Venture Capital in India

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The first major analysis on risk capital for India was reported in 1983 [Chitale 1983]. It indicated that new companies often confront serous barriers to entry into capital market for raising equity finance which undermines their future prospects of expansion and diversification. It also indicated that on the whole there is a need to revive the equity cult among the masses by ensuring competitive return on equity investment. This brought out the institutional inadequacies with respect to the evolution of venture capital. The role of venture capital was met initially by the following institutions:

- Industrial Development Bank of India.
- Industrial credit and investment corporation of India
- State Finance Corporations and
- Small Industries Development Bank of India

The first origins of modern venture capital in India can be traced to the setting up of a Technology Development Fund in the year 1987-1988, through the levy of access on all technology import payments. Technology Development Fund was started to provide financial support to innovative and high risk technological programmers through the Industrial Development Bank of India. Subsequently, Government of India gave the procedures that can be used for starting venture funding.

The growth of VC in India has three separate phases. The first phase was the initial phase in which the concept of VC got wider acceptance. The first period did not really experience any substantial growth of VCs'. The 1980's were marked by an increasing disillusionment with the trajectory of the economic system and a belief that liberalization was needed. The liberalization process started in 1985 in a limited way. The concept of venture capital received official recognition in 1988 with the announcement of the venture capital guidelines.

During 1988 to 1992 about 9 venture capital institutions came up in India. Though the venture capital funds should operate as open entities, Government of India controlled them rigidly. One of the major forces that induced Government of India to start venture funding was the World Bank. The initial funding has been provided by World Bank. World Bank reported that India will require $67 to 133 million per annum as venture capital. It gave a total of US $45 million for starting VC funds in India. The most important feature of the 1988 rules was that venture capital funds received the benefit of a relatively low capital gains tax rate which was lower than the corporate rate. The 1988 guidelines stipulated that VC funding firms should meet the following criteria:

- Technology involved should be new, relatively untried, very closely held, in the process of being taken from pilot to commercial stage or incorporate some significant improvement over the existing ones in India.

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- Promoters / entrepreneurs using the technology should be relatively new, professionally or technically qualified, with inadequate resources to finance the project.

Between 1988 and 1994 about 11 VC funds became operational either through reorganizing the businesses or through new entities. All these followed the Government of India guidelines for venture capital activities and have primarily supported technology oriented innovative businesses started by first generation entrepreneurs. Most of these were operated more like a financing operation. The main feature of this phase was that the concept got accepted. VCs became operational in India before the liberalization process started. The context was not fully ripe for the growth of VCs. Till 1995, the VCs operated like any bank but provided funds without collateral. The first stage of the venture capital industry in India was plagued by inexperienced management, mandates to invest in certain states and sectors and general regulatory problems.

The liberation of the economy and toning up of the capital market changed the economic landscape. The decisions relating to issue of stocks and shares was handled by an office namely: Controller of Capital Issues (CCI). According to 1988 VC guideline, any organization requiring to start venture funds have to forward an application to CCL Subsequent ot the liberalization of the economy in 1991, the office of CCI was abolished in May 1992 and the powers were vested in Securities and Exchange Board of India. The Securities and Exchange Board of India Act, 1992 empowers SEBI under section 11(2) thereof to register and regulate the working of venture capital funds. This was don e in 1996, through a government notification. The power to control venture funds has been given to SEBI only in 1995 and the notification came out in 1996. Till this time, venture funds were dominated by Indian firms. The new regulations became the harbinger of the second phase of the VC growth. The notification had the following salient features:

- The guidelines made it easy for both private and government firms to enter the VC arena.
- It relaxed the criteria so as to allow the entry of any kinds of firms.
- A VC fund is prohibited to carry on any activity other than the VC fund.
- The minimum size of VC that was stipulated as Rs.100 million was removed.
- The new regulations prohibited investment by venture capital funds in the equity shares of any company or institution providing financial services.
- To promote early stage financing at least 80 percent of the venture capital funds shall be invested in the equity related securities issued by a company whose securities are not listed on any recognized stock exchanges.

Within the stipulation of 80 percent of the VCF investment, a venture capitalist can invest in the equity share or equity related securities of the financially weak company or a sick industrial company whose securities may be or may not be listed on any of the recognized stock exchanges.This condition is provided for supporting later stage and turnaround financing by venture capitalists.

- Venture capitalist can finance the companies which have already been assisted in any of the categories mentioned above.
- Venture capitalist can invest the balance 20 percent of the VCF in any listed company's securities viz shares and debentures or make inter corporate deposit with listed companies

or invest directly in R & D division of listed companies.

The second phase of VC growth attracted many foreign institutional investors. During this period overseas and private domestic venture capitalists began investing in VCF. The new regulations in 1996 helped in this. Though the changes proposed in 1996 had a salutary effect, the development of venture capital continued to be inhibited because of the regulatory regime and restricted the FDI environment. To facilitate the growth of venture funds, SEBI appointed a committee to recommend the changes needed in the VC funding context. This coincided with the IT boom as well as the success of Silicon Valley start-ups. In other words, VC growth co-evolved in India.

3.1. CLASSIFICATION OF VENTURE CAPITAL FIRMS

Venture funds in India can be classified on the basis of:

Genesis:

- Financial Institutions Led By ICICI Ventures, RCTC, ILFS, etc.
- Private venture funds like Indus, etc.
- Regional funds like Warburg Pincus, JF Electra (mostly operating out of Hong Kong.
- Regional funds dedicated to India like Draper, Walden, etc
- Offshore funds like Barings, TCW, HSBC, etc.
- Corporate ventures like Intel.

Investment Philosophy:

Early stage funding is avoided by most funds apart from ICICI ventures, Draper, SIDBI and Angels. Funding growth or mezzanine funding till pre IPO is the segment where most players operate. In this context, most funds in India are private equity investors.

Size of Investment:

The size of investment is generally less than US$10mn. As most funds are of a private equity kind, size of investments has been increasing. It companies generally require funds of about Rs30-40mn in an early stage which fall outside funding limits of most funds and that is why the government is promoting sxhemes to fund start ups in general, and in IT in particular.

Some of the companies that have received funding through this route include:

- Mastek, one of the oldest software houses in India.
- Geometric Software, a producer of software solutions for the CAD/CAM market.
- Ruksun Software, Pune-based software consultancy
- SQL Star, Hyderabad based training and software development company.
- Microland, networking hardware and services company based in Bangalore
- Saytam Infoway, the first private ISP in India.
- Hinditron, makers of embedded software
- PowerTel Boca, distributor of tele-computing products for the Indian market
- Rediff on the Net, Indian website featuring electronic shopping, news, chat, etc.
- Entevo, security and enterprise resource management software products
- Planetasia.com, Microland's subsidiary, one of India's leading portals

- Torrent Networking, pioneer of Gigabit-scaled IP routers for inter/intra nets
- Selectica, provider of interactive software selection
- Yantra, ITLInfosys' US subsidiary, solutions for supply chain management

Though the infotech companies are among the most favored by venture capitalists, companies from other sectors also feature equally in their portfolios. The healthcare sector with pharmaceutical, medical appliances and biotechnology industries also get much attention in India. With the deregulation of the telecom sector, telecommunications industries like Zip Telecom and media companies like UTV and Television Eighteen have joined the list of favorites. So far, these trends have been in keeping with the global course.

3.3. VC Trends in India

It is observed that 75 percent of the investments have been placed in five states such as Maharashtra, Tamil Nadu, AP, Gujarat and Karnataka. VC activities have been weak in most of the northern states. This partly represents weak entrepreneurial spirit and lesser emphasis on governance indicating that economic situation and innovation have a strong correlation. Out of the 728 units that has been reported in 1998 about 540 units were located in the top five states.

3.4. VC Investment in Stages

An analysis of VC investments in 1998 in various stages is presented in **Table**. It has been reported that nearly all VCs are hesistant to invest in startups with inexperienced business personal or in firms with unclear scalable business model, consequently seed funding in total disbursements is only 15 percent in 2000-01. It has increased to a higher level compared to what it was in 1998, indicating increased risk bearing attitude. The total amount disbursed over expansion and late funding grew to about 41 percent of the total, indicating VC preference to continue funding ventures that had demonstrated success in their enterprise. The behaviour is similar in other countries, but in India VC is a new phenomena and start-up accounted for 41 percent of the total disbursements. Because of the same reason, the third stage funding is negligible. Also in India VCs did not have any preference for turnaround investments. Till recently, VCFs did not provide any of the following types of assistance to industrial enterprises namely:

Distribution of VC units

Investment	Rs. Million	Number
Maharashtra	2,566	161
Tamil Nadu	1531	119
Andhra Pradesh	1372	89
Gujarat	1102	49
Karnataka	1046	93
West Bengal	312	22
Haryana	300	22
Delhi	294	21
Uttar Pradesh	283	29
Madhya Pradesh	231	2
Kerala	135	15
Goa	105	16
Rajasthan	87	11
Punjab	84	6
Orissa	35	5
Dadra & Nagar Haveli	32	1
Himachal Pradesh	28	3
Pondicherry	22	2
Bihar	16	3
Overseas	413	12
Total	9,994	691

- Expansion capital
- Buy-out finance in the form of management by out or leverage by-out
- Acquisition finance &
- Sick company rehabilitation finance

VC Investment in Stages

Investment Stages	Rs. Million	Number
Start-up	3813.00	297
Later stage	3338.99	154
Other early stage	1825.77	124
Seed stage	963.20	107
Turnaround financing	59.50	9
Total	10000.46	691

One of the first large management buy-out occurred in Oct 4, 2002. Satyam Infoway (SIFY) is the largest Internet Service Provider (ISP) in India. Two venture capital funds acquired 33.4% stake of SIFY for US $20 million. The two venture funds that picked up stake are:

- Softbank Asia Infrastructure Fund (SAIF)
- Venture Tech Solutions Private Ltd. (VTS)

SAIF will pick up 21.7 percent and VTS will pick up 11.7 percent. This is a management buyout. Both the VCs have picked up the stake at a price of $1.72 per ADR.

3.5. Investments by Industry

The distribution of investments in India by industry is given in **Table.** In India, electronics and telecom have a relatively low share. The pattern till 1995 was dominated by industrial products and slowly IT and software started picking up. The reason for the shift has been that revenue generation IT ventures are rapid in comparison with the other sectors.

VC Investments by Industry

Industry	Rs. Million	Number
Industrial Products, machinery	2599.32	208
Computer Software	1832.00	87
Consumer Related	1412.74	58
Medical	623.80	44
Food, food processing	500.06	50
Other electronics	436.54	41
Tel & Data Communications	385.09	16
Biotechnology	376.46	30
Energy related	249.56	19
Computer Hardware	203.36	25
Miscellaneous	1380.85	113
Total	10000.46	691

3.6. Contributors to the Venture Fund

The break-up of contributors to VC are given in **Table.** About 50 percent of funds came from foreign institutional investors. Most of foreign funds came after 1998. One of the major triggers that changed the complexion of the venture funds in India has been the entry of Intel. Intel Capital has used very systematic criteria for screening the candidates and they have extensive experience in assessing VCs. Most of the Intel supported VCs are well managed firms and they acquired capacbility to manage business due to the support provided by Intel Capital. External corporate venturing has been a model used by many firms [McNally 1997]. Intel has been aggressively using this model. The entry of external corporate venturing is a relatively new phenomena and most of the firms supported by them are innovative firms. This phenomena enhances the managerial expertise for assessing and supporting innovative firms.

Methods of Financing

Contributors	Rs. Million	Percent (%)
Foreign Institutional Investors	13426.47	52.46
All India Financial Institutions	6252.90	24.43
Multilateral Development Agencies	2133.64	8.34
Other Banks	1541.00	6.02
Foreign Investors	570.00	2.23
Private Sector	412.53	1.61
Public Sector	324.44	1.27
Nationalized Banks	278.67	1.09
Non Resident Indians	235.50	0.92
State Financial Institutions	215.00	0.84
Other Public	115.52	0.45
Insurance Companies	85.00	0.33
Mutual Funds	4.50	0.02
Total	25595.17	100.00

Instruments	Rs. Million	Percent (%)
Equity Shares	6318.12	63.18
Redeemable Preference Shares	2154.46	21.54
Non Convertible Debt	873.01	8.73
Convertible Instruments	580.02	5.80
Other Instruments	75.85	0.75
Total	10000.46	100.00

3.7. Problems with VCs in the Indian Context

One can ask why venture funding is so successful in USA and faced a number of problems in India. The biggest problem was a mindset change from "collateral funding" to high risk high return funding. Most of the pioneers in the industry were people with credit background and exposure to manufacturing industries. Exposure to fast growing intellectual property business and services sector was almost zero. All these combined to a slow start to the industry. The other issues that led such a situation include:

License Raj and the IPO Boom:

Till early 90s, under the license raj regime, only commodity centric businesses thrived in a deficit situation. To fund a cement plant, venture capital is not needed. What was needed was ability to get a license and then get the project funded by the banks and DFIs. In most cases, the promoters were well-established industrial houses, with no apparent need for funds. Most of these entities were entities were capable of raising funds from conventional sources, including term loans from institutions and equity markets.

Scalability:

The Indian software segment has recorded an impressive growth over the last few years and earns large revenues from its export earnings, yet our share in the global market is less than 1 percent. Within the software industry, the value chain ranges from body shopping at the bottom to strategic consulting at the top. Higher value addition and profitability as well as significant market presence take place at the higher end of the value chain. If the industry ahs to grow further and survive the flux it would only be through innovation. For any venture idea to succeed there should be a product that has a growing market with a scalable business model. The IT industry in India till recently had a service centric business model. Products developed for Indian markets lack scale.

Mindsets:

Venture capital as an activity was virtually non-existent in India. Most venture capital companies want to provide capital on a secured debt basis, to established businesses with profitable operating histories. Most of the venture capital units were offshoots of financial institutions and banks and the lending mindset continued. True venture capital is capital that is used to help launch products and ideas of tomorrow. Abroad, this problem is sovled by the presence of 'angel investors'. They are typically wealthy individuals who not only provide venture finance but also help entrepreneurs to shape their business and make their venture successful.

Returns, Taxes and Regulations:

There is a multiplicity of regulators like SEBI and RBI. Domestic venture funds are set up under the Indian Trusts Act of 1882 as per SEBI guidelines, while offshore funds routed through Mauritius follow RBI guidelines. Abroad, such funds are made under the Limited Partnership Act, which brings advantages in terms of taxation. The government must allow pension funds and insurance companies to invest in venture capitals as in USA where corporate contributions to venture funds are large.

Exit:

The exit routes available to the venture capitalists wee restricted to the IPO route. In general, all issues were under priced. Even now SEBI guidelines make it difficult for pricing issues for an easy exit. Given the failure of the OTCEI and the revised guidelines, small companies could not hope for a BSE/ NSE listing. Given the dull market for mergers and acquisitions, strategic sale was also not a available.

Valuation:

The recent phenomenon is valuation mismatches. Thanks to the software boom, most promoters have sky high valuation expectations. Given this, it is difficult for deals to reach financial closure as promoters do not agree to a valuation. This coupled with the fancy for software stocks in the bourses means that most companies are pre-poning their IPOs. Consequently, the number and quality of deals available to the venture funds gets reduced.

Regulatory Issues:

There are a number of rules and regulation for venture capital and these would broadly come under either of the following heads:

- The Indian Trust Act, 1882 or the Company Act, 1956 depending on whether the fund is set up as a trust or a company.
- The Foreign Investment promotion Board (FIPB) and the Reseive Bank of India (RBI) in case of an offshore fund. These funds have to secure the permission of the FIPB while setting up in India and need a clearance from the RBI for any repatriation of income.
- The Central Board of Direct Taxation (CBDT) governs the issues pertaining to income tax on the proceeds from venture capital funding activity. The long term capital gains tax is at around 10% in India and the relevant clauses to venture capital may be found in Section 10 (subsection 23).
- The Securities and Exchange Board of India has come out with a set of guidelines attached in the annexure.

In addition to the above there are a number of arms of the Government of India- Ministry

of Finance that may have to be approached in certain situations. Also intervention by allied agencies like the Department of Electronics, the National Association of Software and Computers (NASSCOM) and various taskforces and standing committees is not uncommon.

Probably this explains why most of the funds prefer to take the easy way out by listing as offshore funds operating out of tax havens like Mauritius (where the Avoidance of Double Taxation Treaty, incomes may be freely repatriated).

3.8. Major Recommendations of the VC Committee

The committee came to the conclusion that the venture capital industry in India is still at a nascent stage. It also stated that with a view to promote innovation, enterprise and conversion of scientific technology and knowledge based ideas into commercial production, it is very important to promote venture capital activity in India. The report prepared a vision, identified strategies for growth and how to bridge the gap between traditional means of finance and the capital needs of the high growth start-ups.

The committee identified five critical success factors for the growth of VC in India, namely:

- The regulatory, tax and legal environment should play an enabling role as internationally venture funds have evolved in an atmosphere of structural flexibility, fiscal neutrality and operational adaptability.
- Resource raising, investment, management and exit should be as simple and flexible as needed and driven by global trends.
- Venture capital should become an institutionalized industry that protects investors and invitee firms, operating in an environment suitable for raising the large amounts of risk capital needed and for spurring innovation through start-up firms in a wide range of high growth areas.
- In view of increasing global integration and mobility of capital it is important that Indian venture capital funds as well as venture finance enterprises are able to have global exposure and investment opportunities, infrastructure in the form of incubators and R&D need to be promoted using government support and private management as has successfully been done by countries such as the US, Israel and Taiwan. This is necessary for faster conversion of R&D and technological innovation into commercial products.

The second phase of VC growth was essentially a learning phase.The rapid growth of VC during 1995 to 2000 made government examine the issues in the light of the Chandrasekhar Committee. The second phase growth has been mostly of information technoloty driven. This was also due to Government of India's interest in attracting FDI into India. This paved the way for the next pahse of VC growth in India. Based on the recommendations of the committee and based on the budget proposals SEBI approved two new regulations:

- SEBI (Venture Capital) Amendment Regulations, 2000 and
- SEBI (Foreign Venture Capital Investors) Regulations, 2000.

3.9. The Major Changes Brought About by the Regulations

VCF is defined as fund established in the form of Trust, a company including a body

corporate and registered with SEBI which as a dedicated pool of capital raised in the manner specified under the Regulations; to invest in venture capital undertakings in accordance with the Regulations. The minimum size of the fund from any investor will not be less than INR 500,000 and the minimum corpus of the fund at the start has to be at least INR 50 million. The new regulations stipulated that the maximum investment in single venture capital undertaking is not to exceed 25% of the corpus of the fund. The new regulations allowed VCF to participate in a company's initial public offering through the book building route as a Qualified Institutional Buyer.

The new regulations allowed Foreign Venture Capital Investor to register with SEBI. Also, SEBI registered Foreign Venture Capital Investors will be permitted to make investment pursuant to the automatic route within the overall sect oral ceiling of foreign investment without having to obtain the prior approval of the Foreign Investment Promotion Board (FIPB). Along with this, with effect from June 1, 2000 foreign investment in Indian securities is controlled by the provisions of the Foreign Exchange Management Act, 2000. This required that an offshore VCF investing in India will need to consider the requirements under the FEMA which Inter alia requires certain categories of offshore/ foreign investors to seek the prior approval of the Foreign Investment Promotion Board constituted by the Government of India, before they invest in Indian securities.

The changes had a salutary effect on venture capital industry and this is the third phase of VC growth. Though the dot.com problem and global economic slow-down affected VC funding, the software exports continued to surge. The growth of IT exports over the year show that IT exports and VC growth has a strong correlation. Unlike that in US, Government of India did not permit pension fund to flow into VC. One of the basic differences between US SBIC and Indian pre venture entrepreneurship has been that in that case of India there was no relationship between entrepreneurship financing and VC financing.

Top Deals for the Quarter Ended Dec 31, 2003

Company	Sector	$ Million	Investors
Matrix Labs	Pharmaceuticals	133.5	Newbridge, Temasek
Aurobindo Pharma	Pharmaceuticals	71.0	ChrysCapital,CVC,Merlion India
Lupin	Pharmaceuticals	27.7	CVC International
IVRCL	Infrastructure	22	ChrysCapital and CVC International
Outsource Partners In:	BPO	20	Trident Capital, Winston LP
Ephinay Corporation	BPO	10.0	Trinity Ventures
Icode	Software	8.0	Sierra Ventures, Updata Ventures, Others
TWS Hodlings	BPO	6.5	View Group, eTech Vent, CIBC, Capital Partners, Insight Ventures
B2K Corporation	BPO	4.1	Oak Investment, UTI Ventures, Dhanalakshmi Bank
Four Soft	Software	1.8	UTI Venture Funds, APIDC

3.10. Venture Capital Investments in Recent Years

Venture capital (VC) investment in India rose 31 percent to $774 million in 2003 and is set to top $1 billion in 2004 as the country's economic upswing throws up new investment opportunities. Software firms and those running call centers and back-office services over high-speed telecoms grabbed the lion's share of venture capital funding last year.

But VCs are now increasingly investing late stage funding in banking, pharmaceutical, retail and telecom businesses, where many mid-sized, growth-hungry Indian companies are courting private investors to help them bulk up and attack new markets. India's economy, Asia's third-largest, is expected to grow eight percent in the year to March 204, the best in nearly 15 years, aided by a farm sector rebound and services growth stocked by the country's thriving 300 million-strong middle class. India has forecast eight percent growth for next year too.

Attracted by the growth potential, officials from about 40 heavyweight venture firms-including Sequoia Capital, US Venture Partners and JP Morgan Partners-have visited India in the past four months, scouring for deals. Venture capital firms invested in 42 companies in India in 2003, down from 79 in the previous year. This year, investors are expected to pump money into the emerging biotech industry and start-ups designing software and chips for digital consumer markets. In the first two months of 2004 alone, Indian firms raised about $320 million in a few large transaction. With $750 million invested, Warburg Pincus is one of the key VC players in India, along with home-grown ICICI Venture Funds, having invested $500 million, and General Atlantic Partners.

India attracted 31.1 percent more venture capital/ private equity (VC/PE) investment in 2003 ($774 million) compared to 2002 ($590 million), but the country slipped to number five in 2003 from number three in 2002 among top five Asian countries in attracting VC/PE investments. For 2002, India was ranked third among other Asian countries after Japan and South Korea. In 2003, Japan was leading the list of countries in Asia in terms of receiving investments with a total of $7.7 billion followed by South Korea (3.1 billion), Australia ($2.1 billion), China ($1.25 billion) and India.

India emerged as the second most active venture capital (VC) market in Asia Pacific (excluding Japan) in 2002, with VC funds disbursing a total of $590.21 million into 79 domestic companies. Only behind South Korea, India had improved its rank from third in 2001. Investments in 2002 contracted by 37 percent from the previous year, when $937.03 million was invested into 107 Indian companies. Similarly, only 45 VC firms made investments in 2002, compared to 57 a year earlier. Significantly, VC funds continued to look at larger deal sizes- in 2002 the average was $7.11 million, though marginally lower than $7.81 million in 2001, but significantly higher than $3.85 million in 2000.

Top Five Venture Fund Recipients in Asia

Year 2003	Investment Share	Year 2002	Investment Share
Japan	$ 7.7 Bn.	Japan	$ 3.5 Bn.
South Korea	$ 3.1 Bn.	South Korea	$ 906 Mn.
Australia	$ 2.1 Bn.	India	$ 550 Mn.
China	$ 1.28 Bn.	Australia	$ 479.8 Mn.
India	$ 774 Mn.	Hong Kong	$ 310. 65 Mn.