ABSTRACT

EFFICACY OF VENTURE CAPITAL FINANCING PROCESS IN INDIA:
A Study of Selected Venture Capital Firms

A Thesis Submitted to

Department of Commerce & Business Studies
JAMIA MILLIA ISLAMIA, NEW DELHI

For the Award of the Degree of
Doctor of Philosophy (Ph.D)
in Commerce and Business Studies

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NEW DELHI
2008

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Entrepreneurship is the key to economic growth, however financing of small businesses in general and those undertaken by the first generation entrepreneurs in particular has always been a problem in both developed and developing countries. Financing of start-ups is perceived to be extremely risky by the conventional financiers like banks and financial institutions as they do not have collateral assets and the rate of success of such firms are quite low. Being the custodians of public money banks and financial institutions are hesitant in funding such ventures even if they have good potentials. Venture capital fills this vacuum of financing through innovative ways. The Venture Capitalists (VCs) act as intermediaries between the investors with surplus funds and the entrepreneurs desperately seeking finance. The role of venture capitalist is critical for the entrepreneurs as they not only provide equity finance but also give technical, managerial, and networking support and act as a mentor to the entrepreneurs.

Research Methodology

The researcher attempted to examine the process and mechanism of selected venture capital firms through study of their functioning. The venture capital financing process would not have completely been understood without studying the perspectives of the entrepreneurs. The researcher intensively interacted with those entrepreneurs that either obtained the Venture capital funding or are seeking the same. The broad **objectives** of the study includes; studying the present status of Venture Capital Financing in India, examining the Financing Process and mechanism of selected Venture Capital Firms with a view to assess their efficacy through studying the processes adopted by the Venture Capital Firms and through feedback from the entrepreneurs/ VC investee firms, to diagnose the problems and obstacles associated with Venture Capital Financing in India and to explore views and measures required for the growth of Venture Capital Financing in India.

The study is based on the responses collected from a sample of 15 venture capital firms and 104 entrepreneurs who obtained/ seeking venture capital. The study is mainly based on primary data collected through multiple tools, including questionnaire, in depth interviews and discussions with the venture capitalists and entrepreneurs.

Most of the data was categorical and non-parametric, hence the researcher computed frequency tables to have a better handle on the data and to be able to describe and explain the observations meaningfully. Also in order to see the effect of various demographic and organizational characteristics on the Venture capital financing process and perspective of the VC firms and also the preferences and expectations of the entrepreneurs and Venture capital investee firms, researcher attempted cross tabulation and computed contingency coefficient (C) and Chi- square statistics. The data so analysed was collated and tabulated in a meaningful manner and presented in the form of easily comprehensible tables and graphs.

Chapter Plan

Chapter 1 of the thesis deals with the conceptual framework of the research with a detailed discussion of the research problem. Chapter 2 covered the methodology adopted in pursuing the research describing the research objectives, research design, data sources and collection tools, sampling plan and procedure, data analysis tools and techniques etc., Chapter 3 covers the survey of literature,

focusing on various studies undertaken on the subject matter globally as well as in Indian context. Chapter 4 explains the genesis and growth of venture capital financing globally and in India. Chapter 5 highlights the impediments and barriers to venture capital financing in India as found in the present study. Chapter 6 covers the preferences of the Venture capital firms towards industries and investments observed in the study. Chapter 7 of the study explains the financing process, monitoring methods and return expectations of the firms under study. Chapter 8 explains the information sources and decision criterion used by sample Venture capital firms in evaluating early stage and later stage investment proposals. Chapter 9 covers the expectations, preferences, and perspectives of the entrepreneurs seeking VC funding/ VC investee firms that have been approached in the present study. Chapter 10, the last chapter covers the summary, findings, conclusions, recommendations, and managerial implications that have been observed and discussed in the present study .

Findings and conclusions

a) Barrier to VC Financing in India

Analysis of the data reveals that the political environment particularly arising out of instability of government is seen as the most important barrier by the VC firms. This is followed by the problems associated with intellectual property laws. It was observed in the study that perceptual differences between Venture capital firms and entrepreneurs and the lack of transparency are the two important barriers in successful operation and development of VC financing in India

b) Industry and Investment Preferences of Venture Capital Firms

In the study, an attempt was made to probe a common perception that VCs prefer to invest in selective industries/ sectors and the researcher tried to find this phenomenon. The preferences of VCs towards other aspects of investment i.e. investment stage, investment size and instrument, geographic and exit preferences has also been analysed. It has been observed that VCs are more inclined towards investing in those sectors/ industries that have the potential to scale up quickly. The top three sectors, which are attractive to VCs, were found to be IT & IT enabled services, Pharma & healthcare and manufacturing.

The result obtained with statistical analysis showed some significant difference across different category of VC firms towards industry preferences. The major differences observed were; The VC firms, which are affiliate of Banks / Financial Institutions and Govt. affiliated, are more inclined to invest in the manufacturing sector as compare to the private independent firms. Similarly, in case of education & consultancy services only Govt. affiliated firms prefer to invest while others have little or no interest. The IT& ITES sector and Pharma & healthcare sector has attracted the old and mid age firms whereas the newly established firms were not much interested in them. The IT & ITES industry and the Engineering & Construction sector were preferred by the only those firms which are IVCA members.

The significant issues regarding preferences and reservations of VCs towards the various aspects of investment observed in the study are; Most of the VC firms were interested in investing in either first/ early stage or second/ later stage. Majority of the VC firms prefer to invest up to US$ 5 million in a venture. The exit issues are one of the most significant aspects of VC investment. The preferences of VCs towards two important exit issues i.e. exit route and exit period were questioned. It has been found that VCs prefer IPO as the most preferred exit route and a time span of 3 – 5 years reported as the preferred period for exit. Most of the VCs were found to be reluctant to sign the non-disclosure agreement.

c) Financing Process, Monitoring Method and Return Expectations

The study reveals that on an average 8 – 12 weeks is being the time lag in appraising a project, while no more than 3 – 5% of the proposals finally get funded by the VC firms. The present study found that topmost preference of the VC goes for established entrepreneurs particularly those that are in family businesses. Monitoring, being an important aspect of VC financing process, it is not at all surprising that all VC firms require a seat on the board of directors of the investee firm as the most preferred monitoring method. Besides, they also require periodic feedback reports and financial statements from the investee firms. The VC firms operating in the NCR feel more comfortable in financing family businesses and first generation entrepreneurs with substantial work experience and thus take relatively less risk in financing, the return expectations of the VC firms was found to be significantly higher. This is further collaborated by the return expectations and stage of investments that is preferred by VC firms. It was found that in case of start-up, early stage and later stage investments their return expectation is over 35%.

d) Decision Criteria and information Sources of Venture Capitalists

The most important criteria in early stage investments are management quality in terms of the qualification & experience of the promoters, market opportunities, and openness of the entrepreneurs in terms of complete transparency about the various issues. The second most important factor at early stage investment comprise of shorter exit time and , ease of exit and potential of high return and technical and financial feasibility of the venture under consideration. The innovative aspects of product/service/process and the potential of the venture to scale up significantly are the next important most criteria used by the VC firms in selecting an early stage venture to fund. In the later stage investments, criteria such as scalability of business, market opportunities, exit time and possibilities, accessibility to confidential information, potential of high return, management quality, and innovative aspects of the product/ process/ service are considered as most significant decision criteria.

Preferences and Perspective of Entrepreneurs

As regards mode of contacting, the entrepreneurs also prefer the direct contact method and thus the perception of the VC firms and entrepreneurs had no divergence, so was the case with respect to time taken in project appraisal. It was seen that VC firms take 8 – 12 weeks time in arriving at a decision to invest in a proposal, nearly 70% of the entrepreneurs are reconciled to this timeline. The analyses also shows that majority of entrepreneurs feel like approaching VC firms at the start up stage and are willing to share equity with VC firms. It was also found that an overwhelming majority of entrepreneur expects a time of 5 – 7 years before exit and prefers Initial Public Offering (IPO) as the exit route. There is also convergence of perception about the appropriate return that the VCs should get out of their investment. A clear conflict has been observed in case of signing non-disclosure agreement (NDA), VCs are reluctant to sign it whereas an overwhelming majority of entrepreneurs insists to get it signed in order to protect their sensitive information/ business ideas/ secrets.

From the point of view of the entrepreneurs, the two factors that are considered by them as the biggest obstacle in the growth of VC led entrepreneurship in India included lack of start up funding and reluctance of VCs in funding small projects. The perceptual difference between the VCs and entrepreneurs was rated as third most important barrier in the growth of VC led entrepreneurship in India. Multiplicity of regulatory agencies and complications associated therewith and absence of incentives from the government was also considered to be the most important barrier.

Managerial Implications

The present study attempted to diagnose the problems and obstacles associated with the VC financing in India and to explore measures required for the growth of VC financing in India, In order to realise the full potential of the VC financing, the following policy and managerial implications appears to be imminent.

1. Multiplicity of regulatory agencies, one of the deterrence in the growth and development of VC financing in India, has largely being tackled by making the SEBI as the nodal regulatory body. However, the general regulatory mechanism, taxation policies and foreign exchange laws need to be made more facilitative, such as to incentivise VC financing in the country.

2. Intellectual Property Rights (IPR) related issues in India are still only evolving and the entrepreneurs have difficulties in comprehending full implications of such regulations. As a result, entrepreneurs and VC firms have a confusion arising out of such laws. While there is a need to have IPR laws that are aligned to the WTO regime, there is also a need to create awareness about the requirements and implications of these laws amongst the entrepreneurs and VC firms.

3. VC financing process require mutual trust and confidence between the VC firms and the entrepreneurs and obviously any perceptual difference between these two parties would hamper growth of VC funding in India. The best way to minimise the perceptual difference is to organise regular interaction between the VC firms and the entrepreneurs. This can be effectively done by organising meets workshops, conferences, networking and mentoring sessions where government and IVCA can play a pivotal role.

4. The VC firms will have to make conscious efforts to make their financing inclusive of all industries rather than remaining confined to only some selected industries. The industries that need particular attention of VC firms include retailing, agro based and food processing industries media etc., which have tremendous potential in a country like ours.

5. It appears that contrary to its fundamental principle, the VC financing in India have been rather more cautious in its approach as the financing at the seed and start-up stage is not generally favoured. The bulk of venture capital investments go to second/ later stage investments and that too in few selected sectors only. The VC firms need to re look at their financing strategies and be bold in their approach to venture into the financing of start-up companies in different sectors, which have the potential for growth.

6. The VC firms have been found to fund in a particular range. They seems to be not interested in financing small ventures which need less than US$ 1 million and also not willing to invest more than US$ 15 million in a venture. Thus, both very small and large firms find it difficult to raise VC funding.

7. An overwhelming majority of VC firms take much longer time in appraising a business proposal for funding. While most of the entrepreneurs seeking VC funding seem to have reconciled to this lengthy time lag, the VC firms need to adopt mechanism and procedures whereby the proposals could be evaluated within a reasonable time frame of less than 8 weeks.

8. Selection rate in accessing VC funding is ridiculously low for over two third of VC firms accepting no more than 5% of the total proposals received. There might be a variety of reasons for the occurrence of this phenomenon but it is felt that the selection rate can be significantly increased if the business plans are prepared more meticulously.

9. Contrary to the expectation that VC firms would promote entrepreneurship amongst the professionals and technocrats, they are found to be preferring only established entrepreneurs and those with family business background. Clearly, the VC firms perceived higher risk in financing new and innovative ventures by first generation entrepreneurs without work experience. This need to be relooked by the VC firms if they really intent to make significant impact.

10. Given the fact that VC firms consider management quality as an extremely important decisive criteria for accepting a proposal, the entrepreneurs need to build a strong team of professional managers an adopt methods procedures and systems that are sound and efficient for the requirement of their businesses.

11. The entrepreneurs looking for venture capital also expect a strong networking support from the VCs. This is an area that requires special attention of VC firms and their financing process need to have a built in mechanism whereby the VCS actively provide such supports.

12. It is not surprising that the entrepreneurs, particularly the professionals and technocrats are not fully equipped with the financial management and planning and thus the VCs need to provide such supports to the entrepreneurs they select to fund.

13. The VC financing being a relatively new phenomenon in India has yet not been thoroughly researched in the Indian context. While this study has made a modest attempt to fill this research gap but there is need to thoroughly probe each individual dimension of the functioning of VC financing on all India basis. Also comparative studies on VC financing process, monitoring mechanism, decisive criteria etc. need to be promoted. The Indian Venture Capital Association (IVCA) and governmental funding agencies need to sponsor focused research studies in this regard.