VENTURE CAPITAL FUNDING – RECENT TRENDS AND CHALLENGES IN INDIA

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Abstract

Venture capital funds are investment funds that manage the money of investors who seek private equity stakes in startup and small- to medium-sized enterprises with strong growth potential. These investments are generally characterized as high-risk/high-return opportunities. In the past, venture capital investments were only accessible to professional venture capitalists, although now accredited investors have a greater ability to take part in venture capital investments.

Venture capital is a type of equity financing that gives entrepreneurial or other small companies the ability to raise funding. Venture capital funds are private equity investment vehicles that seek to invest in firms that have high-risk/high-return profiles, based on a company's size, assets and stage of product development.

Venture capital funds differ from mutual funds and hedge funds in that they focus on a very specific type of early-stage investment. All firms that receive venture capital investments have high-growth potential, are risky and have a long investment horizon. Further, venture capital funds take a more active role in their investments by providing guidance and often holding a board seat.

Venture capital funds have portfolio returns that resemble a barbell approach to investing. Many of these funds make small bets on a wide variety of young startups, believing that at least one will achieve high growth and reward the fund with a comparatively large payout at the end. This allows the fund to mitigate the risk that some investments will fold.

In this article we shall focus on the recent trends and challenges related to venture capital funding in India.

I. INTRODUCTION

Venture Capital is money provided by professionals who invest and manage young rapidly growing companies that have the potential to develop into significant economic contributors. According to SEBI regulations, venture capital fund means a fund established in the form of a company or trust, which raises money through loans, donations, issue of securities or units and makes or proposes, to make investments in accordance with these regulations. The funds so collected are available for investment in potentially highly profitable enterprises at a high risk of loss. A Venture Capitalist is an individual or a company who provides. Investment Capital, Management Expertise, Networking & marketing support while funding and running highly innovative & prospective areas of products as well as services.

Thus, the investments made by Venture Capitalists generally involves -

- Financing new and rapidly growing companies.
- Purchasing equity securities.
- Taking higher risk in expectation of higher rewards.
- Having a long frame of time period, generally of more than 5 - 6 years.

- Actively working with the company's management to devise strategies pertaining to the overall functioning of the project.

- Networking and marketing of the product /service being offered.

II. REVIEW OF LITERATURE

VENTURE CAPITAL FUNDING

It generally involves start up financing to help technically sound, globally competitive and potential projects to compete in the international markets with the high quality and reasonable cost aspects. The growth of South East Asian economies especially Hongkong, Singapore, South Korea, Malaysia along with India has been due to the large pool of Venture Capital funds from domestic / offshore arenas.

Venture Capitalists draw their investment funds from a pool of money raised from public and private investors. These funds are deployed generally as equity capital (ordinary and preference shares) and some times as subordinated debt which is a semi secured investment in the company (through debenture) ranking below the secured lenders that often requires periodic repayment. Today, a VC deal can involve common equity, convertible preferred equity and subordinated debt in different proportions.

The Venture Capital funding varies across the different stages of growth of a firm.

The various stages are:

1. Pre seed Stage : Here, a relatively small amount of capital is provided to an entrepreneur to conceive and market a potential idea having good future prospects. The funded work also involves product development to some extent.

2. Seed Stage: Financing is provided to complete product development and commence initial marketing formalities.

3. Early Stage / First Stage: Finance is provided to companies to initiate commercial manufacturing and sales.

4. Second Stage: In the Second Stage of Financing working capital is provided for the expansion of the company in terms of growing accounts receivable and inventory.

5. Third Stage: Funds provided for major expansion of a company having increasing sales volume. This stage is met when the firm crosses the breakeven point.

6. Bridge / Mezzanine Financing or Later Stage Financing: Bridge / Mezzanine Financing or Later Stage Financing is financing a company just before its IPO (Initial Public Offer). Often, bridge finance is structured so that it can be repaid, from the proceeds of a public offering.

There are basically four key elements in financing of ventures which are studied in depth by the venture capitalists. They are:

1. Management : The strength, expertise & unity of the key people on the board brings significant credibility to the company. The members are to be mature, experienced possessing working knowledge of business and capable of taking potentially high risks.

2. Potential for Capital Gain: An above average rate of return of about 30 - 40% is required by venture capitalists. The rate of return also depends upon the stage of the business cycle where funds are being deployed. Earlier the stage, higher is the risk and hence the return.

3. Realistic Financial Requirement and Projections: The venture capitalist requires a realistic view about the present health of the organization as well as future projections regarding scope, nature and performance of the company in terms of scale of

UGC Jr.No. 45308 | IFS – 2018: 1.14 | SJIF 2016:3.343 | SJIF 2017: 4.253 | ISI 2017-2018: 0.673

operations, operating profit and further costs related to product development through Research & Development.

4. Owner's Financial Stake: The financial resources owned & committed by the entrepreneur/ owner in the business including the funds invested by family, friends and relatives, play a very important role in increasing the viability of the business. It is an important avenue where the venture capitalist keeps an open eye.

III. Rising Trends In Venture Capital Industry

Today, the most successful companies in the world, such as Snapchat, Xiaomi, Uber, or SpaceX have been funded by various venture capital (VC) investors. The venture capital funding pattern has changed and gained popularity in different countries over the years. In 2015, the VC market around the world consisted of $128.5 billion, wherein, 71 VC backed companies managed to reach a unicorn status along with a total of 7872 deals made.

Industries that Receive the Most VC Funding

According to a 2016 report by Martin Prosperity Institute, VC funding is available across different industries. In the U.S., software sector has around 36 percent of the VC investment with a value of about $12 billion, whereas, bio-technology and media and entertainment comprise 17.3% and 9.5% respectively. The top five industries consist of $25 billion investment constituting 76% of all VC investments.Software sector received the highest funding even in the last quarter of 2015, i.e, $4.5 billion with 369 closed deals. On the other hand, bio-technology collected $1.5 billion via 95 deals and media & entertainment sector managed to secure $881 million by closing 114 deals.

VC Funding Trends

Venture capitalists invest in different stages of a business. According to a 2017 report by Crunchbase, the average seed funding in the first quarter of 2017 was approximately 38% higher than 2016’s first quarter funding, which shows that a number of investors are ready and excited to invest in new startups. These investors are basically accelerator programs that offer funding to newbies showing strong potential to grow in the future.

Major Cities for Venture Capital Investments

In another report by Martin Prosperity, it is stated that industry wise VC investments are also confined to small geographical locations. For example, half of the VC investments in software sector have taken place in San Francisco, representing 25% of the investments, whereas, San Jose represents 20%.

In the US, the flow of VC investments mainly comes from Boston—New York—Washington corridor and San Francisco Bay Area, representing 40% of all the VC investments around the world. In 2012, a total of $42 billion worth of VC investment was recorded worldwide. The data included 150 cities and the center point was the U.S. that accounted for 70% of the global investment, whereas, Europe and Asia only represented 14% investment.

Popular Sectors for VC Investments

Some of the popular sectors that have received a large percentage of investment are advertising, big data, cloud computing, SaaS, marketplaces, hardware and software.

Advertising:Although, it has been a center of attention for many years, but in the past 5 years, it has lost its position and the investment has decreased from 15% to only 5%. Advertising business models are gradually losing their value in the eyes of investors. One of the key reasons behind it is the heavy influence of advertising networks, including Google and Facebook.

Big data: Business models, in which the driving factor is big data, have experienced a growth in VC investment. In 2010, the series A funding comprised of 2.5% investment, but by 2015, the funding rose to 7.5%. On the other hand, seed investment has not shown any improvement or decline over a period of last 4 years.

Cloud computing: It is an infrastructure used by product developers to create services. In the last 4 years, this particular business model has also remained the same, i.e., 4%, in both series A funding and seed investments. However, it slightly went downward back in 2013 to 2014.

E-commerce: Although, e-commerce has been one of the well-known business models in terms of VC investments, yet, the seed stage investment suffered a decline from 15% to well below 10% and series A remained the same.

SaaS: In case of SaaS, series A investors didn't perform as good as seed investors. Series A increased from 5% to 10%, whereas, seed stage experienced a surge from 5% to 15%. This sector shows attractive prospects for funding as merely less than 2% of the software market shifted to SaaS.

Marketplace: This sector experienced a surge in seed funding from 2.5% to 10% in the last four years. Uber and AirBnB are the reason behind its massive success. The current growth rate has motivated investors to consider it a potential sector for investment. Series A investment, however, remained at 5% of the dollar amount.

All in all, it is quite evident that VC investment has become one of the key sources of finance for many successful businesses and is currently dominating the world's market at a rapid pace.

IV. Challenges Of Venture Capital Financing

VCF is in its nascent stages in India. The emerging scenario of global competitiveness has put an immense pressure on the industrial sector to improve the quality level with minimization of cost of products by making use of latest technological skills. The implication is to obtain adequate financing along with the necessary hi-tech equipments to produce an innovative product which can succeed and grow in the present market condition. Unfortunately, our country lacks on both fronts. The necessary capital can be obtained from the venture capital firms who expect an above average rate of return on the investment. The financing firms expect a sound, experienced, mature and capable management team of the company being financed. Since the innovative project involves a higher risk, there is an expectation of higher returns from the project. The payback period is also generally high (5 - 7 years). The various problems/ queries can be outlined as follows :

(i) Requirement of an experienced management team.

(ii) Requirement of an above average rate of return on investment.

(iii) Longer payback period.

(iv) Uncertainty regarding the success of the product in the market.

(v) Questions regarding the infrastructure details of production like plant location, accessibility, relationship with the suppliers and creditors, transportation facilities, labour availability etc.

(vi)The category of potential customers and hence the packaging and pricing details of the product.

(vii) The size of the market.

(viii) Major competitors and their market share.

(ix) Skills and Training required and the cost of training.

(x) Financial considerations like return on capital employed (ROCE), cost of the project, the Internal Rate of Return (IRR) of the project, total amount of funds required, ratio of owners investment (personnel funds of the entrepreneur), borrowed capital, mortgage loans etc. in the capital employed.

V. Prospects Of Venture Capital Funding

With the advent of liberalization, India has been showing remarkable growth in the economy in the past 10 - 12 years. The government is promoting growth in capacity utilization of available and acquired resources and hence entrepreneurship development, by liberalizing norms regarding venture capital. While only eight domestic venture capital funds were registered with SEBI during 1996-1998, 14 funds have already been registered in 1999-2000. Institutional interest is growing and foreign venture investments are also on the rise. Many state governments have also set up venture capital funds for the IT sector in partnership with the local state financial institutions and SIDBI. These include Andhra Pradesh, Karnataka, Delhi, Kerala and Tamil Nadu. The other states are to follow soon.

The following points can be considered as the harbingers of VC financing in India :-

(i) Existence of a globally competitive high technology.

(ii) Globally competitive human resource capital.

(iii) Second Largest English speaking, scientific & technical manpower in the world.

(iv)Vast pool of existing and ongoing scientific and technical research carried by large number of research laboratories.

(v) Initiatives taken by the Government in formulating policies to encourage investors and entrepreneurs.

(vi) Initiatives of the SEBI to develop a strong and vibrant capital market giving the adequate liquidity and flexibility for investors for entry and exit.

VI. Conclusion

The world is becoming increasingly competitive. Companies are required to be super efficient with respect to cost, productivity, labour efficiency, technical back up, flexibility to consumer demand, adaptability and foresightedness.

There is an impending demand for highly cost effective, quality products and hence the need for right access to valuable human expertise to guide and monitor along with the necessary funds for financing the new projects.

The Government of India in an attempt to bring the nation at par and above the developed nations has been promoting venture capital financing to new, innovative concepts & ideas, liberalising taxation norms providing tax incentives to venture firms, giving a philip to the creation of local pools of capital and holding training sessions for the emerging VC investors.

There are large sectors of the economy that are ripe for VC investors,like,. I.T., Pharma, Manufacturing. Telecom, Retail franchises, food processing and many more. The nation awaits for the burgeoning VC business in India inspite of the existing shortcomings in the Indian infrastructure. Looking ahead for a bright future for India Inc..

VII. REFERENCE

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