Venture Capital- Catalyst for Innovation and Growth

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ABSTRACT:

Innovative non-conventional entrepreneurship ideas, coupled with risk taking and need to provide capital for the successful implementation of these ideas, gave birth to the concept of venture capital (VC). The world economy has evolved significantly since 2008, after a strong blow of financial crisis. Venture capitalist is no more exception to it. Venture capitalist is one among the primary engines which drive for expansion and growth. Despite the adverse effect of recession, people with innovative business ideas are coming forward to bring the economy back on track. VC investment rose during 90's. Post 2001, there was a significant decline in venture capital investment due to stringent government policy and the fluctuating economy. But favorable market condition and the support of government in recent times as encouraged youths and people to come up with new business ideas and set up their own ventures, which eventually would solve various economic problem like unemployment. Finding an optimum solution to these problems is the need of the hour. The concept of VC is not new to the Indian economy. This activity was promoted by setting up financial institution like IDBI, ICICI and State Financial Corporations. These institution provided finance to small and medium enterprises by funding them through debt capital. This model benefitted the economy by encouraging the financials inclusion. With the help of these institutions people from the backward areas of the country established their ventures and introduced new technology and products in the markets.

This paper provides the venture capital process as well as discusses the role of VC in providing innovative solutions to economic problems. It also highlights various regulatory frameworks to encourage the venture capitalists. The paper also depicts the future prospects of venture capital in India.

KEY WORDS: venture capitalist, unemployment, financial inclusion, debt capital, economic growth.

1. INTRODUCTION

Venture Capital has long been a significant source of funding for entrepreneurs and startups. Venture Capital is the financial assistance provided to startup companies, which are potentially capable for achieving growth over a period of time and sustain the growth in the long run due to their distinct and unique business model. Venture capitalists and Venture Capital funds earn money by investing in these companies by way of owning a part of their equity capital. Venture capital is of much importance to the startups because they lack credibility and do not have access to capital markets. VC funds identify their growth potential and provide financial assistance for nurturing and successful execution of the business ideas of these startups.

Venture Capital has been in existence all over the world since a long time. In Indian context, it has an equal importance. Today, Indian economy is seen as an economy that has tremendous opportunities, yet it comprises of many industries that have reached their saturation point. Industries such as Information technology and Telecom are already saturated due to intense competition. This has limited the scope of growth. An increase in the number of saturated sectors in the economy and limited opportunities in the market has made way for new innovative ideas and business strategies to take place of the old ones.

State and Central government has also encouraged these new startups by providing various benefits- monetary as well as regulatory. These ventures fall under the category of Small and medium Enterprises (SMEs). SMEs are companies which have a limited capital as well as limited personnel. SMEs are an integral part of the economy as they employ about 40% of the total workforce in India. These enterprises start on a small level, but have the capacity to expand and grow rapidly in the long run. SMEs also encourage financial inclusion as a significant number of these operate in backward and rural areas, thus contributing to the growth and development of these areas. These enterprises attract a large amount of investments due to their growth potential and the ability to introduce new and innovative business strategies.

The contribution of small scale industries (SSIs) has been remarkable in the industrial development of the country. It contributes about 40% in the industrial production. 35% of the total manufactured exports of the country are directly accounted for by this sector. Overall, the small industry sector has done quite well and has enabled the country to achieve considerable industrial growth and diversification.

VCs focus exclusively on companies developing significant innovations. Unless the company is poised for significant growth, a VC won't invest. Making investments at the earliest stages of a company's development involves significant entrepreneurial risk, which severely limits capital sources for such companies. Yet, venture capitalists assume this risk alongside the company founders by providing capital in exchange for an equity stake in the company.

There are typically six stages of VC Financing- Seed Funding, Startup, First round (growth), Second round, Expansion, Exit of Venture Capitalist.

Venture Capitalists look for only those business ventures which fit their investment criteria, after completing extensive due diligence. VCs may have different approaches to analyze their investments in a particular venture. A venture capitalist may ask prospective business for information regarding their product and services, their business model, operations and most importantly, the management of the company.

PRIVATE EQUITY vs. VENTURE CAPITAL

Venture capital can be considered as a segment of private equity. The difference between private equity and venture capital can be understood in simple terms as private equity investors prefer fairly mature companies to invest in, which maybe underperforming or undervalued, with the goal of improving their profitability and getting a return on their investments. Venture capital, on the other hand, targets early stage and high potential companies which can expand quickly over a period of time, with the objective of nurturing them and help them to grow rapidly.

In other words, private equity is the capital that is invested in private companies i.e. those companies whose shares or units are not traded publicly, whereas, in the case of venture capital, the Venture Capitalists investing in the company may take the company to the public and raise more funds. The venture capitalists then sell their stake in the company at higher prices, thus exiting the company.

2. <u>LITERATURE REVIEW</u>

Syed Ahmad Naqi and Samantha Hettihewa *"Venture capital or private equity? The Asian experience"- Business Horizons Volume 50, Issue 4, July- August 2007.*

Venture Capital in Asia has seen a remarkable rise in the last two decades. However, many experts have expressed doubts as to whether what is being reported in Asia about venture Capital can be justified as such. Through an exploration of the industry, development and composition of venture capital in Asia, this article states that venture capital in Asia differs from what is called private equity. As such need exists within the Venture capital literature to recognize the potential of the Asian Venture capital market. Moreover, venture capitalists considering expansion in Asia must comprehend the nature of the market to avoid frustrations which may result from inadequate understanding.

Dossani R and Kenny *"Creating an Environment for Venture Capital in India"- M. World Development. (2002)*

The institution of Venture Capital is a difficult one to initiate through policy intervention, particularly in developing economies with unstable macroeconomic environment. The emergence of thriving software services sector after 1985 created the opportunity for venture capitalists to start investing. Efforts were made to nourish the venture capital industry. After several setbacks, some success has been achieved largely due to moulding rules and regulations. The process was assisted by the role of overseas Indians in Silicon Valley. Yet in terms of what is needed, most of the work remains to be done.

I M PANDEY *"The process of developing Venture capital in India"- Technovation, Volume 18, Issue 4, April 1998".*

This study demonstrates the process of developing venture capital in a developing economy like India. In the initial years, venture capital firms in India encountered number of problems in running their business like raising funds and evaluating prospective ventures. It initially focused its investments in high technology business, but gradually shifted focus towards other potentially high growth, high profitable businesses. The venture capital companies gradually developed an operational framework and took initiatives to popularize the venture capital business in India.

A THILLAI RAJAN “Venture *Capital and efficiency of portfolio companies” IIM B Management Review, Volume 22, Issue 4, December 2010.*

VC has emerged as dominant source of finance for early stage businesses and Indian VC has clocked the fastest growth rate globally. Academic literatures reveal that VC funded companies perform better than none VC funded companies. A detailed study would be required to justify this and many more useful contributions can be drawn from it.

3. OBJECTIVES OF THE STUDY

- To know the current scenario of Venture Capital financing in India.
- To predict the future prospects of Venture Capital financing.
- The effect of Venture Capital Investments on Economic Growth and suggesting solutions for various economic problems.
- To analyze growth of Venture Capital Investments in different sectors of Economy.
- To look out for market share of different economic sector in terms of venture capital investment.
- To analyze whether business confidence index can predict growth rate of venture capital investment.

4. OPERATIONAL DEFINITIONS:

VENTURE CAPITAL (VC) is the finance provided to early-stage, high-potential, and high growth startup companies. A venture capital fund owns some equity shares in the new startups it invests in, which usually have a new and innovative technology or business model.

UNEMPLOYMENT is a situation when people don’t have work and actively seek work.

FINANCIAL INCLUSION is the delivery of financial services at affordable costs to backward and remote segments as well as low-income sections of society.

DEBT CAPITAL is the capital that a business raises by taking out a loan. It is a loan made to a company that is normally repaid at some future date. Debt capital differs from equity or share capital because subscribers to debt capital do not become part owners of the business, but are merely creditors.

ECONOMIC GROWTH is the increase in the market value of the goods and services produced by an economy over time. It is conventionally measured as the percent rate of increase in real gross domestic product, or real GDP. Of more importance is the growth of the ratio of GDP to population (GDP per capita), which is also called *per capita income*.

5. RESEARCH METHODOLOGY:

Research methodology is a way of systematic interpretation of problem and finding new solution for the problem. In other words it is a process of scientific and systematic search for pertinent information on a particular topic and acquiring knowledge on the topic. The study is carried out around diametric source of data regarding venture capital finance in India and GDP of India. Data is analyzed by using many function of Microsoft Office Excel 2007. The tools used in this process are Correlation, growth and linear forecast.

5.1 Data collection:

There are two ways of collecting data primary and secondary. Finding Primary data was not possible so this study is completely based on secondary data. Data is collected from some publications and online resources including-

- SEBI’S website
- Indian Venture Capital Association reports
- Trading economic websites
- Books, publications, report and articles

5.2 Research design:

It is the way of using data to carry out some information from these data for the purpose of research. It is the arrangement of conditions for the collection and analysis in the manner that aims to combine relevance to research. The study is descriptive in nature and research is done with analog observations. Predictive analysis is done for the forecasting the future investments pattern.

5.3 <u>Limitations of study:</u>

- The study is based on diametric sources, any incorrectness or biasness is same might also have been resulted in same for this study.
- Data for calculating business confidence index has been taken from the year 2007. Data from 2007 to 2011 is on semiannual basis while that from 2007 to 2014 is on quarterly basis.

6. ANALYSIS AND INTERPRETATION

BUSINESS CONFIDENCE INDEX

It is given by CII (Confederation of Indian Industries). Business Confidence Index is an economic indicator which is normally given industrial organization conducting such economic surveys of such managers. It measures the amount of optimism that investment managers feel the prospects of business in their countries. It provides the overview of the state of economy.

ABOUT CII

It is an association which works to create the growth of industry in the country. It is a non-government, non-profit organization which plays a proactive role in Indian development process. It works closely with government on policy issues etc.

CII BUSINESS CONFIDENCE INDEX:

The Index is based on the opinions, reflects of performance, and intentions of over 2000 C-suite executives (CEOs, CFOs, COOs), business owners and key decision makers across various industry sectors in the Global Corporate Challenges (GCC). The BCI is calculated quarterly & tracks shifting optimism across various parameters.
The report released at the end of each quarter allows the subscriber to get a full well rounded picture of the region's business outlook and assess the trends and confidence levels amongst the GCC's business community. The Business Confidence Index is generated monthly by South African Chamber of Commerce and industry (SACCI) as a measure the level of business confidence within the South African economy. The report includes commentary on the current state of the economy, as well as other economic indicators.

Dates	**BCI**	**Increase in BCI**	**VCF**	**%Change in VCF investment**	**FVCF**	**%Change in FVCF investment**	**TOTAL**	**%Change in total investment**
DEC/6	71.8		11270		7856		17621	
JUN/7	63.9	-7.9	12868	14.18	10706	36.28	20310	15.26
DEC/7	66.3	2.4	19955	55.07	16705	56.03	31682	55.99
JUN/8	61	-5.3	20128	0.87	16926	1.32	32379	2.20
DEC/8	56.3	-4.7	22771	13.13	23047	36.16	37578	16.06
JUN/9	58.7	2.4	22192	-2.54	24151	4.79	37151	-1.14
DEC/9	66.1	7.4	18273	-17.66	28894	19.64	39051	5.11
JUN/10	67.6	1.5	21500	17.66	30722	6.33	43686	11.87
DEC/10	66.2	-1.4	23023	7.08	33241	8.20	47859	9.55
MAR/11	66.7	0.5	25576	11.09	35593	7.08	52688	10.09
JUN/11	62.5	-4.2	26222	2.53	37098	4.23	54844	4.09
SEP/11	53.6	-8.9	26896	2.57	37635	1.45	55536	1.26
DEC/11	48.6	-5	27592	2.59	38730	2.91	56868	2.40
MAR/12	52.9	4.3	28920	4.81	39815	2.80	59408	4.47
JUN/12	55	2.1	29238	1.10	41277	3.67	61056	2.77
SEP/12	51.3	-3.7	29924	2.35	33291	-19.35	53574	-12.25
DEC/12	49.9	-1.4	31556	5.45	33773	1.45	55542	3.67
MAR/13	51.3	1.4	31336	-0.70	41174	21.91	62866	13.19
JUN/13	51.2	-0.1	31669	1.06	40848	-0.79	63310	0.71
SEP/13	45.7	-5.5	30975	-2.19	43140	5.61	64336	1.62
DEC/13	54.9	9.2	35400	14.29	44889	4.05	69520	8.06
MAR/14	49.9	-5	35987	1.66	45262	0.83	70054	0.77

Table shows the calculation of Business Confidence Index, where:

Change in business confidence

= *business confidence current year-business confidence in previous year*

Percentage of change in investment

*= ((investment in current year- investment in previous year)/investment in previous year)*100*

Correlation coefficient has been derived using MS Excel's CORREL Function on given values of data.

Correlation coefficient of BCI and %Change in VCF investment is 0.0567

Correlation coefficient of BCI and %Change in FVCF investment is 0.0765

Correlation coefficient of BCI and %Change in Total investment is 0.1929

Table shows data of CII'S Business Confidence Index values, % change VCF investment, % change FVCF investment, %change Total investment in each semiyearly from December 2006-2010, and quarter from June 2011. Correlation coefficient is used to measure the significance of business confidence survey by CII in case of venture capital investment.

The correlation coefficient between Correlation coefficient of BCI and %Change in VCF investment is 0.0567, Correlation coefficient of BCI and %Change in FVCF investment is 0.0765, Correlation coefficient of BCI and %Change in Total investment is 0.1929. All correlation coefficient turns out to be positive, relation between BCI and Venture Capital Investment Rate is positive. So there is less risk for venture capital in investment.

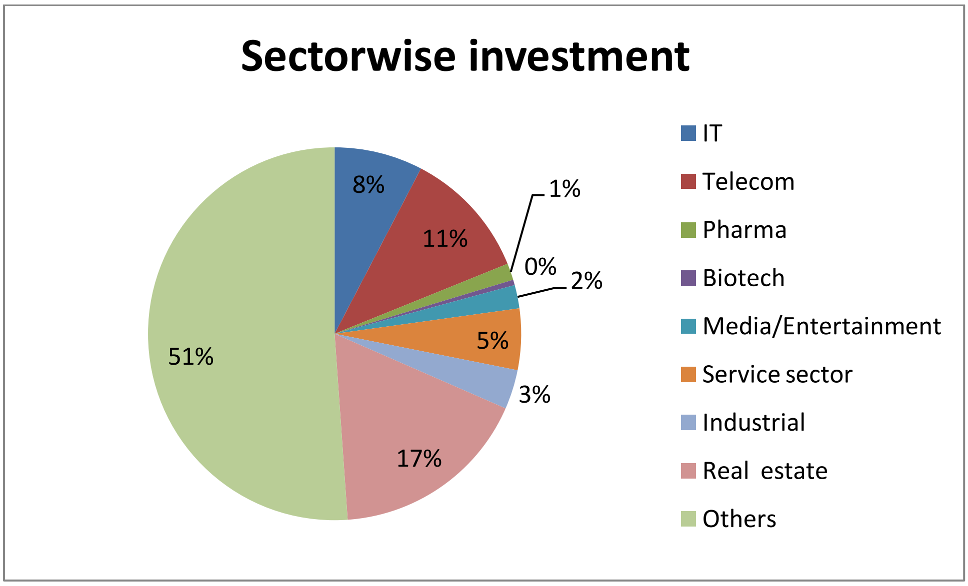
As we can see, Dec 2013 BCI index is increased by 9.2, so we can infer that there is an increase in venture capital investment in these quarters. As in, March 2014 it decreases in BCI values, therefore we can infer that venture capital investment in these quarters can be less than investment in previous quarter of 2013.

If we see on an average, the index is increasing yearly by some percent, so venture capital investment would majorly depend on confidence index. Hence, as the index values would increase venture capital investment would also increase.

Sector wise investments by venture capitalists (Rs. in cr):

Sector	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
IT	2169	2520	2864	3319	4322	4481	5325
Telecom	990	1076	4268	7469	7516	7086	7798
Pharmaceutical	1076	1229	1478	1325	1132	1151	1006
Biotech	385	634	461	289	283	278	326
Media/Entertainment	470	906	1434	1006	1124	739	1406
Service sector	2475	2976	3529	2677	2973	2809	3697
Industrial	2047	1951	2344	1355	2014	2107	2377
Real estate	6348	6311	8185	9783	10831	9987	12048
Others	16749	24413	27158	20637	26637	26903	35535

The table shows the annual venture capital investments data for different sectors of economy.



In 2013 real estate was the biggest sector of venture capital investments followed by telecommunications and IT, services sector stood at 4th position followed by industrial products sector and media/entertainment. Pharmaceutical and biotechnology sector had least share of venture capital fund among 8 sectors. IT had been high growth factor all these years. IT is expected to be one of the most attractive sectors for PE and VC investment in the next couple of years. It infers that IT is going to be one of the high growth sectors attracting large amount of venture capital. Telecom sector had some of the biggest investments in 2009 and 2010 making it hot favorite sector of venture capital investments in those years.

Media/entertainment sector has moderate growth in past years. In 2013 VC showed significant interest and there were good number of deals in the sector. Services sector showed very slow growth in terms of VC investments.

This table gives the Venture capital investments and its effect on GDP and unemployment rate. To understand the scenario of venture capital investments in India, firstly we look at the total investment details of SEBI registered venture capital funds of each year.

Years	**Venture capitalist investments (in billions rupees)**	**Unemployment rate (%)**	**GDP (in billions rupees)**
2007	282.60	8.25	57827.71
2008	339.39	8	75374.89
2009	420.59	9.2	74596.65
2010	478.59	9.4	83192.45
2011	568.68	9.4	104243.42
2012	555.42	6.3	114552.61
2013	695.20	5.2	113248.73

Here we conduct a comparative study of venture capitalist investment and GDP. We are finding correlation between them. Correlation coefficient has been derived using MS Excel's CORREL function on given values of data.

CORREL (array1, array2)

Array 1 = array of values change in Venture capitalist investments

Array 2= array of values of GDP

Correlation coefficient of venture capitalist investments and GDP is 0.930917.

If venture capitalists had not invested, the scenario would have been different. The unemployment rate would increase more than 9% which would have indirectly affected the GDP of the country.

Here, the percentage of contribution of Venture capital investments to GDP is shown and an attempt has been made to find the correlation between unemployment rate and VC investments.

Years	Unemployment rate (%)	Venture capitalist investment contribution to GDP (%)
2007	8.25	0.48
2008	8	0.45
2009	9.2	0.56
2010	9.4	0.57
2011	9.4	0.54
2012	6.3	0.48
2013	5.2	0.61

Correlation coefficient has been derived using MS Excel's CORREL function on given values of data.

CORREL(array1,array2)

Array 1 = array of values change in unemployment rate

Array 2= array of values of % of Venture capitalist investments contributed to GDP

Correlation coefficient of unemployment rate and % of Venture capitalist investments contributed to GDP is ***-0.07338.***

Here correlation is in negative because as the rate of investments is increasing, unemployment rate is falling down. Venture capitalist plays a vital role by contributing to the growth of the economy of the country and reducing the problem of unemployment.

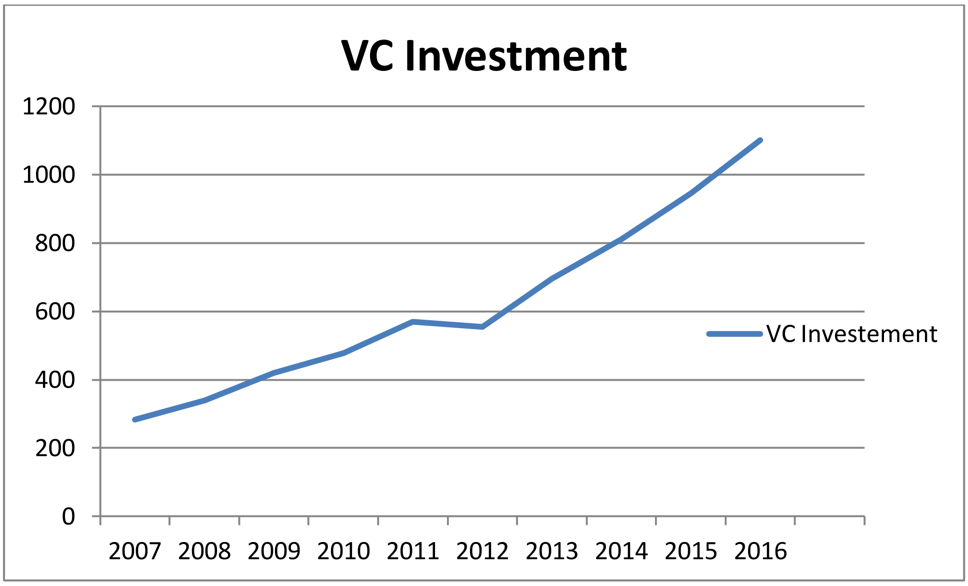
Forecasted venture capitalist investments:

YEARS	Venture capitalist investments (in billions)
2014	810.4524
2015	944.8117
2016	1101.445

With the help MS word excel, growth rate is calculated by taking average of growth rate of venture capital investments

Growth rate= (current year-previous year)/previous year

= previous year (1+%average growth rate)



Venture capital investments in India have grown exponentially and if same trend continues the investments by VC in India would continue to increase in the near future. From the averages of the above investments in every year we can find the average growth rate in investments in each year and using that growth rate we predict the future investments in 2014, 2015 and 2016.

Also, investments have slowed down by 13.26 billion rupees in the year 2012 but they have acquired their position again in 2014 by increasing to 139.78 billion rupees. The value of investments in 2014, 2015 and 2016 is showing growth by 0.16%.

6.1 FINDINGS:

- There was an epidemic increase from 2007 till now in venture capital investment.
- Around Rs. 810.45 billion of VC investment will be made in 2014.
- In 2015 and 2016 we predict VC investment around RS. 944.81 And RS.1101.44 billion.
- As per forecasting there will be sufficient amount of investment about to occur in next two years i.e. 2015 and 2016.
- As we can see the maximum share of total venture capital investment in 2013 is in real estate sector, Telecommunication and Information Technology.
- Telecommunication and media/entertainment sectors are growing at medium pace. Because of a series of scams and policy paralysis, telecommunication sector in India has seen decline in recent years.
- Venture Capitalists have not been attracted to invest in the service sector and industrial product sectors.
- Venture Capitalist is playing an important role in growth of GDP as they are contribute by investments in country thus encouraging it to grow globally by providing funds to new entrepreneurs to start their venture.
- Venture Capitalists are reducing the unemployment problem by investing more in the new ventures thus creating a platform for employment generation.
- There are positive correlations between VCFs and FVCFs with CII business confidence index.
- The CII business confidence Index for first two quarters of 2014 i.e. March 2014 and June 2014 has decreased from their previous quarters which has negative impact on investment of venture capital.
- As per the historical the Business Confidence Index is quite high and increased sharply in the future quarter of 2014.
- Business confidence surveys like CII's can predict the flow of venture capital investment in long term but cannot surely predict small term movement in investment values.

7. CONCLUSION

On the basis of the study, it can be said that Venture capital has a bright scope in the upcoming years. It has been constantly on the rise in the recent years but the economic slowdown of 2008 proved to be an impediment in its growth. But as the industry is reviving from the adverse effects of recession, Venture capital investments are again on the rise. The Indian economy is on the rise thanks to a large number of startups being set up regularly. This has increased the importance of Venture Capitalists who can take the advantage of this growth and earn money thus benefitting themselves as well as the economy.Venture capital is also gaining importance due to the increasing saturated sectors in the Indian economy. Many saturated sectors like Telecom and Information technology have limited the scope of individual growth. Hence, more people are opting for entrepreneurship after getting enough experience in the industry.

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