

UNLOCKING GROWTH: HOW VENTURE CAPITAL FINANCING DRIVES THE ECONOMIC DEVELOPMENT

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Abstract: In the global venture capital industry, investors and investee firms work together closely in an environment that allows entrepreneurs to focus on value creating ideas and allows venture capitalists to drive the industry through ownership of the levers of control, in return for the provision of capital, skills, information and complementary resources. Venture capital financing provides insights into its dynamic impacts, challenges, and future prospects, offering valuable knowledge for policymakers, investors, entrepreneurs, and researchers alike. The study tried to examine various categories of venture Capital Companies in the country and also the various types of VCF. It is also analysed in detail the trend of venture capital funds by comparing the funds of the years 2015 and 2016.

Key Words: Venture capital, Venture Capital Financing, Seed capital, Economic development

1. Introduction

Venture capital financing, provided by venture capital firms, offers private equity capital primarily as seed funding for early-stage, high-potential growth companies. Alternatively, it often serves as growth funding following the initial seed round. The objective is to generate returns through events like IPOs or company acquisitions. In India, despite conventional finance from numerous banks and financial institutions, the widespread practice of risk financing seen in the United States remains limited. Due to conservative lending practices, aspiring entrepreneurs face challenges securing project financing. Therefore, there is a significant demand for venture capital to support technological investments in sectors such as information technology, software, electronics, biotechnology, healthcare, chemicals, consumer products, and non-conventional energy.

Venture capital activity in India was formalized in 1988 when the central government announced guidelines for the establishment and functioning of the industry. Venture capital companies sprang up, several sponsored by government development financial institutions. With significant economic liberalization policies introduced by the central government in 1991, more domestic and foreign venture capital companies began operations. Despite the central government's introduction of new and improved guidelines in 1996 to regulate India's venture capital industry, its growth has been constrained by conservative government policies, limited availability of funds, and an inadequate equity market infrastructure.

2. Review of literature

Mason and Harrison (2000) stated that after bubble of internet hype got busted, most of the venture capital companies had started funding only at maturity level because they did not want to take any risk while funding the ventures. Because these companies had invested heavily into venture so they had wanted only safer option while investing.

Smith (2001) has explained about the venture capital firm that these companies had given valuable support in terms of product development, production, marketing and other areas of business function. A venture capital firm had searched and had invested into those companies which were already research oriented and had shown a growth curve.

Harding (2000) in his paper provides a critical review of UK government proposals to develop venture capital funds in the English regions to address the 'equity gap'. The real equity gap is between the more informal, packaged finance structures and the formal venture capital market which is dominated by MBOs and MBIs. It is argued that the creation of strong venture capital markets in the regions requires the close co-ordination between all the various actors in the system at regional and national levels. Regional Development Agencies have the tools to enable them to perform this co-ordinating task.

Lerner (2001) argued that venture capital had impacted on four factors: firms, economy, innovation and geographical regions. Firms had benefited from additional capital that was necessarily required for research and development, meanwhile economy was growing because of more new jobs, and bigger value addition of new venture capital backed firms as well as particular industry was flourishing because of bigger investment.

Gorman & Terjesen (2006) examined the gender differences in entrepreneurship and informal investment in Ireland which is a country with one of the lowest rates of female entrepreneurship in the developed world. Females in Ireland are less likely than males to be engaged in either the demand for (as entrepreneurs), or the supply of (as informal investors), entrepreneurial finance. The study reveals that the start up capital from females may have less demand in the country and they concluded with the suggestion that the policies should be framed specially for females on the provision of finance to female entrepreneurs that may invite limited impact on the levels of female entrepreneurship activity.

Wonglimpiyarat (2009) argued that venture capital had improved the nation's innovative capacity by making investments in early stage businesses that had offered both high potential and high risk. Engel and Keilbach (2007) have used firm data to

examine the influence of venture capital financing on innovation behaviour, specifically on the number of patent registrations at the German patent office.

Winton and Yerramilli (2008) have presented a paper and in this paper, they had compared venture capital financing and bank financing. While Veda (2004) mainly focused on screening abilities of bank and venture capital funding, Winton and Yerramilli (2008) have mainly focused on financing decision so they could analyzed about post financing scenario as well.

Klonowski, D.(2010) the study conducted by them about the companies which had become private between 1990 and 2007 and they argued that main reason of the companies to go private was their failure to attract investor's interest. Firms which were having low stock turnover, they would prefer to go public as early as possible.

Bender (2011) tried to examine the role of special spatial proximity between the venture capitalist and the entrepreneurial team throughout the VC investment process, a plurality of theories will be used. Critical relationships can be analysed from different point of view with multiple theories and concludes with the approach that a more refined insights can be arrived at by comparing the analysis based on one specific theory.

In the light of a comprehensive review of literature the present paper tries to study the impact of venture capital financing in India.

3. Statement of the Problem

The venture capital financing typically encompasses a range of areas related to specialized form of financing for high-potential, early-stage companies. Venture Capital Financing can play a vital role in the modern business environment. In India several initiatives have been carried out to shell out its benefits for facilitating the economic growth. The present study attempts to analyse the extent to which such initiatives have achieved its objectives through a trend analysis.

4. Objectives of the Study

- 4.1 To study the nature of Venture Capital in general.
- 4.2 To know the different categories of Venture Capital Companies in India.
- 4.3 To understand different types of venture capital financing.
- 4.4 To analyse the trend of venture Capital Funds in India.

5. Research Methodology

The present study is purely based on secondary data. For this conceptual work the data have been collected from books, journals, magazines, Websites etc. Ratios and percentages have been applied for the analysis.

6. Characteristics of Venture Capital

In the global venture capital industry, investors and investee firms work together closely in an enabling environment that allows entrepreneurs to focus on value creating ideas and allows venture capitalists to drive the industry through ownership of the levers of control, in return for the provision of capital, skills, information and complementary resources. This very blend of risk financing and hand holding of entrepreneurs by venture capitalists creates an environment particularly suitable for knowledge and technology based enterprises. Literature often begins by defining venture capital (VC) and distinguishing it from traditional financing forms. It emphasizes that VC involves equity investments in start-ups and growing companies with high growth potential.

6.1 Stages of Venture Capital Financing: Researchers categorize VC financing into stages such as seed funding, early-stage financing, and later-stage financing. Each stage serves a specific purpose in the growth trajectory of a company.

6.2 Role and Importance: Reviews highlight the crucial role of venture capital in fostering innovation and entrepreneurship. They discuss how VC enables risky but potentially high-reward investments that traditional financial institutions may be hesitant to undertake.

6.3 Motivations of Venture Capitalists: Literature explores the motivations and objectives of venture capitalists (VCs), such as seeking high returns on investment, contributing to economic development, or leveraging industry expertise.

6.4 Impact on Innovation and Economic Growth: Researchers examine the broader impacts of VC on technological innovation, job creation, and economic growth. They analyze how VC-backed companies contribute to industry disruption and the creation of new markets.

6.5 Challenges and Risks: Reviews discuss the challenges faced by both entrepreneurs seeking VC funding and venture capitalists themselves, including high failure rates among start-ups, liquidity issues, regulatory challenges, and market volatility.

6.6 Geographical and Sectoral Trends: It is important to look at geographical variations in VC activity, comparing regions like the United States, Europe, and emerging markets such as India and China. The trends in sectors such as technology, healthcare, biotechnology, and clean energy are also explored.

6.7 Policy and Regulatory Environment: Researchers analyze the impact of government policies and regulations on the VC industry, exploring how policy changes influence investor behaviour, fund formation, and the overall ecosystem for start-ups.

6.8 Performance and Returns: An in-depth look at the financial performance of venture capital investments involves examining metrics such as internal rate of return (IRR) and multiple on invested capital (MOIC), comparing these to other asset classes like public equities and bonds.

6.9 Future Directions and Emerging Trends: Literature reviews may speculate on future trends in venture capital, including the rise of impact investing, the role of corporate venture capital, the influence of artificial intelligence and data analytics on investment decisions, and the evolution of fundraising models.

7. Categories of Venture Capital Companies in India

There are six broad categories of Venture Capital Companies (VCCs) or venture capital funds (VCFs) in India. These include VCCs/VCFs promoted by: (1) national financial institutions; (2) state-level development financial institutions; (3) nationalized commercial banks; (4) foreign entities including banks, financial institutions, and non-resident investors; (5) domestic private sector companies; and (6) joint initiatives of domestic private sector companies, financial institutions, and foreign entities.

In the subsequent analysis, funds represented under categories (1), (2), and (3) are grouped as "government" funds, while those under categories (4), (5), and (6) are grouped as "private."

8. Different types of venture capital financing

The different types of venture capital financing depends on the investment of specific purpose within the life of target company as the high return rate of the company remains constant and it has no effect on it. There are three types of venture capital financing. Within the "government" groupings, the VCCs/VCFs in category (1) have historically received a variety of incentives and benefits from the Indian government and require separate examination.

8.1 VCFs promoted by the Central govt. controlled development financial institutions such as TDICI, by ICICI, Risk Capital and Technology Finance Corporation Limited (RCTFC) by the Industrial Finance Corporation of India (IFCI) and Risk Capital Fund by IDBI.

8.2 VCFs promoted by the state government-controlled development finance institutions such as Andhra Pradesh Venture Capital Limited (APVCL) by Andhra Pradesh State Finance Corporation (APSFC) and Gujarat Venture Finance Company Limited (GVCFL) by Gujarat Industrial Investment Corporation (GIIC).

8.3 VCFs promoted by Public Sector banks such as Canfina by Canara Bank and SBI-Cap by State Bank of India.

8.4 VCFs promoted by the foreign banks or private sector companies and financial institutions such as Indus Venture Fund, Credit Capital Venture Fund and Grindlay's India Development Fund.

The private and government VCFs differ regarding the scale of their investments. Private funds tend to have fewer but larger investments in later-stage ventures, which require less monitoring. In contrast, government funds invest smaller amounts over a larger number of start-up and later-stage ventures. Sometimes investments requiring large funding are financed by government agencies on a syndicated basis. Lately, government funds are moving more towards larger investments to gain the benefits of reduced monitoring.

9.Exit routes available to VCF

The exit routes of VCF are as follows:-

9.1 Trade sale : It is a sale of shares and business assets which has been invested by the investors and the assets are of the investee. Company uses by the way of private sale agreement.

9.2 IPO (Initial public offering) is used to publicly share the offering which will be followed by the listing of shares on stock exchange.

- 1) Recycling - it is a sale to the sub-investors which are working under the investors or other equity houses.
- 2) Company buying -back the shares

Recently, there has also been greater visibility of Indian companies in the US. Given such vast potential not only in IT and software but also in the field of service industries, biotechnology, telecommunications, media and entertainment, medical and health services and other technology based manufacturing and product development, venture capital industry can play a catalytic role.

10. An analysis of Venture Capital Financing

The measured pace of investments in start-ups so far in 2016 may not be such as bad thing for the long term. Last October, when India's venture capital market stepped into the final quarter of 2015, a great many things had changed for both investors and entrepreneurs. The food technology sector was on the brink of collapse.

The following data shows the comparison of the Funding trends and the Corresponding activity Levels in the three quarters of the years 2015 and 2016.

FUNDING TRENDS

Venture capital activity for nine months ended September 2016, compared with 2015.

Investments

Quarter	Volume			Value (in \$ mn)		
	2015	2016	Change (in %)	2015	2016	Change (in %)
Q1	127	116	▼ -8.6	466	352	▼ -24.4
Q2	116	98	▼ -15.5	503	292	▼ -41.9
Q3	153	76	▼ -50.3	657	392	▼ -40.3
Total	396	290	▼ -26.7	1,626	1,036	▼ -36.2

Investments by stage

Stage	Volume			Value (in \$ mn)		
	2015	2016	Change (in %)	2015	2016	Change (in %)
Seed	120	121	▲ 0.8	90	79	▼ -12.2
Series A	186	97	▼ -47.8	766	344	▼ -55.0
Series B	64	50	▼ -21.8	484	377	▼ -22.1
Series C	21	13	▼ -38	235	126	▼ -46.3

Exits

	Volume	Value (in \$ mn)
Jan-Sep 2015	43	1,395
Jan-Sep 2016	54	1,411

Source: Venture Intelligence

11. Findings and Discussion

The online property search segment was also looking shaky, with one of the largest players on the block. The hot money that had fuelled a valuation bubble, especially in e-commerce, was in retreat. And, start-ups across the board woke up one fine day to unfamiliar questions from their investors on matters such as cash burn and profitability. With the market in the final quarter of the year again, there is much more to cheer than despair. We know that from the numbers on venture capital activity for the nine months ended September.

There's no couching the fact that investment levels have declined sharply all around from last year. Between January and September this year, venture capitalists concluded 290 deals worth \$1.03 billion, down 26.7% and 36.2%, respectively from the same period last year. With each quarter, venture capitalists put less and less money to work and across fewer deals. Only the third quarter, July to September, has been a tad different—\$392 million was deployed compared to \$292 million in the second quarter (April to June). This doesn't necessarily indicate a change in sentiment. Rather, it's probably more a function of a number of big-ticket deals that closed during the quarter, among them Lendingkart's \$20 million Series B round, Treebo Hotels' \$16.7 million Series B round and Livspace's \$15 million Series C round. However, the key takeaway from the past nine months is that investment levels in each quarter have settled in the \$300-400 million range, which is closer to the normal for the early-stage investment market than was the case last year (*see graphic*).

Unfortunately, the biggest losers in the ongoing correction in the start-up funding market have been very young companies. Series A capital, typically the first institutional capital into a start-up that needs to take its product or service to market, has been particularly hard to come by for entrepreneurs. In the nine months ended September, Series A investments plunged 47.8% in terms of the number of deals struck and 55% in terms of the amount of capital deployed, compared to last year.

Incidentally, the number of seed-stage deals, typically funded by angel investors, has grown marginally by 0.8%. This presents a problem. The 121 start-ups that raised seed-stage funding in the last nine months will have to wait longer than expected for their Series A funding rounds to materialize. For venture capitalists, this presents an opportunity to pick and choose from the best assets at more reasonable entry valuations than was available last year. For entrepreneurs, the Series A funding crunch spells a higher start-up mortality rate.

(1) If venture capitalists are putting less money to work, what's consuming their time and energy? This is the part where we cheer. Investors across the board have been focused for a while now on returning money to their investors, or limited partners.

Between January and September this year, venture capital firms closed 54 exit deals worth \$1.4 billion. That represents a 25.5% increase in the number of deals and a marginal 1.1% rise in the value of deals. Just last month, Sequoia Capital-backed payments start-up Citrus Payments Solutions was acquired by South African internet conglomerate Naspers Ltd in a \$130 million all-cash deal. Earlier, the public market debuts of microfinance institutions Equitas Holdings Ltd and Ujjivan Financial Services Ltd delivered exits to both traditional venture capital investors such as Helion Venture Partners and Sequoia Capital and impact funds such as Lok Capital and Aavishkaar (*see graphic*).

Exits are likely to continue to occupy venture capitalists for the next few quarters. For the past few years, venture capital investments in India have gone well past the billion dollar mark and the concern among limited partners is that not enough has been returned in profits. Most venture capital firms in India have raised and invested more than two successive funds and exits have now become imperative.

It will be a while before the funding market for India's start-ups returns to what many consider the irrational exuberance of 2014 and early 2015. But, the measured pace of investments we have seen so far in 2016 may not be such a bad thing for the long term.

12. Conclusion

Venture Capital investment is one of the most flexible form of financing technology based or innovative business firms. In other words, venture capital is a source of necessary risk capital like financing for shares. It has now emerged as a best financing alternative in developing and developed countries. Most venture capital firms in India have raised and invested more than two successive funds and exits have now become imperative. The paper concludes with a promising note that the venture capital fund can invite drastic change in the economic development of the country.

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