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Venture Capital in India: Model, Process and Culture

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ABSTRACT

The problem is that there aren't many buyers out there for those portfolios. Most of the portfolios on sale represent the so-called copycat investing that has marked the greater part of the past decade of early-stage investing in India and aren't worth much today in the midst of what is now clearly a prolonged downturn. "We (the venture capital industry) are getting branded globally for not being able to show much (in returns) for the money that's gone in so far. There are a lot of portfolios on sale but such sales are not easy to price. Buyers are naturally wary that people are trying to get rid of the lemons through these secondary portfolio sales," says a fund manager at the office of a global venture capital firm who spoke on condition of anonymity.

Keywords: Venture Capital, Venture Capitalists, Investments, Working Models, Process.

1. INTRODUCTION

Now a days Invention and innovation are major factors to a developing and developed economy. What's more, they have a powerful grip on the nation's collective imagination. The popular press is filled with against-all-odds success stories of Silicon Valley entrepreneurs. In these sagas, the entrepreneur is the modern-day cowboy, roaming new industrial frontiers much the same way that earlier Americans explored the West. At his side stands the venture capitalist, a trail-wise sidekick ready to help the hero through all the tight spots—in exchange, of course, for a piece of the action.

It is a private or institutional investment made into early-stage/start-up companies (new ventures). As defined, ventures involve risk (having uncertain outcome) in the expectation of a sizeable gain. Venture Capital is money invested in businesses that are small; or exist only as an initiative, but have huge potential to grow. The people who invest this money are called venture capitalists (VCs). The venture capital investment is made when a venture capitalist buys shares of such a company and becomes a financial partner in the business.

Venture Capital investment is also referred to risk capital or patient risk capital, as it includes the risk of losing the money if the venture doesn't succeed and takes medium to long term period for the investments to fructify. Venture Capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms.

It is the money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there's a significant risk associated with the company's future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan.

Venture Capital is the most suitable option for funding a costly capital source for companies and most for businesses having large up-front capital requirements which have no other cheap alternatives.Software and other intellectual property are generally the most common cases whose value is unproven. That is why; Venture capital funding is most widespread in the fast-growing technology and biotechnology fields.

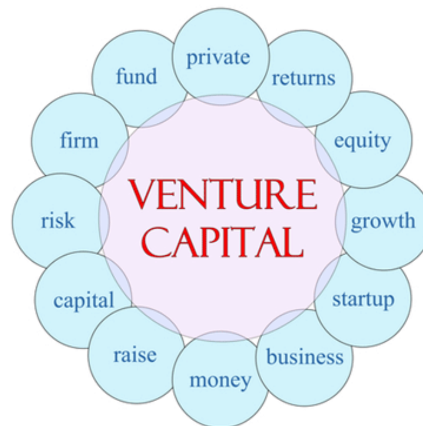


Figure 1

2. REVIEW OF LITERATURE

There is an extensive body of literature covering role of venture capital financing in developed countries like United States and the United Kingdom where the Industry has been historically more active, but in India, the venture capital investment in India was seen post-liberalization. There was a continuous increase till2001 and thereby drastically reduced. Surprisingly, there was a negative growth of 4percent in 2001-02 it was continued and a 54 percent drastic reduction was recorded in the year 2002-2003. Since 2005, there venture capital financing has been at an increasing rate in India. Success stories of venture backed companies leading to substantial financial gains made by venture capitalists evoked interest in academic research in this area.

Amit et. al., (1990), Commercial banks and other lending institutions required an established track record and collateral before considering any application for funds. This attitude of financial institutions has always left a funding gap for potentially viable ventures with either insignificant collateral to offer or little history of success. Therefore, 'risk sharing and lack of funds drive entrepreneurs to seek venture financing'.

Fried and Hisrich (1994), concluded that venture capitalists use three generic screening criteria for investments: the viability and novelty of the project; the integrity, track record and leadership skills of management; and the possibility for high returns and an exit, before proceeding to detailed evaluation.

Thompson et. al., (1997) found that venture capitalists are becoming proactive in identifying management buy-outs, investor led buy-out, and divestment candidates, resulting from corporate refocusing programmes.

Zider (1998), Venture capitals niche exists because of the structure and rules of capital markets.

Features of Venture Capital Investments:

- High Risk
- Lack of Liquidity
- Long term horizon
- Equity participation and capital gains
- Venture capital investments are made in innovative projects
- Suppliers of venture capital participate in the management of the company

Methods of Venture Capital Financing:

- Equity
- Participating debentures
- Conditional loan

The Funding Process

Approaching a Venture Capital for funding as a Company

Figure 2

The venture capital funding process typically involves four phases in the company's development:

- Idea generation
- Start-up

- Ramp up
- Exit

Step 1: Idea generation and submission of the Business Plan

The initial step in approaching a Venture Capital is to submit a business plan. The plan should include the below points:

- There should be an executive summary of the business proposal
- Description of the opportunity and the market potential and size
- Review on the existing and expected competitive scenario
- Detailed financial projections
- Details of the management of the company

There is detailed analysis done of the submitted plan, by the Venture Capital to decide whether to take up the project or no.

Step 2: Introductory Meeting

Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project in detail. After the meeting the VC finally decides whether or not to move forward to the due diligence stage of the process.

Step 3: Due Diligence

The due diligence phase varies depending upon the nature of the business proposal. This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews, and other such exchanges of information during this time period.

Step 4: Term Sheets and Funding

If the due diligence phase is satisfactory, the VC offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.

Types of Venture Capital Funding

The various types of venture capital are classified as per their applications at various stages of a business. The three principal types of venture capital are early stage financing, expansion financing and acquisition/ buyout financing.

The venture capital funding procedure gets complete in six stages of financing corresponding to the periods of a company's development

- *Seed money*: Low level financing for proving and fructifying a new idea.
- *Start-up*: New firms needing funds for expenses related with marketing and product development.

- *First-Round:* Manufacturing and early sales funding.
- *Second-Round:* Operational capital given for early stage companies which are selling products, but not returning a profit.
- *Third-Round:* Also known as Mezzanine financing, this is the money for expanding a newly beneficial company.
- *Fourth-Round:* Also called bridge financing, 4th round is proposed for financing the "going public" process.

(a) **Early Stage Financing:** Early stage financing has three sub divisions seed financing, start up financing and first stage financing.

- Seed financing is defined as a small amount that an entrepreneur receives for the purpose of being eligible for a start up loan.
- Start up financing is given to companies for the purpose of finishing the development of products and services.
- First Stage financing: Companies that have spent all their starting capital and need finance for beginning business activities at the full-scale are the major beneficiaries of the First Stage Financing.

(b) **Expansion Financing:** Expansion financing may be categorized into second-stage financing, bridge financing and third stage financing or mezzanine financing.

Second-stage financing is provided to companies for the purpose of beginning their expansion. It is also known as mezzanine financing. It is provided for the purpose of assisting a particular company to expand in a major way. Bridge financing may be provided as a short term interest only finance option as well as a form of monetary assistance to companies that employ the Initial Public Offers as a major business strategy.

(c) **Acquisition or Buyout Financing:** Acquisition or buyout financing is categorized into acquisition finance and management or leveraged buyout financing. Acquisition financing assists a company to acquire certain parts or an entire company. Management or leveraged buyout financing helps a particular management group to obtain a particular product of another company.

Venture Capital Business Models

Nothing seems to grab headlines more easily than a company that raises, say, $50 million and is valued at $2 billion. No revenue? Never mind. Doesn't matter. Then there's the promising young company that actually has $20 million in sales but only manages to seek out a valuation of $200 million. Sounds like en episode of "VCs Gone Wild," doesn't it?

But, when you look deeper, it's all about metrics - and maybe not the metrics that you, the entrepreneur, are most focused on.

That's why business owners have to know how venture capitalists think. Key metrics for growth-stage companies can vary as much as their products and services. Nothing is more important than calibrating an appropriate valuation for your company. Most entrepreneurs think the correct valuation is the highest

one they can get. Nope. You want the valuation that sets achievable expectations. Let's face it: If the term "down round" doesn't strike fear into your heart, it should.

Traditionally, revenue and profit have been the gold standard metrics. But those metrics rarely reveal what really makes growth-stage companies tick. That's because they are in expansion mode and will be operating at a loss and burning cash. In addition, the metrics venture capitalists focus on have evolved over the years. And the competition for good deals can drive prices up too. To help out with all this voodoo, here are some of the most popular metrics that venture investors consider.

3. RECURRING REVENUE

Investors who love the sound of a predictably-ringing cash register pay a premium for businesses who can achieve this. The subscription revenue model used to be limited to domains such as magazines, pay TV, phone companies and fitness centers. Now the entire software industry has moved in this direction with the introduction of "Software as a Service," or SaaS, where you pay a monthly fee and get free updates rather than buy a specific version for a set price.

The beauty of this model: once the costs of acquiring a subscriber are established, and you've figured out how long they stay (life time value) and what the cancelation rate or "churn" will be, investors can predictably calculate how each dollar invested will increase the value of the business. Who doesn't love predictability?

If they Come, we Will Build it

Audience growth is eye candy to venture capitalists, especially for Internet companies where dramatic audience growth has drawn breathtaking valuations even before there was a penny of revenue. The presumption is that if you have something that the masses are flocking to, ultimately you'll figure out some way to monetize it. The social trinity of Facebook, LinkedIn, and Twitter, followed by Instagram, Tumblr and Waze, has all garnered nosebleed valuations yet this way. These successes have driven valuations of the next wave-Pinterest, Snapchat and so on-right into orbit.

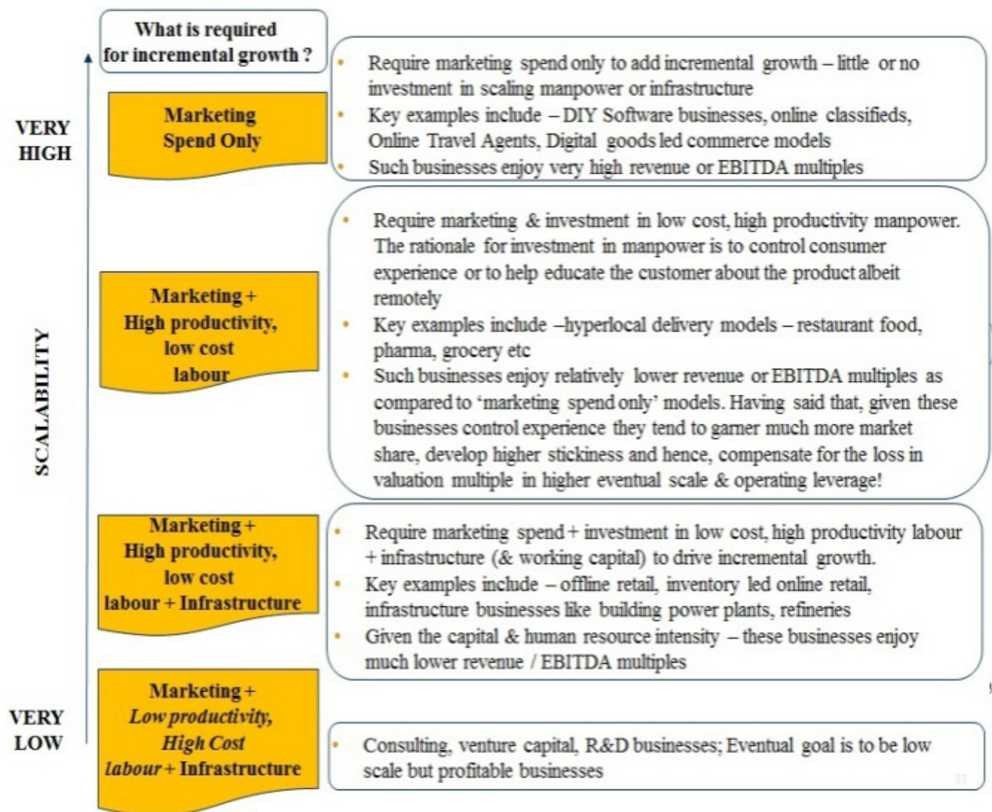
Fermiums

Fermium is a go-to-market approach that allows customers to try a product before buying. Customers who like buy the whole thing, or maybe some extra features (common in games such as Candy Crush). This model often goes hand-in-hand with recurring revenue, since the free version may convert into a subscription. Here VC's will focus on conversion rates: what percentage of free users ultimately starts paying.

So there you have it: three popular models VCs love. But consider this: expansion stage investors care most about the growth rate of the metrics most relevant to your business model. How fast you get profitable may be less important than you think. Dramatic growth is the real gold standard. If you can demonstrate annual- and sustainable-growth rates of 100% or more in your key metrics, you will have no shortage of investors knocking at your door with buckets of cash.

Keeping the above two parameters in mind, the following is my attempt to build a 'Business Model Scalability Stack' – this should enable businesses to better understand the relative scalability of different types of business models.

Business Model Scalability Stack



VCs love for highly scalable business models – scalable business models grow fast (this, of course, assumes that there exists a large market). This means that the business has the opportunity to become large in a short period of time (read 'dream of every venture capitalist and entrepreneur'). Large scale and growth brings fat valuation multiples, which means high valuations and high returns. While all this sounds really good and seductive – scalability and total valuation (read 'not valuation multiple but the final valuation in $') might not have a linear relationship always.

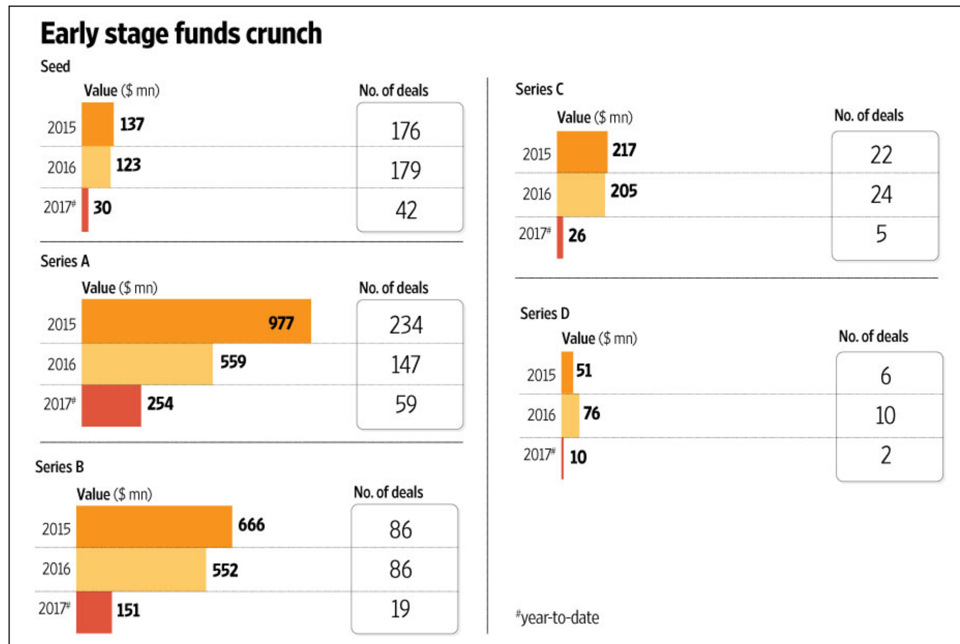
The fact that entrepreneurs are choosing scalable business models over business models that solve customer problem in the most efficient manner is a testament to the fact that there exists over-simplification in their understanding of scalability and valuation.

Investment through Venture Capital in India

Since 2007, when venture capital as an asset class returned in earnest to the Indian market, venture capital firms have invested more than $10 billion in local start-ups, mostly in the technology and Internet sectors, according to data compiled by Chennai-based researcher Venture Intelligence. So far, such investors have struck exit deals worth $8.5 billion. After providing for fund manager fees, which is calculated at 2% on the fund principal on a recurring annual basis, and accounting for principal investments, the profits left for distribution wouldn't be a very significant sum. All of that is just the early-stage capital that's been sunk into the market. Add to that the later-stage or growth capital that has followed the early-stage money, and the overall investment would easily ride up to at least $20 billion.

Much of the later-stage money, which has come mostly from global hedge funds and strategic investors, also remains unrealized, further compounding problems for the early-stage market.

For the past 18 months, since the venture capital market slipped into a downturn, early-stage investors have been more focused on conserving cash and less eager to back new start-ups.



Last year, Series A investments, the first institutional round of capital raised by a start-up, nearly halved to $559 million. The funding crunch continues into this year and, by most accounts, will last several more quarters.

"Early stage investments will remain on pause till investors are able to consolidate existing portfolios. Right now, nearly every venture capital firm out there is trying to get rid of assets that aren't going anywhere in the hope that they will get at least the principal (investment) back," says a venture capitalist at a Bengaluru based-firm who also spoke on the condition of anonymity.

Copycat Investing

The current crisis that the venture capital industry finds itself in today can, to a great extent, be attributed to investors backing too many so-called copycat businesses, especially in the consumer Internet sector. A substantial portion of the money that has been invested over the past 10 years has gone into businesses that one way or the other tried to clone successful versions from elsewhere in the world. In the consumer Internet sector, these manifested themselves across a variety of segments such as e-commerce, cab-hailing services, food ordering and delivery services or the so-called food-tech segment, online classifieds and property search.

Now, there's absolutely nothing wrong with borrowing business models from overseas markets. Except, it cannot be done without paying heed to ground realities. "Even if business models are borrowed from the West or East, they will need to have some strong India-centric localization to make the business

both differentiated and better suited for Indian consumers. For example, we have fintech models that cater to the mass consumer market," says Niren Shah, managing director at Norwest Venture Partners India, a franchise of Silicon Valley-based Norwest Venture Partners which invests in early- and growth-stage companies. Furniture retailer Pepperfry, classifieds platform Quikr and food ordering and delivery platform Swiggy are among the less than handful of consumer Internet bets the firm has made in India. In rushing after copycat businesses, investors may have forgotten to diversify their bets enough to cushion themselves against a downturn in select segments.

By nature, venture capitalists tend to invest in a herd. As the so-called copycat businesses gained popularity, investment portfolios became heavily skewed in favour of such businesses. Further encouragement came from unlikely quarters such as hedge funds and strategic investors who jumped onto the bandwagon. The entry of such non-traditional investors in the start-up market would lead to a ballooning of valuations that would eventually crash. The consumer Internet sector alone is estimated to have been the recipient of nearly 80% of all the money that has been invested in start-ups, early- and late-stage, over the past decade.

Eroding Valuations

The downturn that is currently in session is largely on account of consumer Internet start-ups losing their bearings in the deluge of capital that flooded the market, especially in the later part of the decade.

"Indian entrepreneurs need to change their mindset. The goal should be to build viable and profitable companies with great business models as quickly as possible. I just don't understand funding (for start-ups) in billions. I also don't understand entrepreneurs getting rich without building great companies," says Kanwal Rekhi, founder and managing director of Bengaluru-based venture capital firm Inventus Capital Partners.

The firm has largely stayed out of the consumer Internet rush and invests across the technology spectrum both in India and the US. Even the celebrated unicorns, start-ups privately valued at $1 billion or more, haven't been able to withstand the downturn. Delhi-based e-commerce company Snapdeal, once India's second most valuable technology start-up, is on the block after running out of cash. Its valuation has crashed from a peak of $6.5 billion to about $1 billion in a matter of months.

Flipkart, the Bengaluru-based e-commerce company in talks to buy Snapdeal, has also seen its valuation erode from a peak of more than $15 billion to about $11 billion over the past 18-odd months. Though it has recently been able to raise $1.4 billion in a fresh funding round, the jury is still out on whether that will be enough for the company to square off against Seattle-based Amazon.com Inc.

It doesn't help that the company's founders, Sachin Bansal and Binny Bansal, have taken a back-seat and its affairs are largely in the hands of its largest investor Tiger Global Management. But just blaming copycat businesses for the current crisis is a bit harsh, says Karthik Reddy, co-founder and managing partner of Mumbai-based venture capital firm Blume Ventures.

"We tried to build the ecosystem with some large copycat business models and then a bit of classic herd mentality meant that a disproportionate chunk of capital went into these copycats," he said. "But it wasn't as if these businesses weren't appropriate for India. The business models needed to be tweaked."

Blume was an early investor in cab-hailing service Ola, one of India's consumer Internet unicorns, among a host of other start-ups across the technology spectrum. "The deluge of capital, the need for speed and scale and, funds that were initially disproportionate to the size of the opportunity has created relatively sub-optimal returns. Without an infrastructure for scaling or pools of trained skills or exit routes such as small IPOs (initial public offerings) and M&As (mergers and acquisitions), the first 10-year cycle was destined to be a mild disappointment," adds Reddy.

The next 10-year cycle

While the downturn may have slowed down early-stage investments, they haven't come to a grinding halt. Overall, venture capitalists still put $1.5 billion to work across 450 early-stage deals in 2016. This year isn't looking too bad either.

In the first five months of the current calendar year, venture capital firms closed 127 deals worth close to $500 million in early-stage companies (from the seed to the Series D stages). Out of that, 59 deals were at the Series A stage and accounted for $254 million in investments, which is nearly half of what was invested at the Series A stage in all of last year, according to data compiled by Venture Intelligence.

Advantages of Venture Capital

- They bring wealth and expertise to the company.
- Large sum of equity finance can be provided.
- The business does not stand the obligation to repay the money.
- In addition to capital, it provides valuable information, resources, technical assistance to make a business successful.

Disadvantages of Venture Capital

- As the investors become part owners, the autonomy and control of the founder is lost.
- It is a lengthy and complex process.
- It is an uncertain form of financing.
- Benefit from such financing can be realized in long run only.

Exit Route of Venture Capital

There are various exit options for Venture Capital to cash out their investment:

- IPO
- Promoter buyback
- Mergers and Acquisitions
- Sale to other strategic investor

4. CONCLUSION

Venture Capital Financing Industry had shown a good progress in terms of participation as an investment, number of deals, providing a vote of confidence in economy and its overall prospects. It is believed that there interests are aligned with the overall interests and development of the economy. They tend to make higher profits if economies grew faster and their portfolio companies grew more profitable. Therefore it is in the interest of the Government to attract such Capital. Along with development of entrepreneurship skills, such capital can be used for BOT (Build, Own and Transfer) and Public-Private Partnerships for long gestation projects. The Present Era is an, evolution that provides new opportunities for venture capital investors, corporate investors and innovative entrepreneurs allowing industry to continue making essential contributions to innovation and job creation worldwide. Considering the high risk involved in the venture capital investments complimenting the high returns expected, one should do a thorough study of the project being considered, weighing the risk return ratio expected. One needs to do the homework both on the Venture Capital being targeted and on the business requirements.

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