Financial Institutions and Markets
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Lecture – 32
Venture Capital

So, in the previous class, we discussed about the non-banking financial companies. There we have seen that there are some companies which are registered with Reserve Bank of India and on the basis of their activities those are characterized into different ways or in the different categories. Then the another venture or we can say that other organizations, which are also work in this particular sector or particular domain, but these are not regulated by Reserve Bank of India these are regulated by the other regulatory bodies like SEBI and IRDA.

So, today, we will be discussing about another important financial organization or institutions which exist that is Venture Capital, which is quite important in today's world. The reason is because the business sector is growing and we are dealing with lot of risky business and new companies are basically going to start their business and there is a problem of getting the funds from the different organized sector, in that particular point of time the importance of venture capital is quite large and quite important.

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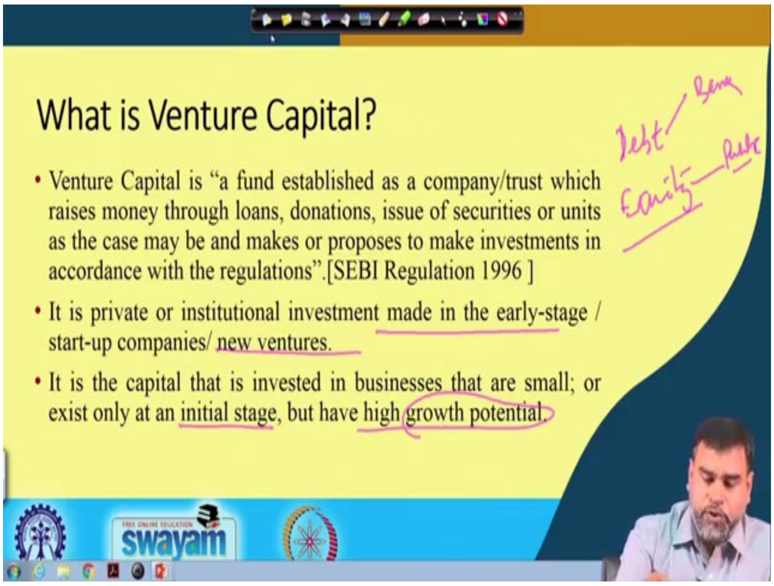

So, in this context let us see that what exactly the venture capital is. If you see that the venture capital is basically your venture capital fund. It is basically a fund which is established as a company or a trust which raises money through loans donations issues of securities or units and proposes to make investment in accordance with the regulations of the SEBI.

What this SEBI regulation 1996 is? According to SEBI regulation 1996, the venture capital basically is established as a company or as a fund which can raise the money through loans, donations, issue of securities or units or it may be any kind of instrument which are available in the financial system. So, this is basically what this is a private or institutional investment made in early stage or for the start-up companies or for the new ventures.

Why basically we were doing this? For example, if somebody wants to start a new company and you do not have enough fund available with you then what is happening then already we know that there are different sources of finance; we have some finance which is in terms of depth and some of the finance which always we raise in terms of equity; that means, for debt financing you can go to the bank and for equity financing we can go to the public.

But, the question here is whenever the company was not properly set up and it is a new venture and there is no such kind of regulation or such kind of reputation already exist for this particular company that time it is relatively difficult to raise the money from the bank. And, if you are going for a very risky proposition or the particular business what you are going to make that is a relatively risky business then sometimes the banks are reluctant to provide the money.

So, in that particular point of time the venture capitalists basically play a significant role who basically provides this loan provide this debt financing to this particular entity and the new start up can start the business by using that money whatever the venture capitalist have invested in that. So, therefore, this particular organization is quite important in terms of the setup of the new business in any financial system or any economy. That is why it is basically in the early stage or for the new ventures it is inevitable or it is very important who provides this necessary financing to make this business possible.

So, that is why it is the capital that is invested in business, that are small or exist only in at an initial stage. So, initial stage here is quite important because in the initial stage it is very difficult to raise the money from the market or from the banks which are organized financial institutions which exist in the system. So, venture capitalists basically what, they do not look at whether what kind of business you are doing, but they look at the whatever business you are doing that business should have high growth potential. So, they look at the growth potential and accordingly the financing has been made by this venture capitalists. So, that is why the venture capital or venture capital funds are defined.

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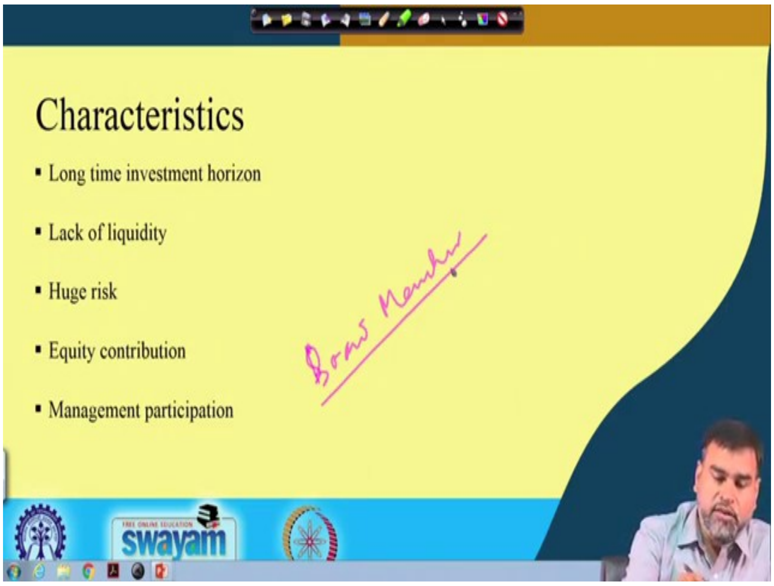

So, then moving towards the different issues or different ways, how the venture capitalists work in this particular system. Let us see, what are those different characteristics of a venture capital fund. If you look at the venture capital fund, venture capitalists do not invest the money for short term. Venture capitalist invest their money for a longer term horizon at least more than 3 years they basically put their money in the investment.

So, that is why the funds which are invested in that it is not a very liquid instrument or you cannot encash that, basically you cannot liquidate that particular money whenever you want, because that money has a very long term objective or the use of that money has a long term objective. So, because of that the liquidity is very less in that particular funds. There is huge risk; venture capital always take huge risk because they put the money in this particular business which is not properly set up and it is not proved that whether the business is going to be a success or not and maybe there is a probability of growth potential, but further the growth potential is really able to be materialized in the future or not.

So, those things are not known from the beginning and no such reputation was already available for the company whenever the company has started to the business. So, keeping those things into the mind what has been observed that the venture capitalists are highly risky investors in the market and the venture capital funds which are invested they are basically invested in the risky or in the initial stage of the business.

They can contribute in terms of equity also and they largely participate in their management. So, whenever the company makes the board the one of the venture capitalists member anybody any representative for venture capitalists will become a board member. So, they basically participate in the policy decision making process. Why they basically interfered in the policy decision making process? The reason is whatever profit this particular business can say, venture capitalists also said that profit with them. So, because of that the arrangements have been made in such a way that the venture capitalists also make this participation in terms of the strategic decisions for the company takes.

So, that is why they participate largely in their management or they become the board members are appended if were there in the board and the look at that how the business is going to be better off for that particular new entity which was funded by this venture capitalists. So, that are the different characteristics what we can see whenever we are talking about the venture capital funds.

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So, what are those functions? Already we have defined some of the functions. So, the finance new and speedily growing companies that already we have discussed that they can acquire the equity shares. They also finance in terms of the development of the new product or the services. The existing company if they are going to float a new product and they are going to provide the new services venture capitalist also help in that. So, some kind of venture capitalists are there, some category or some class classified venture capitalists are there they also finance if any company wanted to develop the new products and services in the market.

So, they support the development of not only the finance the new start up or the new initiation taken by any kind of business unit, they also support the development of new products or the services if at all the particular company is going to make. And, they add value to the venture by providing active inputs because they are highly experienced in this particulars kind of activities and they have the idea that how this particular business can better off even if it is in the initial stage. So, because of that the better inputs this founder of these particular companies can get if the financing are made by the venture capitalists.

And, venture capitalists already we have discussed that they always love to invest in those kind of projects which are risky, but the growth potential is relatively higher. So, because of that their experience or the inputs whatever they provide that is very much helpful for the growing business of that new entities which are basically have started the business for the first time in the market.

So, these are the major functions, what the venture capitalists always have whenever they do their services and they provide their services in the financial sector.

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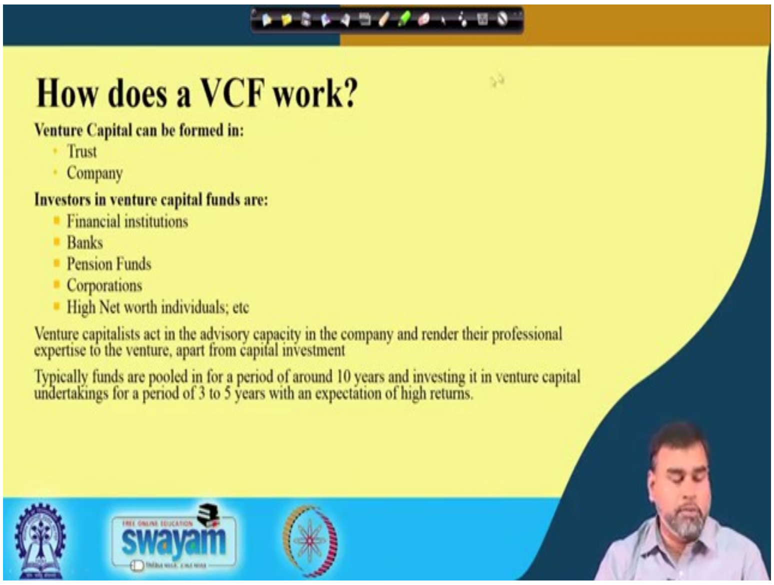

Then how does VCF basic venture capital fund work? If you see already we have discussed that venture capital can be formed either in terms of a trust or in terms of a company. So, there basically who are the people who are invested or who can be acted as the venture capitalists in the market, so, they can be a financial institutions, they can be any banks, they can be any pension fund, they can be the corporations or they can be also the high net worth individuals.

So, the venture capital funds can be created by any of the financial companies or any kind of financial entities which exist in the financial system. It can be a company; private company, it can be a pension fund, it can be a bank, it can be any other financial institutions not a problem, but also it is a high net worth individuals. So, the venture capitals can be fund or can be always designed by or this particular services can be provided by any of the financial organizations of the institutions which exists in the financial system.

So, the venture capitalists basically act in the advisory capacity of the company and render their professional expertise to the venture apart from the capital investment. They invest the capital they provide the financial capital for the business and as well as also they act as an advisory body who provides the different kind of inputs in terms of the investment or in terms of the spending the money or in terms of the decisions what the companies were trying to take whenever they want to start the business in that particular sector.

Typically the funds which the venture capitalists gave they are pooled in for a period of around 10 years and investing it in a venture capital undertaking for a period of 3 to 5 years with an expectations of the high returns. Already we have discussed that the funds which are invested or spent under the venture capitalists there basically always put for a long period of time. So, that is why what we can see that the investment which are made by the venture capitalists they look at the investment for a reasonably undertaking for 3 to 5 years and it can go up to also the longer period of time in that particular context.

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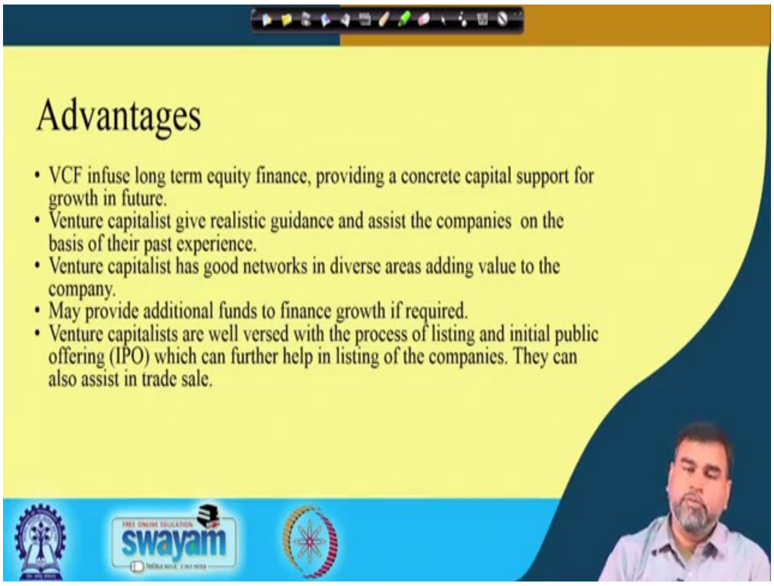

Why basically we can go for venture capitals or the money can be raised from the venture capitalists? So, that is another question. You see venture capitalists basically of venture capital funds infuse the long term equity finance already we know that because the funds are in long term in nature provide a concrete capital support for growth in the future. As there provide the long term finance; that means, a long term capital support can be realized whenever we are investing or the venture capital funds are used for the investment.

Venture capitalists give realistic guidance and assist the companies on the basis of their past experience. As they are providing the finance to the different start ups so, different companies over the periods they have huge experience that how this money is productively utilized or can be better utilized in the market for their success of the business. So, because of that what is happening they basically provide that kind of experience or past experience helps the companies to get a better input for that.

They have a good networks in various areas which adds to the value to the company in terms of consulting, in terms of risk management or in terms of finding out a good customers. So, those kind of network whatever the venture capitalist have that also helps the companies to make their business stable and as well as successful. So, that is also another advantage what we can get it whenever the venture capitalists fund or invested in that particular business.

And, if it is required then the venture capitalists have funded something, but they find that the business is going to do well, but the business is not able to prosper because of the lack of the funds then there is a possibility they can also raise some additional funds or they can provide some additional funds for the if it is required at all they realize that there is a growth potential, but the business is not able to do well because of the lack of the funds. So, in that context they can provide the additional funds to finance the growth if at all required by that particular company.

And, venture capitalists are well versed with the process of listing and initial public offerings if at all the company has been established and for that they want to raise the money from the public they can go for the IPO. We will discuss more how the IPOs are issued in the market whenever we discuss about equity market or the stock market in the future sessions, but if at all the company wants to be listed in the stock exchange and they want to raise the money from the public first time which is we call it the initial public offerings in that context also the venture because of their experience the venture capitalists can help them in the IPO process and also in the listing process. And, once this listing is done also whenever the company goes to this trading in the secondary market that time also the venture capitalists can help them in terms of the trading.

So, there are various advantages what we can observe or what we can find whenever we talk about the different kind of services what we can find from the venture capitalists or venture capital funds whenever their money is put on that particular business or the money is invested in that particular business. So, these are the major advantages what we can realize or what we can get. So, the major thing is they provide all kind of a financial services in whatever area they have the expertise.

So, in that context also the companies get some kind of benefit to make their strategy better and can generate the better amount of the profit or this business can be successful.

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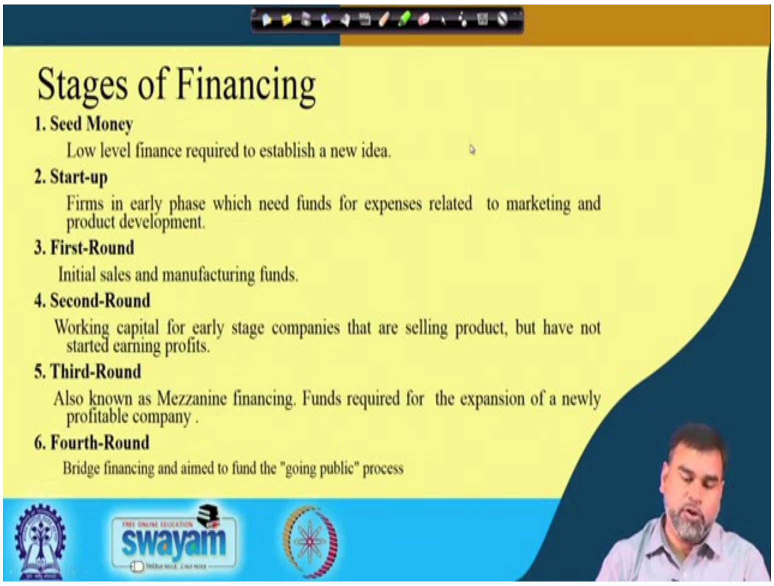

Then, let us see that whenever the venture capitalists basically finance the capital to the companies, so, there are different stages through which the financing of venture capital funds are done. What are those stages? First of all if anybody has a plan as planned to start a new business they have a good plan, they have a good project, but the question is they do not have the money.

So, in that context what they can do they have a good idea that how this business can prosper can grow, but still there because of the lack of the funds they are not able to start this particular business. So, for the seed money purpose they can request or they can get the kind of funding from the venture capitalist what we call it the seed money , but let one firm is already established because of some private money whatever private fund whatever they have or own fund they have and now, they want to expand that particular business for the marketing purpose or the development of the more product etcetera for that also they can get the funding from the different kind of venture capital funds and that is basically we can say that start up stage.

So, the venture capital funds can finance them as a seed money, they can also finance if the company is already started, but they are not able to do the proper marketing and they cannot make the proper product development because of the lack of or because of scarcity of money so, then that particular point of time this particular funding of from the venture capitalists also possible.

Then, we have the first round; that means, the initial sells in the manufacturing process they fund it that means, the company is established they are sold they have started producing the product, but how basically they can sell the product or how they can increase their manufacturing or the quantity of the product for that also, they can take the help from the venture capitalists because venture capitalists already know that how this business is going to be and in that process they help us or the help that company to make that particular business successful in terms of the selling and manufacturing.

And, further there is another first stage that is basically sometimes the companies also want money for the working capital financing. The working capital for the early stage companies that are selling the product, but have not started earning profits. They are selling the product, but they have not reduced the break even.

So, if they have not reached the break even then what is happening; the working capital requirements cannot be finance by them that mean day to day requirements cannot be finance by them because they are not able to generate any profit out of this. So, that time also the venture capitalist can help them to provide some money by that the company can run the business, company can run and as well as the manufacturing of that particular product will continue.

So, for working capital financing also venture capitalists can fund the money sometimes also the funds the venture capitalists get for the expansion of a newly profitable company. Already the company is basically established they are producing, but they want to have a new in it or they want to expand their business. So, in that case already it is profitable, but still they need money because they want to expand it. They want to have a new profitable company or they want to go for expansion of that particular company in that time also the financing of the venture capitalists can be possible.

And, finally, the venture capital is also fund for the going public process. If at all you want to raise the money from the public for the initial expenditure whatever is required for the company to go to the public those kind of funding also sometimes made by the venture capitalists. So, there are different ways for different purposes of our different reasons the venture capitalists can finance those business in the different stages.

So, this is the way the venture capitalists basically plays a very significant role in the business process.

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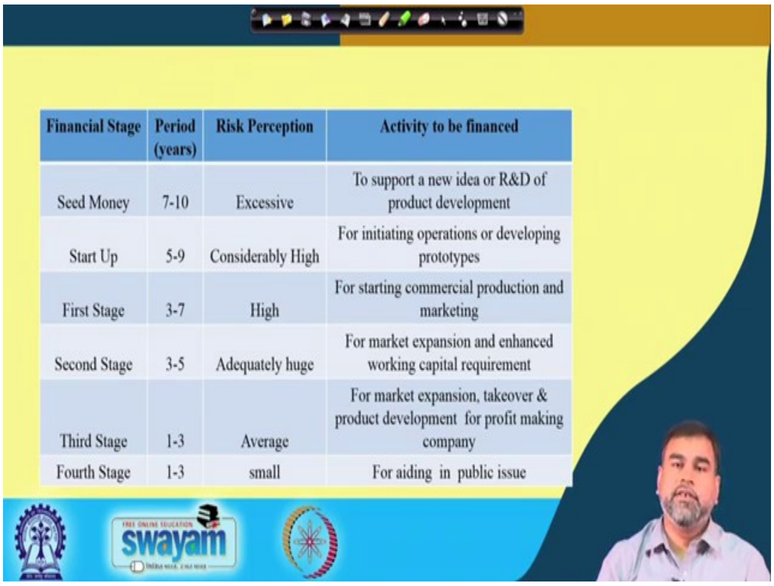

So, if you see there are different periods whenever the lock in period basically we are talking about and the risk perception about that. So, whenever they provide the seed money the lock in period is around 7 to 10 years; risk perception is quite high excessive and it is basically to support the new idea or the R&D of the product development and start up stage the lock in period is around 5 to 9 years; risk is considerably high.

For initiating in that why the finance is made for initiating the operations are developing the prototypes of that particular product and in the first stage lock in period 3 to 7 years risk is relatively high for starting the commercial production and marketing purports to finance. In the second stage lock in period is 3 to 5 years; this is also risk perception is relatively high and this financing is done for market expansion an announced working capital requirement.

And, third stage the lock in period 1 to 3 years risk is relatively less which is very average, it is for the market because it is already the company is profitable. So, they are going for the market expansion, takeover and product development for profit making company. So, in that case the risk level is relatively low. And, finally, we have the fourth stage where the risk is very less because the company is already established in there also generating profit and all kinds of thing so, in that case basically the finance can be made for going public.

So, these are the risk perception and on the basis of the risk perception also the periods are defined and as well as the reasons for financing are also clearly explained. So, these are the different ways the different types of financing for different reasons we can always get it from the venture capitalists for the development of the business.

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Then, how they basically finance? They can finance either in terms of shares, they can finance in terms of the loans, they can also finance in terms of the participating the debentures means if the company at all raising the one to invest the money in terms of the debt financing or the bond financing they can participate in to that, also they can finance in terms of the preference shares. Quasi equity means we are referring to preference shares where the particular shares basically has the kind of both bond and equity features.

So, these are the different instruments through which the finance of the venture capitalists are done or the venture capitalists finance those kind of entities in the different ways.

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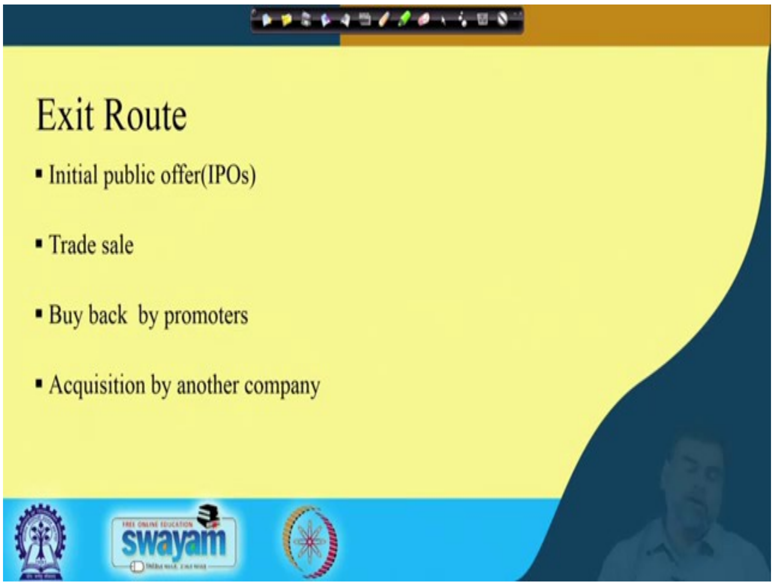

So, if at all ones venture capital is any venture capitalist wants to be out of this particular company if as company has gone for IPO and as well as then if it has gone for IPO they can raise the money from the public in that particular point of time they do not have to they can go out, they can sell their shares and go out of the company. They can also selling their equity in the secondary market if the companies are already gone for public and also traded in the stock exchange, they can do that.

The buyback of the shares by the promoters of the company is possible from the venture capitalists whatever shares they have and also if the company is acquired by another company. If the companies are acquired by another company and that particular point of time whatever equity conversion and all these things will happen in that process also the venture capitalist can exit as the owner of that particular company or partial owner of that particular company.

So, these are the different exit routes or different ways of exiting in that particular company if at all the venture capitalists want or in some cases the venture capitalist has to go if the companies acquired by another company and all the equities whatever the existing shareholders have those things those kind of transactions and all these things will be decided by the acquiring company who is basically acquiring that particular acquired company.

So, because of that what is happening in that process the exit route will be or the venture capitalists can exit from that particular business.

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Then if you see that how the venture capitalists capital funds are developed in India. You see this venture capital fund was formally introduced in India in 1987 by IDBI; then, after this 1996 regulatory norms of SEBI venture capital regulation norm 1996 and venture a foreign venture capital investor regulation, 2000 on the recommendation of the Chandrasekhar committee the development of the venture capitals in the Indian context has grown or the development of the venture capital basically has taken place in the Indian financial sector.

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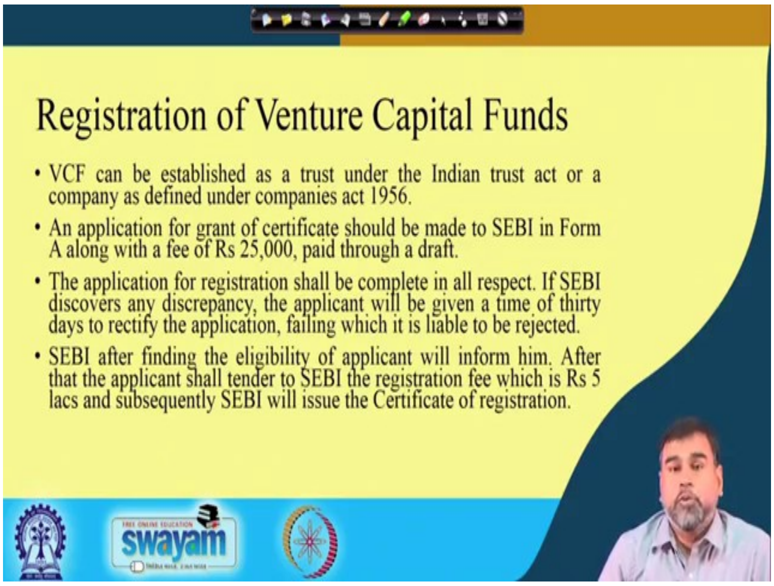

So, now if you see that how the venture capitals funds can be registered or they can register themselves for their business.

So, they are already we know that this can be established as a trust under the Indian trust act or a companies act which as defined in 1956 companies act. So, what is the process? The application, an application for grant of certificates should be made to SEBI; SEBI is the regulator of the venture capitals in a form along with a fee of 25000 rupees paid through a draft. Then the application for registration will be complete in all respect, all the information will be provided.

If SEBI discovers any discrepancy the applicant will be given a time of 30 days to rectify the application and if you they could not rectify that application in the provide they cannot provide that adequate information then the particular form will be rejected or the application will be rejected. Then if everything will be given all the information are severely satisfied with all those information what that application contents then the after finding the eligibility the SEBI will inform and after that the applicants shall tender the SEBI the registration fee which is 5 lacs and subsequently SEBI will issue the certificate of registration.

So, every venture capitalist has to register themselves with SEBI and with proper kind of regulatory norms once all these things will be scrutinized, SEBI is able to provide that kind of registration certificate to them.

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So, foreign venture capitalists also can operate in India and there are certain guidelines for them this should disclose their investment strategy and the life cycle to the SEBI and at least 66.667 percent of the investable funds we invested in unlisted equity shares or equity linked instrument. Not more than 33.33 percent of investible funds may be invested by way of either subscription to initial public offer of a venture capital undertaking.

Debt or debt instrument of the venture capital undertaking in which the foreign venture capital investor has already made an investment by way of equity or preferential allotment of equity shares of a listed company subject to a lock in period of 1 year. Or the equity shares or equity link the instruments of a financially weak or a sick industrial company whose shares are listed. And, a foreign venture capital may invest, it is total corpus into the one venture capital fund in India.

So, these are some of the regulations, the regulations are very lengthy, but the venture capital funds foreign venture capital funds also can operate in the Indian financial sector.

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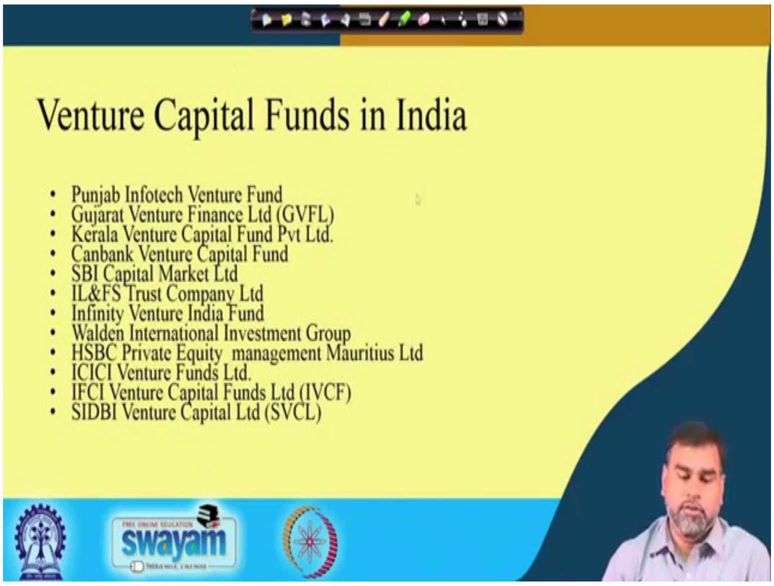

These are the some of the examples of the venture capital funds which are existing in India. We have the Punjab Infotech Venture Fund, Gujarat Venture Finance, Kerala Venture Capital, Canbank Venture Capital, SBI Capital Market Limited, IL&FS Trust Company Limited, Infinity Venture India, then HSBC, ICICI Venture Funds, IFCI Venture Capital Funds, SIDBI Venture Capital Fund. So, these are some of the funds are also sponsored by the government and some are highly private companies, some are funded by the state governments.

So, these are the ways the different kind of venture capital funds which operate in the Indian market who cater this demand for the business over the years.

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Please go through these particular references for this particular session.

Thank you.