evaluate the concepts.

Venture Capital Investments in various sectors was evaluated and VC growth in different sectors was taken into consideration. The facts and data show that venture capitalists play an important role over and above, beyond those of traditional financial intermediaries. How to procure a finance and valuate it, for new venture is an under researched question in entrepreneurial financing which is detailed in the current study and this research study proposes venture capital as a complementary method of financing for new start-ups along with existing ones who want to expand in later stage.

Starting a company on the grounds or expanding it requires money and raising the right kind of finance is still a major question for many entrepreneurs which includes all small, medium or large scale enterprises. The lack of capital is a major barrier which cannot be removed by family, friends or borrowings in early stage. The current study evaluates whether these barriers can be overcome by instruments like VC. The paper also evaluates the pros and cons associated with VC, mechanism of borrowing of VC, initiatives taken by the government and legal framework of the SEBI to execute it.

1. Introduction

Venture Capital, defined as independently managed dedicated pools of capital that focus on equity, or equity-linked investments in privately held, high-growth companies (Lerner, 2009)

The term 'venture capital' represents financial investment in a highly risky project with the objective of earning a high rate of return. Venture capital is of two types viz; Corporate venture capital (CVC) and Independent venture capital (IVC). The scope of venture capital companies is increasing in India due to increasing emergence of technology based industries, companies and entrepreneurs who lack capital to be risked. Venture capital is a form of equity financing especially designed for funding high risk and high reward projects. The VC- finance is usually equity finance, which can be directly placed on the share capital.

Up to 1946 most entrepreneurial firms were not able to get the loan from banks of the various financial institutions due to non availability of the securities or an asset which was the prime condition put forth by the lenders of the money. But the organizations or entrepreneurs had no regular source of such capital, meaning that entrepreneurs had a very little opportunity to fund their ventures. In this way Venture Capital came to existence. Venture Capital emerged as a new financial method of financing during the 20th century. Venture capital (VC) is the capital provided by firms to professionals who invest and operates in young, rapidly growing or changing companies that have the potential for high growth.

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These venture capital companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters' contribution as required by the financial institutions. Venture Capital is a new way of sourcing to the companies where they are interested in businesses with high growth potential that will allow them to gain more than average return in a time frame ranging from 3 to 10 years, depending on the type of investment and risk. Most of the venture funding goes to companies in rapidly expanding industries such as technology, bio-technology, and life sciences.

Venture Capital is a subset of private equity which refers to the equity investments for launch, expansion and development of the business which is solely based on the entrepreneurs understanding of the business with his skills and knowledge.

VC will also consider factors such as results of past operations, amount of funds needed and their intended use, future earnings projections and conditions, expected skills and knowledge set of the management etc. As compared to the banker, VC looks for potential long-term capital benefits rather than interest income. Obtaining venture capital is very different in its nature like raising debt or a loan from a lender. Lenders usually seek security for their investment such as a charge over the assets of the company and will charge interest on a loan and seek repayment of the capital where Venture Capitalist invest in exchange for a stake in the company and like the equity shareholders returns are dependent on the growth and profitability of the business. The investment is unsecured, fully at risk and usually does not have defined repayment terms. It is this flexibility which makes Venture Capital an attractive and appropriate form of finance for early stage.

Venture Capital funding is not a perfect suit for all the businesses neither a unique option for all start-ups. In fact there are various other options too which the entrepreneurs have to explore in search of funding, which includes Angel investor, strategic investment, crowd funding, micro-funding which again is based on the objectives of the firm, kind of control required by the management and expertise in the field.

2. Review of literature

Various reports published by IVCA (Indian Venture Capital Association), Asian Venture Capital Journal, and many research journals at national and international level enlighten the concept. Various researchers published their work on the said topic which has been reviewed by the researcher for the concept formation and problem area identification.

Pallavi Rani and Hitesh Katyal (Pallavi rani, 2015) concluded that, in terms of number of investments, IT, ITES and Manufacturing sector were the top two sectors in the overall VCPE investments. They also concluded that Venture Capitalists in India are biased toward technology companies with 68.0% of investments made in this sector and other sectors include healthcare and education accounting for 9.0% and 7.0% of total investments respectively.

In the study of Venture Capital Financing for Micro, Small & Medium Enterprises (MSME) in India, Vijayalaxmi & et.al. (Vijayalakshmi, 2015) found that, in venture capital finance it is important to recognize strategic elements, which lay the basis for the success of the selected company. The decision of the scope of the VC fund is also relevant, because guidelines the allocation of selection. The researcher also revealed that the development and building of the management team and organization requires resources, which venture capital

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investor supplies. The time to exit seems to take more time than planned. The economic fluctuations effect strongly to the level of revenues in exit.

Viren Chavada (Chavada, 2014) in his paper titled "An Overview on Venture Capital Financing in India" concluded that, India is promoting venture capital financing to new projects, innovative ideas, liberalising taxation regulations providing tax benefits to venture capitalist. He stated that there is a requirement of rapid venture capital funding business in India in spite of the existing problems in the Indian industrial infrastructure.

Thomas and Manju (Puri, 2002) in their paper titled "Venture Capital and the Professionalization of Start-Up Firms: Empirical Evidence" examined the impact of venture capital on the development of new firms.

In the above backdrop it can be concluded that venture capitalists play roles over and beyond those of traditional financial intermediaries.

3. Objectives

i) To study Venture Capital as a Source of Funding.

ii) To Study the need of Venture Capital for start-ups in India.

iii) To focus on the development and current scenario of Venture Capital in India .

iv) To Study the financing Mechanism and methods of Venture Capital.

v) To understand the Rules and Regulations for Venture Capital formulated by SEBI.

4. Research Methodology

The paper is purely based on the secondary data sources in which articles of the various researchers, published reports on the topic published by IVCA (Indian Venture Capital Association), Asian Venture Capital Journal, blogs of the various authors and different books written on the said topic were studied. For conceptual framework, researchers studied the various entrepreneurs and their stories and interviews in various daily news papers and magazines.

5. Problem Area and need of Venture Capital

A new business requires three important economic resources viz; man, money and material. Money i.e. capital is an important and scarce economic resource which is a prime requirement, for starting any kind of business. For the new entrepreneurs, it is very important to know the various sources of finance available and suitable for their business. Steady, continuous and long term finance at cheap rate, is very essential for the business to grow and sustain in the long term.

Venture capital is an another option available for the new entrepreneurs, who have an idea and expertise of the business but don't have the creditworthiness to procure the finance from the banks or from the financial institutions due to the securities required to create a mortgage. For the entrepreneurs, those who are having an idea, knowledge, expertise and business plan but due to scarcity of finance not able to start their own enterprise, for them Venture Capital is an better option.

This paper tries to find out the suitability of the Venture Capital financing for the new entrepreneurs and the pros and cons related with it. The paper emphasizes the various terms and conditions which this venture capital firms set before financing the project along with the scenario at the national level.

6. Concepts

6.1 Venture Capital

Venture capital is money provided by an outside investor to finance a new, growing, or troubled business. Capital is invested in exchange for an equity stake in the business rather than given as a loan, and the investor hopes the investment will yield a better-than-average return. Venture capital is an important source of funding for start-up and other companies that have a limited operating history and don't have access to capital markets. Venture capitalists provide the capital by the various modes which include Equity, Convertible loan and Conditional Loans.

6.2 Venture Capital Firms

Group of professionals who provide capital to the firms are known as venture capitalists. Venture capitalists also provide value-added services and business and managerial support. The venture capitalist provides funding knowing that there's a significant risk associated with the company's future profits and cash flow. A venture capital firm (VC) typically looks for new and small businesses with a perceived long term growth potential that will result in a large payout for investors. Venture Capitalists aim to use its business knowledge, experience and expertise to fund and nurture companies that will yield a substantial return on the VC's investment, generally within three to seven years.

7. History of Venture Capital

General George Doriot's firm, American Research and Development Corporation (ARD), began operations in 1946 as the first true VC firm. Unlike modern funds, it was organized as a corporation and was publicly traded. (Yasuda, 2011) In recognition of this problem faced by small-growth businesses, the U.S. government began its own VC efforts as part of the Small Business Act of 1958, which was a legislation that created the Small Business Administration and allowed the creation of Small Business Investment Companies (SBICs) (Yasuda, 2011)

The concept originated in USA in 1950s when Rockfeller Group financed the new technology companies. The concept became popular during 1960's and 1970's when several private enterprises started financing highly risky and highly rewarding projects. The American Research and Development was formed as the first venture organization which financed over 100 companies and made profit over 35 times its investment. (Rai) An important milestone for the VC industry came in the 1960s with the development of the limited partnerships for VC investments. In this arrangement, limited partners put up the capital, with a few percentage points of this capital paid every year for the management fees of the fund.

8. Venture Capital as a Source of Finance

Sourcing money for business may be done for a variety of reasons and from variety of sources. Some sources are short term and others are long term sources e.g. Equity Financing, Corporate Bond, Debentures, Commercial Paper, Promissory Note, Bank loan, Accounts Receivables etc. Amongst all venture capital is suitable for new innovative projects which generally offer high profitability in long run. Venture Capital is not a passive finance like other sources. A long term commitment of funds is involved in the form of equity

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investments with the aim of capital gains rather than income and active involvement in the management of business.

Apart from the obtaining financial backing, venture capital financing can provide a start up with a valuable source of guidance and consultation. Young business houses gets active support in critical areas including legal, tax, and personnel matters. Tapping good connections which venture capitalist typically have, the organizations can leverage the contacts for their organizational growth and expansion which will bring them the tremendous benefits.

8.1 Types of Funding

VC fosters growth at the company through its involvement in managerial, strategic, and planning decisions. Venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability. The different times at which the finance is provided to the firms are-

8.1.1. Seed Capital.

The low level financing needed to prove a new idea. If the entrepreneur is just starting out and have no product or organized company yet, he would require seed capital. The amount invested would probably be small. Investment capital may be used to create a sample product, fund market research, or cover administrative set-up costs.

8.1.2. Startup Capital.

At this stage, the organization company would have a sample product available with at least one principal working full-time. Funding at this stage is also rare. It tends to cover recruitment of other key management, additional market research, and finalizing of the product or service for introduction to the marketplace.

8.1.3. Early Stage Capital.

Two to three years into the venture, when the company comes off the ground, a management team is in place, and sales are increasing. At this stage, VC funding helps the entrepreneurs to increase sales to the break-even point, improve productivity, or increase company's efficiency.

8.1.4. Expansion Capital.

Venture capitalists provide finance for expansion purposes like bigger factory, large warehouse, new factories, new products, new markets or through purchase of existing businesses. The time frame of investment is usually from one to three years. Also called Mezzanine financing, this is expansion money for a newly profitable company.

8.1.5. Late Stage Capital.

At this stage, the capital provided for one's company has achieved impressive sales and revenue and one has a second level of management in place and may be looking for funds to increase capacity, ramp up marketing, or increase working capital.

8.2Procedure Followed by Venture Capitalists (Rai)

venture capitalists scrutinize the proposal before investing and they consider the various factors before investing which includes management involved in the project, idea of the team, business plan, project cost and returns, future market prospective, existing technology etc.

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8.2.1 Receipt of proposal.

A proposal is received by the venture capitalists in the form of a business plan. A detailed and well-organized business plan helps the entrepreneur in gaining the attention of the VCs and in obtaining funds. A well-prepared business proposal tells the venture capitalists about the entrepreneur's ideas and it shows that the entrepreneur has detailed knowledge about the proposed business and is aware of the all potential problems.

8.2.2 Appraisal of plan.

VC appraises the business plan giving due regard to the creditworthiness of the promoters, the nature of the product or service to be developed, the markets to be served and financing required. VCs also conduct cost-benefit analysis by comparing future expected cash inflows with present investment.

8.2.3 Investment.

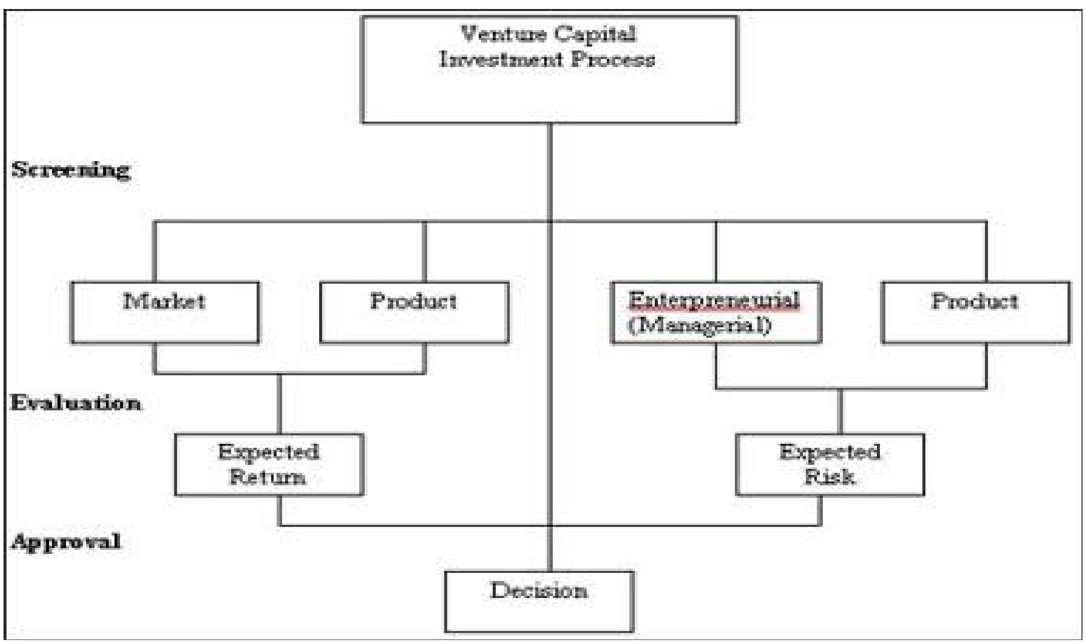
If venture capital firm is satisfied with the future profitability of the proposal, it will take step to invest his own money in the equity shares of the new company known as the assisted company.

8.2.4 Provide value added services.

Venture capitalists not only invest money but also provide managerial and marketing assistance and operational advice. They also make efforts to accomplish the set targets which consequently results in appreciation of their capital.

8.2.5. Exit.

After some years, when the assisted company has reached a certain stage of profitability the VC sells his shares in the stock market at high premium, thus earning profits as well as releasing locked up funds for redeployment in some other venture and this cycle continues.



8.3 Methods of VC :- (Vijayalakshmi, 2015)

The financing pattern of the deal is the most important element. Following are the various methods of venture financing:

8.3.1 Equity: All VCFs in India provides equity but generally their contribution does not exceed 49% of the total equity capital thus the effective control and majority ownership of the firm remains with the entrepreneur. They buy shares of an enterprise with an intention to ultimately sell them off to make capital gains.

8.3.2 Conditional Loan: it is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India VCFs change royalty ranging between 2% to 13%: actual rate depends on other factors of the venture such as gestation period, cost flow patterns, risk and other factors of the enterprise

8.3.3 Income Note: it is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty but at substantially low rates.

8.3.4 Participating Debenture: such security carries charges in 3 phases. In the initial phase, before the venture attains operations to a minimum level, no interest is charged, after this, low rate of interest is charged, up to a particular level of operation. Once the venture is commercial a high rate of interest is required to be paid

8.3.5 Quasi Equity: quasi equity instruments are convened into equity at a later date. Convertible instruments are normally convened into equity at the book value or at certain multiples of EPS. i.e. at a premium to par value at a later date. The premium automatically rewards the promoter for their initiative and hand work. Since it is performance related it motivates the promoter to work harder so as to minimize dilution of their control on the company

9. Development and Current scenario of VC in India

In India, the need for Venture Capital was recognized in the 7th five year plan and long term fiscal policy of Govt. of India. In 1973 a committee on Development of small and medium enterprises highlighted the need to faster venture capital as a source of funding/financing new entrepreneurs, projects and technology. Venture capital financing was actually started in India in 1988 with the formation of Technology Development and Information Company of India Ltd.

Total India PE deal value in 2015, including real estate, infrastructure and smaller deals, grew to approximately $23 billion an increase of 51% from 2014 and an increase of 34% over peak levels of 2007 ($17 billion) . Increased deal activity in 2015 is attributed to improving macroeconomic conditions, positive changes in the exit environment and changes in valuation expectations. Several government initiatives such as the Startup India program, tax regime rationalization and Make in India have encouraged investments. More funds now participate in Indian markets (240 in 2015 compared with 193 in 2014) Funds expect India's attractiveness for new deals to increase with respect to other Asia-Pacific markets . Number of exits increased by 10% in 2015; total exit value increased by 57% to reach $9 .4 billion . Volatile macroeconomic factors, difficulty in fund-raising and an inability to exit continue to be the biggest challenges to the VC and PE industry in 2015. *(India Venture Capital and Private Equity Report, 2016)*

The major venture capital financers in India are: (Chavada, 2014)

• Promoted by the Central Government controlled development finance institutions.

For example:

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ICICI Venture Funds Ltd.
IFCI Venture Capital Funds Ltd (IVCF)
SIDBI Venture Capital Ltd (SVCL)

• Promoted by State Government controlled development finance institutions.

Punjab Infotech Venture Fund
Gujarat Venture Finance Ltd (GVFL)
Kerala Venture Capital Fund Pvt Ltd.

• Promoted by public banks For Example:

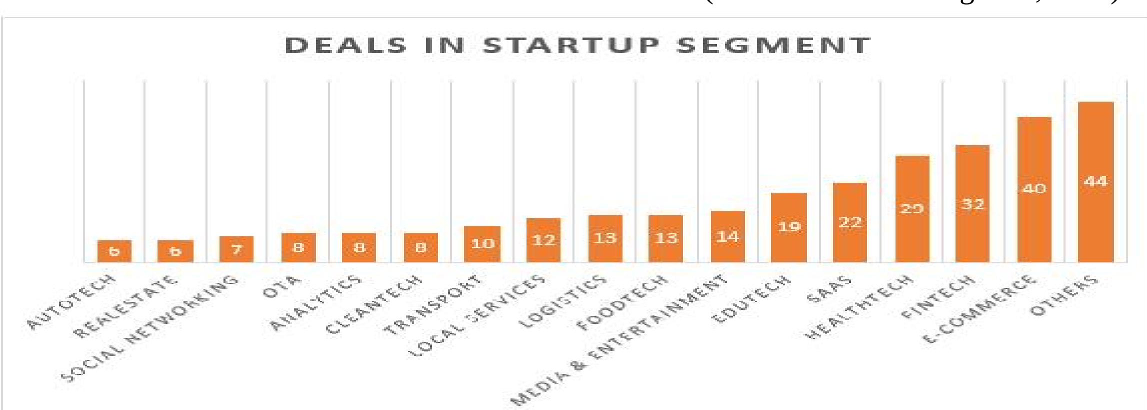
Canbank Venture Capital Fund
SBI Capital Market Ltd

• Promoted by private sector companies For example:

IL&FS Trust Company Ltd
Infinity Venture India Fund

Industry wise Cumulative Investment Details of SEBI Registered Venture Capital Funds (VCF) and Foreign Capital Investors (FVCI)			
Particulars	**as on June 30, 2016 (Rs. in Crore)**		
Sectors of Economy	**VCF**	**FVCI**	**Total***
Information Technology	1358	5163	6244
Telecommunication	1108	5464	6071
Pharmaceuticals	489	278	707
Biotechnology	246	110	356
Media/Entertainment	341	629	903
Services Sector	2954	2749	4044
Industrial Products	1047	495	1259
Real estate	9732	989	10256
Others	16228	28896	38714
Total	33503	44772	68555
	*excludes INR 9720 crore of FVCI investments through VCFs		

(Source :- www.sebi.gov.in, 2016)



(Source : http://www.india-financing.com,2016)

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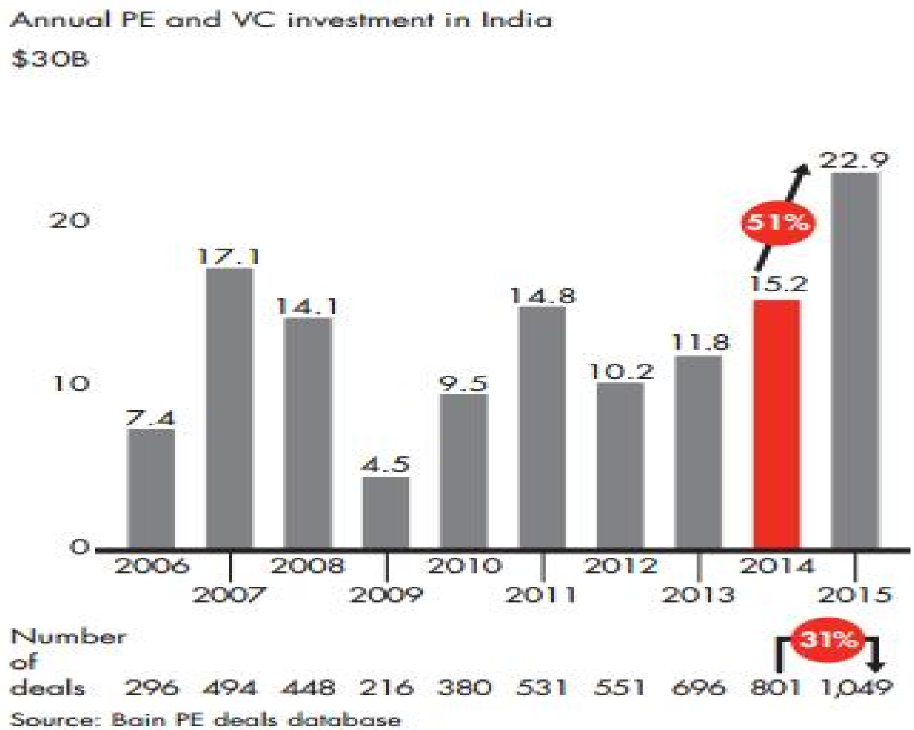

(*India Venture Capital and Private Equity Report, 2016)*

Top 10 deals in 2015 accounted for 20% of total deal value		
Company	**Fund(s)**	**Value ($M)**
Flipkart	Tiger Global Management, Steadview Capital	**700**
One97 Communications/Paytm	Alibaba Group Holding, SAIF Partners	**635**
Jasper Infotech/ Snapdeal	Blackrock, Myriad Asset Management, SoftBank, Hon Hai Precision Industry, Alibaba Group, PremjiInvest	**500**
Atria Convergence Technologies/ ACT Television	TA Associate Advisory; India Value Fund Advisors Indium-V	**500**
ANI Technologies/ Ola Cabs	Baillie Gifford; Didi Kuaidi; DST-Advisors; Falcon Edge Capital; SoftBank; Tiger Global Management	**500**
ANI Technologies/ Ola Cabs	Tiger Global Management, Steadview Capital, Accel India, DST Global, ABG Capital, Falcon Edge Capital, GIC, SoftBank, RNT Associates	**402**
Shriram City Union	Apax Partners	**386**
Intelenet Global/Serco India	Blackstone	**384**
Crompton Greaves Consumer Electricals	Temasek, Advent India	**316**
Tata Realty & Infrastructure	Standard Chartered PE	**302**
Total		**4,625**

(Source :-*India Venture Capital and Private Equity Report, 2016)*

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10. Pros and cons

10.1 Pros / Benefits of VC over other Funding Methods: (Vijayalakshmi, 2015)

Emerging scenario of global competitiveness put pressure on industries for minimization of cost and improved quality. For this organizations require hi-tech equipments and adequate financing which can be attained by obtaining venture capital firms. Venture capital has a number of advantages over other forms of finance:

a) It injects long term equity finance which provides a solid capital base for future growth.

b) The venture capitalist is a business partner, sharing both the risks and rewards. Venture capitalists are rewarded by business success and the capital gain.

c) 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.

d) 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.

10.2 Cons/Issues

The various problems queries can be outlined as follows.

1. Payback period is longer (5-7 years) so it is difficult to get invested who are ready to invest for shorter period.
2. Expectation of rate of investment is above average rate which is uncertain.
3. Skills and training required along with the cost of training.
4. Though Government has formulated policy it is backed with many rules and regulation and formalities so it creates problems in getting funds.
5. To enter into Venture capital industry many companies have to follow SEBI rules and Regulations so they may face difficulty at entry level only.
6. Requirement of an experienced managerial team (Chavada, 2014)
7. Requirement of high rate of return on investment
8. Payback period is normally long
9. Uncertainty regarding the success of the product in the market.
10. The category of potential customers regarding products and service offerings.
14. The size of the market
15. Major rivals and their market share.

11. Rules and Regulations for VC in India by SEBI:

VCF are regulated by the SEBI (Venture Capital Fund) Regulations, 1996.

The following are the various provisions:

a) 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.

b) 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

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c) 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
d) At least 80% of the funds should be invested in venture capital companies and no other limits are prescribed.
e) SEBI Regulations do not provide for any sector restrictions for investment except investment in companies engaged in financial services.
f) A VCF is not permitted to invest in the equity shares of any company or institutions providing financial services.
g) 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
h) A Scheme of VCF set up as a trust shall be wound up when the period of the scheme if any, is over
i) If the trustee are of the opinion that the winding up shall be in the interest of the investors
j) 75% of the investors in the scheme pass a resolution for winding up or, if SEBI so directs in the interest of the investors.

12. CONCLUSION

There are many sectors of the economy, which are expanding like, information technology, engineering, Pharma, Manufacturing industries and other service industry too, which requires large investment and the traditional mechanism of financing to this sectors but currently is not adequate. In the search of the new sources of the finance, the entrepreneurs have an good option that is, Venture Capital Finance. The developing nation requires the rapid venture capital funding to tackle with the existing problems in the Indian industrial and financial infrastructure.

For young minds in India, those who are having the skills, knowledge and abilities with necessary degrees, the requirement of unsecured loan can be fulfilled with the help of sources like Venture capital finance. The world markets are becoming more and more competitive. Companies are required to be super efficient if they want to compete at global level with respect to cost, productivity, labor efficiency and technical skills, the entrepreneurs has to take risk in terms of business which is not easy in our traditional financial system and venture capital can be a better source of finance for this kind of risk taking entrepreneurs.

The effect of venture capital is also marked important in the early stages of a company's development. Venture capitalists play a role beyond the traditional roles of financial intermediaries. The start-ups and the increasing share of venture capital financing provide evidence for the role of venture capital in the growth and professionalization of start-up companies.

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