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Venture Capital Financing in India: Prospects and Challenges

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***Abstract**: The study aims to analyze the Venture Capital financing scenario in India, in terms of growth, geographical dispersion, sectoral analysis, and the economic environment relevant to venture capital industry during the years (2007-17. The study finds that India is undergoing a paradigm shift in terms of Venture Capital financing particularly in IT/ITES sector, which register a phenomenal growth of 240% during the period of study. The study brings out that the Indian market attracted Venture Capital funds from even the competitor economies like China. The study also finds clear evidence of spatial proximity effect that the investments are concentrated in certain regions.*

Keywords: Dispersion, IT/ITES, Spatial proximity, Venture Capital Finance, Venture Capital.

I. INTRODUCTION

India, arguably the most populated country with a population count of approximately 1.3 billion (Census, 2011), is among the top ten fastest growing economies in the world at present. With a projected CAGR of 9% and above, India's GDP is likely to be 3.26 trillion USD by 2020 and if the resolution of the present government is to be believed it should reach somewhere 5 trillion USD. A very important role in the past growth has been played by the Indian IT/ITES sector, and same trend has to be continued to keep the promises alive.

Since the decade of 90's, when the Indian economy opened up under the guidance of then Finance minister Dr. Manmohan Singh and the impetus provided by a bunch of IT giants like Tata Consultancy Services, Infosys, and HCL, IT/ITEs industry of India stamped its own brand on the global level. With a good technological knowledge network provided in the form of Indian Institute of Science, Bangalore and various Indian Institutes of Technology along with a population quite adept in English language, India is capable of delivering in this sector at much cheaper cost than the western counterparts.

The availability of technically skilled and linguistically adept manpower, large size of market, sustainable high growth rate, low domestic penetration and improving regulatory conditions make India a very attractive destination for venture capital investment. The increasing inflow of Foreign Direct Investment (FDI) and International Institutional Portfolio Funds (IIPFs) support this fact.

Moreover, the inclination of the public and private business houses to incorporate more technological orientation in order to increase the effectiveness and efficiency in the business processes has given rise to the huge and urgent demand of capital. This area holds a very special attraction for venture capital sector as it deals with large uncertainties due to lack of any such pre-existent business model, hence a promise of high return. The introduction of Make in India and Start up India campaigns in the years 2014 and 2016 respectively also strengthens the case of more venture capital investments. The Make in India campaign is an attempt to make India a global manufacturing hub, while the Start-up India campaign is designed to encourage entrepreneurial talent. Venture capital is the right kind of financing to provide the impetus to these new technology-based firms as it works on the basic premise of high risk, high expected return and the enterprises involved which develop an attitude towards these two. Over the years, the more generic term of 'private equity' was coined to encompass a variety of transactions relating to venture capital investments in companies providing high return opportunities along with good monitoring and better contribution.

Table 1. Startup Funding

Funding Mode	Funding Rounds (USD Million)	
	2017	**2018**
Angel	270	179
Seed	583	407
Series A	248	243
Series B	133	117
Series C	35	71
Series D	20	21
Series E	12	19
Series F	2	6
Series G	3	2
Series H	2	2
Series I	1	3
Series J	2	1
PE	46	37

Source: Tracxn

This paper examines the growth and expansion of venture capital investment in India (refer Table 1) and the evolving regulatory framework providing a conducive environment to such investment.

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Venture Capital is a very special subset of private equity where the investments are made for the launch, growth and expansion of enterprises which are expected to provide high returns. The amount invested based on this principle by professionals i.e. Venture Capitalists are termed as Venture Capital Fund. The characteristic of the venture capital that differentiates it from other type of financing options is that here the venture capitalist exclusively invests through the mode of equity making a claim to participate in decision making, contributing towards the growth of the enterprise and en-cashing the increased worth through various exit modes.

The investors also take active part in the management of the company with the intention to increase the return with the help of their expertise. The firms, which are new or relatively new and starting their journey on ascendancy of life cycle curve, are preferred for substantial capital gains. The ideal candidates for Venture Capital financing are the firms with innovative technology and new business model, where the growth is steep and rewards are great. Venture Capitalists provide financial strength to the new/existing projects, their professional expertise to earn high return on their investments. Venture capital originated in India in the year 1973. Industrial Finance Corporation of India (IFCI) established the first venture capital fund in India in 1975. In India, venture capital funds are brought under regulation of Securities and Exchange Board of India (SEBI). The Compound Annual Growth Rate (CAGR) of Venture Capital financing in IT/ITES sector had been 9.6% over the years 2012-16. In the past couple of years, India has emerged as one of the fast-developing countries in the world and its GDP is expected to reach US$5 trillion by the year 2025.

The initiative of the Government of India to make India, a global manufacturing hub through its ambitious “Make in India” program is more likely to accelerate the growth of Venture Capital Industry in India. However, in order to achieve this target, India needs to further boost its investments in the manufacturing and service sector enterprises. In view of the current favorable economic environment, Venture Capital Financing assumes significant role in the coming years.

II. OBJECTIVES OF STUDY

The objective of the paper is to present an analysis of Venture Capital financing in India. In terms of growth, geographical dispersion, sectoral analysis, economic environment relevant to venture capital industry during the last 10 years (2007-17) in the Indian context. The paper also highlights the prospects and challenges for Venture Capital Funding Industry in India.

III. LITERATURE REVIEW

Venture capital derives its name from the very trait it follows of financing the projects and enterprises that venture in unknown and uncharted on the promise of unprecedented profit. But more recently, Mason and Harrison (2002) in their study highlighted that after the boom of the Internet since 2000, venture capitalists are more inclined towards investing in mature projects rather than start-up projects. Generally, the venture capitalists invest in firms on the rising portion of their lifecycle curve, with a view to earn a 20 x return or more in average period of five years. Grave et al. (2005) concluded that venture capitalists are biased towards industries such as high technology and biotechnology, which tend to have high levels of return. According to Ashok (2003), venture capitalist provides not only money but also extends assistance, such as access to technology, markets and networking with key resource persons/organizations etc. Popov and Roosenboom (2011) in their research paper summarize that Venture Capital financing is relatively more successful in fostering innovation in countries with lower barriers to entry, with less stringent labor regulations, and with higher human capital. Viren Chavda (2014) suggested that for the growth and expansion of high-tech industry, there is a need of risk capital in India. Rani and Katyal (2015) in their study found Indian Venture Capitalists are inclined towards tech-based projects as 68% of investments are in technology driven projects in comparison to 9% in healthcare and 7% in education projects. The study concluded that Indian venture capital industry is struggling. Sabrinathan (2017) in his Exploratory Study highlighted that the Indian Venture Capital industry has grown manifold in breadth and depth including the advanced fund management practices. The analysis further revealed that the Venture Capital Industry is becoming highly competitive with high entry and exit barriers.

IV. GROWTH OF VENTURE CAPITAL IN INDIA (2007-17)

The trend of venture capital financing over 10-year period (during 2007-17) is shown in Fig.1. It may be observed that the long-term Private Equity/ Venture Capital (PEVC) investment growth has been inconsistent and had registered CAGR of 1.87%.

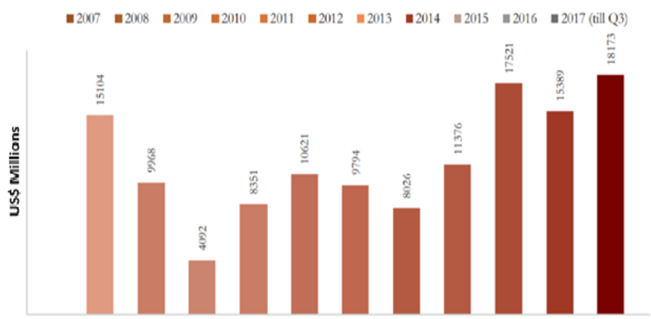

Fig.1: PE/VC Investments Over Years
Source:http://www.aralaw.com/wp-content/uploads/2018/01/India-Private-Equity-and-Venture-Capital-2017.pdf

Further, Fig.2 depicts trend of quarterly venture capital financing in IT/ITES sector over the period 2007-14. As per the investment reports of SEBI, IT/ITES is the second major sector after real estate, which has gained a major momentum in terms of increasing investments year by year.

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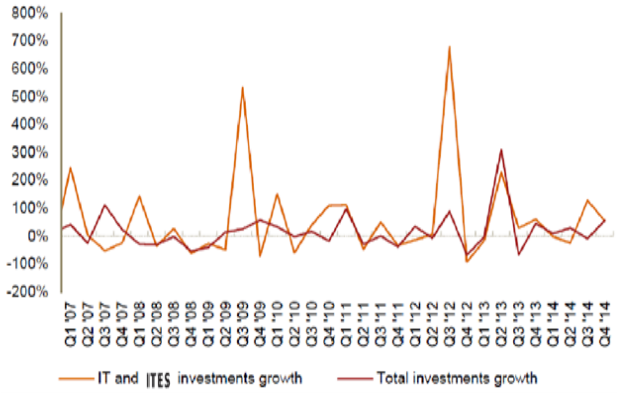

Fig.2: Value Of PE/VC Investments In IT/ITES Sectors.

Source: http://www.aralaw.com/wp-content/uploads/2018/01/India-Private-Equity-and-Venture-Capital-2017.pdf

Fig. 3 indicates the trend of private equity/ venture capital financing in IT & ITES companies over the years 2012-16. It may be observed that this sector registered steep growth (approximately 240%) during the years 2013-15. The number of deals has also registered steep growth of almost 230% over the same period. This reflects inclination of Venture Capitalists towards Investment Indian IT/ITES sector. The major names in the list was of Flipkart, Ola, Snapdeal and CMS Info Systems. This favorable trend has enthused many new entrepreneurs to opt for venture capital financing.

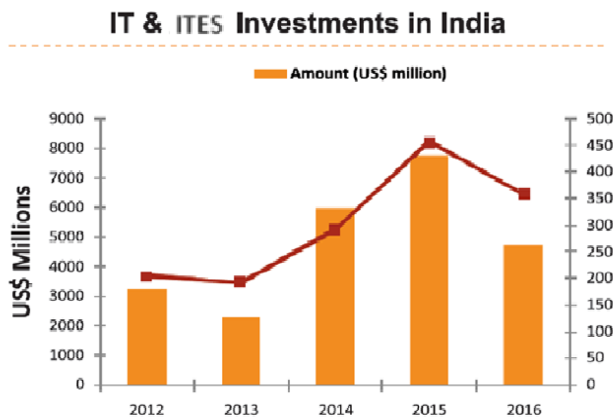

Fig.3: PEVC IN IT & ITES (2012-2016)
Source: Venture Intelligence

Fig. 4 indicates venture capital financing sector wise in percentage terms during the year 2016. Fig. 5 indicates that IT & ITES has been a major sector for venture capital financing over the years 2012-16.

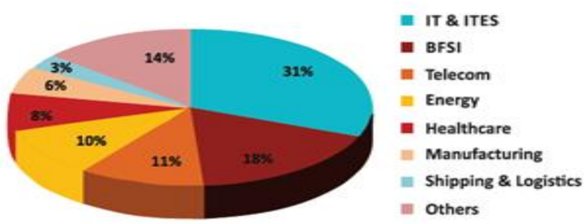

Fig.4: PE Investments by Iindustry-2016 (BY VALUE)
Source: Venture Intelligence

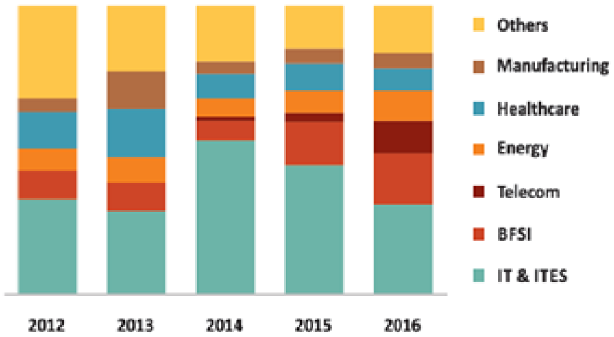

Fig.5: Investments by Industry (VALUE)
Source: Venture Intelligence

The sign of revival is evident in the year 2017 as the venture capital financing increased to the level of US$10,668 million (Fig.6).

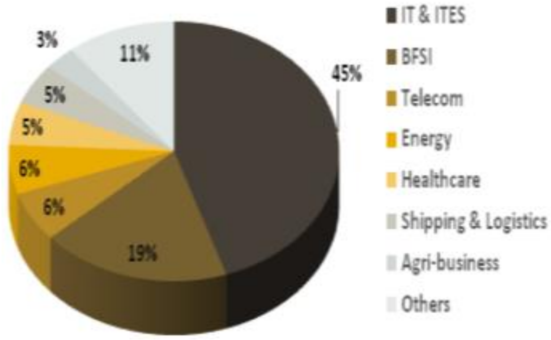

Fig.6: PE/VC Investments in IT & ITES Sector
Source: Venture Intelligence

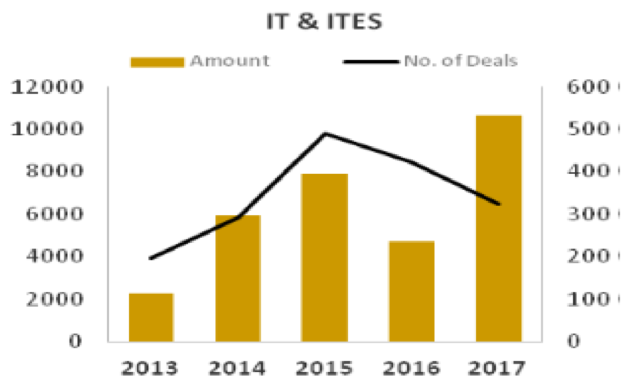

Fig.7: PE/VC Investments by Industry- 2017 BY Value
Source: Venture Intelligence

IT & ITES companies accounted for 45% of the venture capital financing led by Flipkart, Paytm and Global Logic-attracting US$10.7 billion across 325 deals, as shown in Fig.7. The prominent sectors are BFSI, Telecom, Energy, Healthcare, etc.

V. TRENDS OF VENTURE CAPITAL FUNDING DURING THE YEAR 2018

The following key trends have been observed:

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• A total of USD 12.68 billion was raised by Indian start-ups through private equity, an additional USD 1.14 billion in debt funding in 2018, across a total of 864 deals.

• Eight unicorns emerged on Indian Venture Capital horizon during the year 2018 having bagged the valuation of more than a billion USD.

• Indian Venture Capital continued their trend of financing Late-stage start-ups with a proven track record that grabbed the lion's share of funds raised.

• The star-performers were:

i. Ecommerce, as market placed Flipkart on different pedestal due to its acquisition by Walmart and valued it at more than USD 20 billion.

ii. Fintech, as government dissuaded the use of cash transactions and actively persuaded the shift to e-payments.

iii. SAAS, reached a revenue size of more than USD 70 billion, leaving behind both Infrastructure as a Service (IaaS) and Platform as a Service (PaaS) combined.

• A very optimistic trend also emerged, investment started arriving from South East Asian Countries like Japan, China also started entering Indian market especially Indian start-ups, certifying its arrival on the global stage.

A month on month growth rate of 15% was observed from end of November 2018 (USD 11 billion) to end of December 2018 (USD 12.68 billion) in the venture capital funding. An additional USD 1.14 billion was also raised in debt funding, taking the total to $13.88 billion.

The trends of 2018 continued in the first three quarters 2019, as PE/VC investments into India grew to an all-time high of USD 36.7 billion, according to a report by the Indian Private Equity and Venture Capital Association and consulting firm EY.

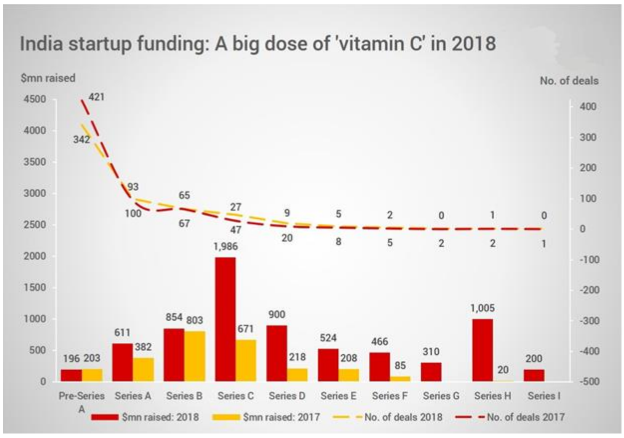

Fig.8: India Startup Finding Source: https://yourstory.com/2019/01/2018-india-startups-funding-roundup-unicorns

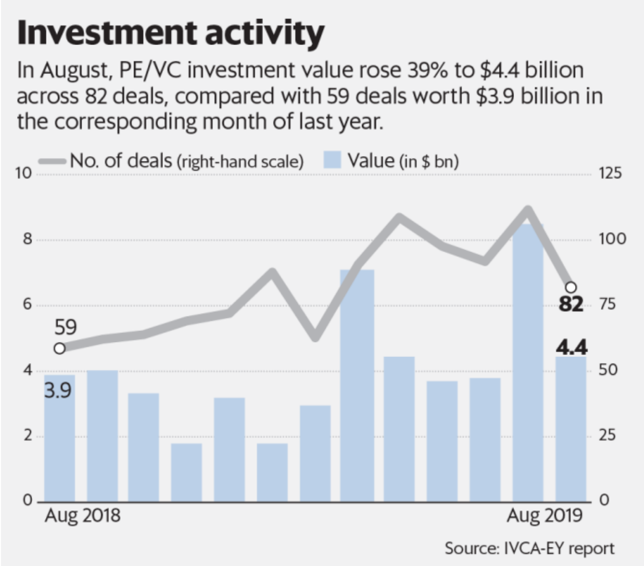

Fig.9: A comparative of VC investment activity during the month of August, 2018 and 2019. (Source: https://www.livemint.com/companies/start-ups/pe-vc-investments-climb-to-an-all-time-high-of-36-7-bn-in-january-august-1568135719273.html)

VI. GEOGRAPHICAL DISPERSSION- VENTURE CAPITAL INVESTMENTS BY REGION

Venture capital financing has a tendency to get clustered in particular regions in response to various favorable environmental factors such as economic, political and technological (Mason, 2007). Silicon Valley in United States is the most cited example of this type of clustering where availability of entrepreneurs with innovative drive, adventurous financiers ready to take leap into unknown, and government providing policy and procedural support, all three culminated to give it a unique status.

In India, there exist three such clusters. A large concentration of venture capital firms exists in Bombay (finance-related cluster), New Delhi (political related cluster) and Bangalore (technology-related cluster) (Subhash, 2007).

There are practical reasons for these cities to emerge in the form of such specific clusters. Mumbai is the financial capital of India, with two largest Indian stock markets; BSE and NSE and head offices of RBI and SEBI. Almost all major banks have their headquarters in this city (Thomas, 2007). Moreover, it has a got a great linkage on both sides to the large South Asian Markets – Middle Eastern destinations like Dubai, Abu Dhabi etc. on western side and Singapore, Taiwan, and Vietnam on other. A combination of both – internal and external – factors made it a great destination for business firms in general and venture capital firms in particular.

Many VC firms located here are linked to, or are offshoots from, other financial institutions, such as banks and investment houses. Many other are the subsidiaries of corporate houses to keep abreast of recent advances and take advantage of such development in their own business processes.

Besides, location of VC firm in the financial centre offers the access to the pool of knowledge and expertise and provides access to other financiers, entrepreneurs, legal, accounting and consulting firms. The stock exchanges (BSE and NSE) facilitate the exit mechanism from venture capital investments via IPOs. (Mason, 2007).

Almost all the southern states in India have developed a strong reputation as destination for software development services, with Bangalore emerging as the favorite one. Apart from IT majors like Infosys, Wipro, Tata Consultancy Services and Microland, the world's leading IT companies like GE, Texas Instruments, CISCO, Digital, IBM, HP, Compaq, Motorola, Lucent Technologies, Microsoft, Sun Micro Systems, Oracle, Novell and several others have made Bangalore their home. Several educational institutes and research centers are located in Bangalore and contributed enormously to the development of the city as an IT center (Dijk, 2003) so much so that it is called as Indian "Silicon Valley."

Delhi, the Capital City, may be considered as the best place for Venture Capital investment. It is a major cultural, political, and commercial center of India. With the government's explicitly positive attitude towards the business activities the corporate houses swarmed the capital including the venture capital firms. Being closer to the political capital makes the flow of activities connected with VC financing much easier.

The study found that most of the Indian venture capital firms have shown interest in financing the local ventures, refer Table 2. The emerged pattern shows that a majority of the investments have been captured by Bengaluru followed by Mumbai and other cities mainly Delhi, Chennai and Ahmedabad. The VC investment outcomes show clear evidence of spatial proximity effects i.e. investment is disproportionately concentrated in those regions that also contain the major clusters of venture capital firms. This supports the fact that venture capital firms mostly believe in relational form of investment with hands-on approach. Venture capitalists are very much inclined to be involved in the management of the ventures they undertake to invest in. The reasons mostly are to contribute as much as possible on various aspects like resource organization, networking, liaising and keeping a vigilant eye on their progress so as to cash out at the most opportune point. This attitude may exist due to the absence of any formalized structure, policy and procedure. (Mason and Harrison, 1992).

Table 2. Venture capital investment city wise during the years 2016-18 (Source: https://trak.in)

Cities	2016		2017		2018		Total No of Deals from 2016-18	Total Amount (in USD) of the deals
	No. of Deals	Amount (in USD)	No. of Deals	Amount (in USD)	No. of Deals	Amount (in USD)		
Ahmedabad	18	500000	8	43200000	6	10930000	**32**	**59130000**
Bengaluru	294	1106372108	226	7416604000	100	1399459600	**620**	**9922435708**
Chennai	31	34050000	24	103823000	16	226439000	**71**	**364312000**
Delhi NCR	335	467384500	198	1240562500	82	816284163	**615**	**2056846663**
Mumbai	188	416391500	141	1161515000	61	577736200	**390**	**2155642700**
Other Areas	152	127777500	90	463605230	43	666254600	**285**	**1257637330**
Total	**1018**	**2156975608**	**687**	**10429309730**	**204**	**3697103563**	**1909**	**15816004401**

7. CONCLUSION

The Venture Capital sector in India is undergoing a paradigm shift. The venture capitalists are providing funds to new enterprises, prospective enterprises, innovative projects etc. The study found that since a decade IT/ITES is dominating the venture capital financing. It can be concluded that venture capital financing has been fluctuating during the period of study (2007-17), but towards the year 2017, the venture capital financing stabilized at US$18,173 million and there is a marked reference for venture capital financing in IT/ITES sector. It has been observed from the various trends presented above that the investors are bullish about investing in start-ups. There is money in the market but investors are cautious in deploying funds as they have developed a sharper focus on sectors and spaces in which they want to invest in.

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