CHAPTER 20

Venture Capital and Private Equity[1]

A young private company that is not yet ready or willing to tap the public financial markets may seek venture capital (VC, hereafter). Such capital is provided by VC funds, which are prepared to finance risky projects that appear to have promising prospects. Yet another related term in industry circles is a private equtiy (PE). While there are some fine distinctions between VC and private equity (which are elaborated later in the chapter). There is considerable practical overlap between the two. Most of the discussion here would apply to private equity as well.

While the concept of VC is perhaps as old as the human race the practice of VC remained somewhat fragmented and individualised throughout the long history. Only in the last six decades or so, the field of VC has acquired a certain degree of coalescence, maturity and sophisitication, particularly in the US. VC is a relatively new phenomenon on the Indian scene and has emerged as one of the much talked about financing alternatives in India in the nineties.

This chapter discusses various aspects of VC. Throughout the discussion the VC investor is referred to as the "investor", the company that receives VC funding as the "investee" or, simply, the "company", the management of the company as "management" or " management-team" and the portfolio of investments of the VC investor as the "portfolio".

The chapter is organised into nine sections as follows:

- VC investors
- What is a VC investment
- What makes a VC investment different
- The VC investment appraisal process

1. This chapter has been contributed by Professor G. Sabarinathan of IIM, Bangalore.

- VC and PE: A comparison
- Indian VC industry
- Tax and regulatory aspects of VC
- Current concerns of the Indian VC industry
- How to approach a VC

20.1 VC INVESTORS

A variety of financial institutions, corporations, and individuals participate in the VC industry as investors. The most significant among these are VC funds. VC funds may be described as pools of capital constituted for investing in relatively high-risk opportunities in anticipation of potentially high risk adjusted rates of return. These funds are usually committed for extended periods of time, ranging from seven to twelve years. At the end of the period the investments are liquidated and the capital is returned to the investor, with any capital appreciation thereon. Investors in these funds are usually interested in long term capital appreciation and not short-term gains or periodic yields by way of dividend or interest. Most VC funds are not listed on any exchange or do not have an alternate secondary market mechanism worth mentioning. Investments in these funds are therefore usually illiquid in the initial years. Investors in VC funds are institutional investors and high net worth individuals who have the ability and the preparedness to accept the illiquidity. VC funds are usually *independent* in the sense that they do not represent or subserve the strategic interests of any of the investors in these funds. Their primary objective is to produce a financial return for the investors in the fund. This last criterion is important as it helps companies who raise capital from VC funds to be sure that they can function independently, without the fear of being "controlled" by another business interest group.

Managers of VC funds charge investors in the fund a fixed annual fee, usually 2.50% of the capital under management. As a performance incentive fund managers also retain 20% of the capital gain realised from the investments. The share of the capital gain provides an incentive to the fund manager to maximise the value of the portfolio and aligns the interests of the fund manager with that of the investors in the fund.

The constitution of VC funds and the unique compensation mechanism for managers of these funds, as outlined above, considerably influence the investment strategy of VC funds as will be seen in the discussion that follows.

20.2 WHAT IS A VC INVESTMENT

The popular impression is that VC is synonymous with the financing of technology-centric businesses or innovative and hitherto untried business ideas. In reality VC is a broader and much more flexible form of financing business enterprises. A better understanding of the broad scope of VC could be conveyed by the following examples of some typical VC investments that have been made in the past.

- A national or regional chain of stores across India, based on a new retailing concept such as retailing of office supplies.
- A software development company in Israel that has developed a state of the art telecommunication switch.
- A Chinese manufacturer of hand tools who competes in the international market on the basis of operational efficiencies and low cost, without compromising on quality.
- An African exporter of processed horticultural produce.

Common to these examples above are exceptional growth prospects, a sustainable competitive advantage that helps maintain growth in sales and profitability, which could potentially result in superior returns to the investor.

A survey of the literature on VC including practitioner accounts, industry association definitions, and academic publications indicates that VC investments will usually involve

- Businesses with high growth potential in terms of sales and profitability
- Medium to long term investment horizons or holding periods ranging from two to ten years
- Risk levels which are higher than that inherent in debt financing transactions or investment in equities of well-established firms with a history of profitable operations.
- Equity or quasi-equity financing instruments which enable the investor to participate in the risk and the financial upside of the enterprise
- Active investor involvement in the investee after the funding.

Over the past two decades, VC has emerged as a financing alternative in many countries—at last count in over seventy countries, both developed as well as developing. In many economies, which do not have well-developed capital markets, VC funds have emerged as the source of essential risk capital such as equity financing.

20.3 WHAT MAKES A VC INVESTMENT DIFFERENT

A VC investment is different from a traditional loan transaction or investing in the equity of a well-established firm, listed on a stock exchange, in many respects. In this section we examine some of the more important distinguishing features.

High Uncertainty Levels

VC investors usually fund firms that are exposed to higher degrees of uncertainty. Resolving the uncertainty affecting these firms is rendered more complex by the absence of historical information that can provide the basis for assessing the likelihood of various future outcomes.

The sources of risk and uncertainty in a venture investment are many more in number and complexity than in most other investment opportunities. These risks include:

1. *Technology risk:* The risk that a product, process or service based on a hitherto untried technology may fail to perform as expected or run into related problems or have undesirable or unforeseen side effects.
2. *Product market risk :* The risk that sales volume or price realisation of a product may be lower than expected due to poor customer acceptance of the product or unanticipated competitive conditions.
3. *Management risk: :* The risk that the management team may not have the capability to deliver the results projected in the business plan. Historically, from practitioner accounts, management failure appears to have been the single most important reason for failure of VC backed enterprises. In turn, the failure of the management could be due to a host of reasons ranging from just lack of competence to more serious issues such as the inability of the team members to stick together in running the business or even lack of integrity.
4. *Liquidity risk: :* The risk that the VC investor may not be able to encash his investment. VC funds mostly invest in unlisted companies. Unless the shares of these companies are successfully listed and traded on a stock exchange, or the companies are acquired, the investment in these companies could turn out to be illiquid. (In this note, it is being assumed that buy back of shares by the issuing firm is not a practically feasible alternative, circumscribed as it is by various regulatory requirements.) Illiquidity risk emanates from weak conditions in the capital market, or, due to lack of interest in the company or the industry sector among investors or due to the lacklustre performance of the company.

Information Disclosure

Unlike in the case of public companies, unlisted companies which VC investors fund are not mandatorily required to disclose information. The investor has to ensure that he gets all the information that is required for making an informed decision. Often, being a company that is in the early stages of evolution, the prospective investee may not have the organisational systems and mechanism to generate the information that a professional investor may seek.

20.4 THE VC INVESTMENT APPRAISAL PROCESS AND MANAGEMENT

We look at some of the key elements of VC investment appraisal and management as a VC transaction evolves through the life cycle of a deal within a VC fund's system.

Assessment of Business and Management

The VC investment process commences with a meeting with the promoters and the key members of the management team of the company. This is followed by a critical evaluation of the business plan. The business plan document is central to the VC transaction. In terms of its coverage the business plan goes well beyond a detailed project report. The plan articulates the vision of the promoters and top management of the company over the investment horizon. It spells out the firm's strategy in much greater detail. Often the proforma financials presented in the business plan, in part or in whole, are incorporated into the formal contractual agreements between the investor and the management of the company.

The emphasis of evaluation is on the following aspects.

Management Team VC fund managers realise that the key to building a successful company is an effective and top class management team. The VC investor's appraisal process lays considerable emphasis on the evaluation of the management team of the company for its leadership ability, integrity, completeness in terms of skills to manage various functional areas, and their cohesiveness as a team. As the company develops, VC investors prepare themselves to even bring about changes in the management team when the incumbent members of the team fail to deliver. At the same time, experienced investors also recognise that such changes are painful to bring about; as such, it is well worth the effort to ensure that the company has the right management team to start with.

Business Strategy Another area of difference is the emphasis on a thorough strategic analysis of the business. VC investors spend much more time seeking answers to broad strategic questions such as

- What is the value proposition that the company's product or service offers? Can it be understood by the end user in simple terms?
- Is there a felt long term need for the company's product? Is there a sizeable market?
- Does the investee firm have a sustainable competitive advantage? What is the source of the competitive advantage?
- What is the revenue model of the company?
- What are the operating economics of the business?
- Is the investment opportunity consistent with the VC fund's investment philosophy and strategy? Can the partners in the fund add value to the investee company?
- How valuable will the company in question be over the investor's holding period?

It may be observed that the common drift among the questions above is an attempt to assess whether the company, over a three to five year period, will have a sizeable share of a large market, based on an unassailable, competitive position, and consequently produce a super normal growth in profit and shareholder wealth? Will that in turn enthuse other shareholders or corporations to own shares in the company so that the VC investor can exit by selling his investment and realise a return on the same?

Given the levels of uncertainty surrounding a VC backed company and the lack of quality data, VC investors do not place much emphasis on complex quantitative analyses of the prospective financial position of a VC backed company. The VC investor develops a set of several broad business - and corresponding financial – scenarios such as a base case and one optimistic and pessimistic scenario each. He then applies his judgment to form a view on the most likely financial picture of the company over the expected investment horizon.

Exit Focus Most VC investors manage funds with a limited life, as mentioned earlier. That limits them to look at investments with finite holding periods. Unlike the lender, whose loan is repaid from the borrower's cashflow, or an investor in shares listed on a stock exchange, the VC investor does not have a ready made mechanism to liquidate his investment. The VC investor tends to assess the prospects of and the likely means to liquidate his investment, right at the time of committing the investment. (The common means of disinvestment are discussed later in this note.) Absent a clear path to liquidity, the VC investor is reluctant to commit capital to the company.

Valuation of a VC Transaction

All aspects of the VC transaction process are equal in importance; but it would be fair to argue that valuation is more equal than the others in terms of importance. Valuation is the process by which the investor decides the price he wishes to pay for the equity shares of the investee company. (For the purposes of this discussion we assume that the deal is being structured as subscription to equity shares. In the following section, we will look at alternate structuring mechanisms investors resort to.)

The most commonly used method of valuation used by VC funds involves the following steps:

1. Identify the amount of capital to be invested by the investor.
2. Identify the target rate of return expected by the investor. These rates are usually based on rough-and-ready return estimates taking into account the stage of investment (such as seed, startup, etc.), the expected holding period and the level of risk perceived in the investment by the investor.
3. Estimate the multiple of the original investment that will fetch the required rate of return over the anticipated holding period. For example, a 25% compounded annual rate of return over a four year holding period would translate into a multiple of 2.44 times the original investment.
4. Project the market value of the firm based on performance projected during the proposed (or anticipated) year of exit. This involves multiplication of an appropriate metric such as Earnings Per Share (EPS) or Earnings Before Interest Depreciation, Tax and Amortisation (EBIDTA) by a multiple number that reflects the valuation that investors may be willing to pay (or may have paid) in other recent transactions.
5. Estimate the percentage of the projected value (P) that the investor needs to claim in order to achieve his return objective. This will be the percentage of the company's equity that the investor would need to own at the time of exiting from the investment in order to realise his return objectives.

The following observations are worth noting regarding the valuation approach described above:

1. The approach assumes that the market value of the firm at the time of exit is the same as the value of the equity. In turn, this implicitly assumes that the firm is all equity financed. For most VC backed firms this should be a reasonable assumption.
2. Critical assumptions behind these calculations relate to the estimates of Profit After Tax (PAT), EBIDTA, Price/Earnings (P/E) ratio or the P/EBIDTA ratio, choice of comparable firms, etc. The valuation of the transaction can vary considerably depending on the choice of value for each of these parameters.
3. More often than not, an investor in an earlier round of financing ends up with a lower percentage shareholding than he starts off with as the firm issues new equity in subsequent rounds of financing. This phenomenon is known as dilution. Early stage investors, in particular, will have to provide for such potential dilution. The extent of such dilution is tricky to estimate. It involves estimating the amount of capital the company is likely to raise in future and the price at which these rounds of financing are raised. Experienced investors estimate these using large doses of judgment and their past experience.

The valuation of deals is influenced by the following factors.

Outlook for the Economy Other things being equal, a positive overall outlook for the economy influences investors to pay a higher price for a given investment opportunity. This is because a healthy economy could lead to improved outlook for investee companies as well as to higher exit valuations at the time of exit, encouraging investors to pay a higher price for the transaction.

Capital Market Conditions A buoyant stock market appears to influence investors to pay liberal valuations. This could be due to two related reasons. As the most preferred exit route, buoyant stock markets could suggest prospects for higher exit valuations for the VC investor if and when the company plans an IPO. Equally, in some markets buoyant stock markets could also end up financing companies that would have had to resort to VC financing in more restrained stock market conditions.

Industry Related Factors From time to time investors seem to prefer certain sectors over others. Such preference is reflected in the price that shares of companies in that sector command. This trend has been observed across many VC markets, including the American market. The changes in Indian VC investors' preferences appear to reflect the shifts in investor preference in the secondary (stock) market.

Deal Related Factors The specifics of the investment opportunity in question also influence the valuation of the investment opportunity. Such factors will include the stage of investment, the sources of risk, product or service differentiation and other factors that could affect the company's competitive position.

Demand for and Supply of Capital Excess supply of capital has been observed to result in more liberal valuations. Many analysts and practitioners seem to believe that excessive liquidity can push valuations up to unhealthy levels, resulting in low portfolio returns for VC funds. The exuberance of VC investors in India in 1999 and 2000 could be attributed, among other factors, to a similar situation in supply of capital that prevailed not only in India but in many other parts of the western world as well.

Deal Structuring

Most VC transactions are structured as equity or equity linked instruments presumably because of the elegance of equity shares as an instrument and their risk reward sharing features. However, as mentioned earlier, structuring funding as equity subscription exposes the investor to liquidity risk. Equity investors run the risk of getting locked into investments at a fixed price arrived at on the basis of some anticipated financial performance. In case the company does not deliver the anticipated performance the VC investor will have overpaid for the investment. To avoid such a risk, investors structure their funding as convertible instruments. The price at which these instruments are converted into equity is often linked to the actual performance of the company, measured in terms of appropriate metrics such as EPS or EBIDTA that is agreed upon right in the beginning. The conversion mechanism provides an incentive to the management team to deliver projected, or even better-than-projected performance since higher performance leads to higher price paid by the investor (at the time of conversion) for the company's shares. The advantage for the investor, in the process, is that he gets to subscribe to shares at a price linked to the performance of the company.

While structuring a deal VC investors also build in performance incentives for management. These incentive mechanisms usually have the following features.

- Options to subscribe to additional equity shares in the company at attractive, low valuations.
- The allotment of new shares in recognition of managerial or technological contributions, for consideration other than cash, popularly called 'sweat equity', so that founders and members of the management team may build up a sizeable share ownership even if they do not have significant financial capital to contribute.
- These incentives are tied to pre-identified performance milestones. The milestones are defined unambiguously and contracted between the company, investors and the management team. Examples of such milestones are profit measures, market value of the firm, or measures of operational performance such as successful product or technology development.

This powerful combination of incentive compensation and post financing involvement by the VC investor is considered to be key to the effectiveness of VC investors in building valuable portfolios. (We discuss post-financing involvement later.)

Investor-Investee Relationship

Another point of significant distinction is the relationship between the investor and the investee in a VC transaction. On a commercial plane the investor and investee are bound by the potential for mutual economic benefit: Capital gain for the investor and funding and value addition for the investor. On a legal or contractual plane the investor realises that over time, the interests or motivation of the entrepreneur may diverge from that of the investor or other financial stakeholders. For example, the investor will usually seek a timely exit through an IPO or trade sale. The entrepreneur may be keen to ensure his continued role in the management of the company. In the event of such divergence of interests, the investor may like to ensure that his interests prevail. Lastly, the high degree of uncertainty and riskiness of VC transactions require the investor to respond to many exigencies in the company as they emerge after the funding by the investor. Many of these eventualities cannot be envisaged at or before the commitment of funds despite the most thorough due diligence and appraisal process. The investor has to be equipped with the ability and the authority to be able to respond to these eventualities in the investee company.

The VC investor also recognises that the entrepreneur has an important advantage. As an "insider" he has a deeper insight into the business than the investor. Economists refer to this situation as information asymmetry. Information asymmetry increases the probability of wrong investment decisions by the investor. Unlike in a lending situation, where the loan is most of the time secured by some assets which the lender can dispose of to recover the loan dues in case of a default by the borrower, the VC investor's only option is to ensure that the company stays on track. The VC investor ensures that he has the contractual right to protect his interests in these situations by entering into an appropriate set of agreements with the investee.

Post Financing Relationship

The VC investor spends a great deal of time, engaging with the company after the funding has been disbursed. The VC investor involves himself with the company at two distinct levels. At one level, he contributes to strategic decisions such as constitution of the board, appointment of key managers and strategy formulation. He also plays an active part in planning the Initial Public Offering (IPO) of the company's shares. In many markets, including India, a reputed VC investor's share ownership of a company is viewed as the "certification" of the quality of the issuing company. At another level, he plays a monitoring role by ensuring important decisions relating to expansion or restructuring the capital base of the company (equity as well as debt), declaration of dividend, business expansion and diversification, formation of strategic partnerships, restructuring of the business in terms of hiving off or divesting existing businesses, are not prejudicial to the financial interests of the investor.

The investor participates in these decisions by nominating one or more directors to the Board of the company. In addition, the partner in a VC fund who is responsible for a company in the portfolio typically spends some time every month meeting with the CEO of the portfolio company and key members of the management team, discussing matters of strategic importance. The investor also reviews periodic financial information from the company. In some instances the partner from the VC fund assumes even executive responsibility as the CEO or Chairman of the Board.

More importantly, though, the VC investor wields considerable influence over the entrepreneur's conduct by controlling the continued availability of funds. If the VC investor threatens to cut off supply of funds, other VC investors would hesitate to invest in the company too, essentially choking the company of any VC funding. At the least, the unwillingness of incumbent investors to commit additional capital makes it so much more difficult for the company to raise capital from other investors that VC investors do not always have to flaunt the agreement to make founders of investee companies to see their view point.

It must however be pointed out that the style and extent of post financing involvement tends to vary across investment situations and funds. Interestingly certain styles appear to be more widely prevalent in particular markets. For example, in the Indian context the investor involvement appears to be largely to protect the interests of the investor. VC investor's nominees do not appear to be involved in strategy formulation or key recruitments, in any significant manner.

Exiting from Investments

'Exiting' from an investment is an important consideration for the investor for reasons mentioned at the beginning of this chapter.

The two most common exit routes for VC investors are disposal of shares on a stock exchange, once the shares are listed; and sale of the portfolio company or its assets to a strategic acquirer (also known as a "trade sale".) In a few instances, the investor sells his shares back to the founders or other incumbent principal shareholders of the company. Sale-back to the promoters however is a less popular option among investors, given the limited prospects it appears to provide for capital appreciation. Further, getting investors to honour buy back obligations is not always an easy or friction-free option.

VC investors ensure at the time of committing the investment that there are one or more potential exit paths from the investment. The investor may even articulate his exit expectations to the entrepreneur in some detail right in the beginning. Further, investors provide for adequate measures in the investment agreements to be able to influence exit related decisions.

20.5 VC AND PE—A COMPARISON

As noted earlier, there are several common characteristics between the institutions of VC and private equity (PE). Both of them invest in companies that would be unable to attract capital from public securities markets; if at all these companies were to access the public equity markets the prices at which they would raise capital would be unattractive because of the perceived riskiness and information asymmetry problems. Both PE and VC funds are constituted as independent pools of capital, managed by fund management teams which have considerable financial incentives tied into the overall objective of maximising investor wealth. These fund management teams are most usually constituted as small, compact partnership teams comprising individuals who share a common investment philosophy and style. The investors in these funds are either large institutions such as pension funds or high networth individuals who can afford to absorb the risk and illiquidity. Both VC and PE believe in active oversight of their investments, armed with tightly written investment agreements that give them the contractual right to ensure good governance of the investee firms. Finally, the investment activities of both VC and PE fund are subject to relatively little regulation in nearly every country.

There are several differences, however, in terms of the nature of the investment opportunities that they pursue, their styles of engagement, the structure of the financing packages, the types of investors from whom they raise capital, and the professional backgrounds of the investment managers.

PE investors, in contrast to VC, mostly invest in later stage opportunities. They invest in companies which have a substantial operating history in mature industries. These companies may often times have sizeable cashflows. They fund buyouts of companies from existing owners, either to facilitate the retirement of the incumbent owners or to help rejuvenate the company's operations under a new management team (known as Management Buy Outs or MBOs). Sometimes, the transaction may involve the incumbent management team buying into the ownership alongwith the PE investments (known as Management Buy Ins or MBIs).

The PE investment may be used to effect financial or operational restructuring of companies in all these cases. In any event, PE investments never involve untried products or technologies, unlike VC which has been credited with bringing to the market most of the technological innovations in the areas of computers and communication, healthcare and pharmaceuticals, biotechnology and new materials, to name a few. At the most in certain emerging economies PE investors invest in companies that are launching a service product based on technologies or processes that have been commercially established elsewhere in the world. Most of the time, even when they invest in start-ups or other early stage investments in such emerging markets, they do so alongside a successful industrial partner so as to mitigate risks in project implementation or management.

Since they involve later stage businesses with large cashflows, PE investment packages may involve secured or unsecured debt, which is rare in VC transactions. These loans, which are often not investment grade, provide a higher yield than investment grade debt and are retired using the company's operating cash flows. The loans may be provided by one or more lending institutions which are a part of the investment syndicate and not necessarily by the PE fund. The maturity of the loans and the terms of their structure depend upon the nature of the transaction. It is not unusual for companies which raise PE to retire these debts by selling off parts of the investee company that the new owners of the business or the PE investors are not interested in retaining. It is the use of debt in these transactions and the change in ownership that led to these transactions being termed as Leveraged Buy Outs (LBOs), a term that is often considered synonymous with PE transactions.

The extent and nature of risks in PE investments are understandably different from those in the case of VC. Companies to which PE investors provide funding rarely involve new products or technologies. Typically, these companies already enjoy substantial franchise or good will for their products or services. The products may be in the maturity phase of the product life cycle. PE investments either involve replacement of an incumbent management team by a superior management team or helping a successful incumbent team to improve operational efficiency through restructuring. Companies which raise PE have well rounded management teams that pose relatively lower levels of management risk unlike VC investees. Given these differences, the nature of involvement of the investor in the post investment phase is different and is limited to oversight at the Board level, unlike the VC investor whose involvement is far more hands-on. In terms of risk management paradigms PE investors prefer to limit their risks to product-market risks rather than project implementation, start-up, technology or management risks. These distinctions are important to note because they have important implications for the post financing engagement with the portfolio companies.

The PE investor lays greater emphasis on the broader aspects of corporate governance of the firm whereas the VC investors may often spend more time on ensuring that the investee has a high quality top management team and has adequate internal systems and processes for producing information and for control purposes.

These distinctions are also reflected in the professional backgrounds of the investment managers. VC fund managers typically tend to have more operational experience as entrepreneurs or managers. They draw upon this experience in evaluating companies as well as in their post financing engagement that we have noted earlier. PE investment managers are largely from financial markets backgrounds, which they draw upon to value companies, time their entry and exit from investments, and in structuring large and complex packages of debt, equity, and hybrid instruments. Wherever they perceive the need for operational backgrounds or managerial inputs, PE investors might syndicate the investment with companies which have business interests that might provide the necessary operational or managerial inputs. Eventually such a corporate member of the investment syndicate might even acquire the investment from the various PE investors and the other owners and thus provide liquidity to the PE investors.

These distinctions between PE and VC are summarised in the table below.

Feature	VC	PE
Investment Target	• Early state businesses, expansion • Innovative products, services, technologies • Heavily dependent on external financing • Unlisted companies	• Later stage businesses, involves operational or financial restructuring, with or without management team and/or ownership changes • Mature products, services • Generally have large cashflows • May be listed or unlisted
Horizon	Medium to long term: Three-eight years	Medium: Two-five years
Risks	May be one or more of technology, product development, market response to product/service, management, operational and illiquidity of investment	Usually limited to product-market risks and does not involve the other elements listed in the case of VC
Structure	• Equity or equity-type instruments such as convertible debt or preference shares • Syndication of investment, if any, among fellow VCs	• Equity and debt combinations. Debt is usually high risk, of speculative grade. • Syndicate may include institutions such as insurance companies and banks, who are primarily lenders.
Post Financing Engagement	Active as it encompasses board composition, top management team recruitment, strategy formulation and internal systems processes and controls.	Active, but less than their VC counterparts. Involvement mainly limited to ensuring high quality governance.
Investment Management Team	Former managers and entrepreneurs with tremendous experience and vast, powerful networks in professional and industrial circles, primarily keeping in mind the post financing engagement needs	Primarily, former financial market professionals.
Prevalence	Largely in the US and to some extent in the UK, Canada, Singapore, Israel and Japan. What goes on in the name of VC elsewhere in the world is largely PE. Started as VC in India, evolved into distinct activities from late nineties.	Prevalent in the US, Continental Europe, Asia Pacific, Japan and many emerging markets.

Finally, it must be noted that some of these distinctions are not as sharp as they may be made out to be. The investment by Warburg Pincus (WP), a Hong Kong based fund in Bharti Cellular, India's leading cellular phone services provider, in an illustrative case in point. While popularly it is referred to as a PE investment and the fund itself is commonly known as a PE fund, the investment at that time may have had several VC characteristics, given the early stages of the development of the market for cellular phones, large cash losses the company may have been incurring in the market development phase, considerable operational risks and the risks in liquidating the investment. It is quite possible that accordingly, WP's style of engagement during that phase may have been akin to that of a VC rather than that of a PE investor.[2] The buyout of the shareholding of Punjab State Investment Development Corporation by Actis, a UK based PE institution and that of the Business Process Outsourcing (BPO) of GE Capital in India, GE Capital Information Services (GECIS) by General Atlantic Partners, a US based investment organisation are examples of transaction involving change in ownership without a change in management. The funding of the purchase of a division of the Indian subsidiary of ICI, UK by a group of professionals would be an example of an MBO in India. At the same time there have been investments that involve less dramatic changes in shareholding or ownership such as the investment by the fund Chrysalis in GMR Vasavi's construction business or the investment by Citicorp's PE arm in Yes Bank or in Jindal Vijayanagar Steel. In the latter type of investments one would expect that the level of post financing engagement of the PE investor may be less intensive in line with the lower level of shareholding acquired by the investor. One might expect that as the industrial economy in India matures further and pursues international competitiveness one might witness many more such PE transactions.

PE has emerged as a large part of the financial markets in the US and Europe and has played an important part in the restructuring of these economies. In the US it helped restore profitability to many poorly run companies. In Europe, where PE has been much more common than VC, it helped ageing owners to find owner-management teams. Given the large size of transactions, it is much larger than VC in terms of capital under management.

In the technology sector, investors appear to have evolved organisational models that take advantage of the availability and cost effectiveness of internationally competitive engineers and product development personnel in India. These companies are incorporated in the US and members of the top management of the company are located there since the markets for the products of these companies are often in those geographical regions. Further, these companies raise VC from investors in the US or Europe, who in turn also provide post investment value addition by way of customer introductions and assistance in recruiting key managers. Eventually these companies get acquired by larger companies in the US. This may well augur a new trend in which VC helps entrepreneurs in India and the US to come together, take advantage of factor market attractions in India and in a way form an important part of the innovation process of large companies. Cisco, the large communications solutions company in the US is one example of a large company that has adopted this route successfully.

2. The discussion of the various transactions in this section are based on reports which appeared in the financial press, mainly. Some observations are based on the author's inferences and impressions.

An upshot of these developments is that in the early years in India the industry was characterised more by VC style investing in small, early stage companies. More recently, in the past five years or so, PE type investments have become far more common. One possible explanation for the same is the difficulty in liquidating many of the early stage companies. Another reason cited by practitioners is that the size of the investments and the capital gains realised from VC type investments do not provide economies of scale, given the soaring fixed cost of managing those investments. But it need not be a surprise if the absence of high quality early stage opportunities that one finds in the US and the lack of experience among investment managers to deal with the risks in those investments are equally important reasons for the same. (These also happen to be some of the reasons for the impressive success of PE in Europe and less than impressive performance of VC in Europe.)

These evolutionary developments in the industry have also meant that the size of funds, the investment backgrounds and experience of the managers who manage these investments, and the rules for successful investing models for success also have changed. A cursory examination of the profile of the funds that have been active in the Indian market and their managers over the past five to eight years seems to bear this out.

It must not be forgotten that these developments have taken place in the backdrop of a dynamic industrial economy. Across sectors, the twin forces of global competition and the dynamism of Indian entrepreneurs and managers have driven the growth of companies and the reformulation of their strategy in their endeavour to become globally successful players. Along the way several new businesses such as IT enabled services, bioinformatics and clinical trial services have evolved. It is reasonable to expect that the VC investment landscape will continue to evolve in response to such developments in the industrial sector. Early signs of such trends are apparent in some of the investment transactions that involve ownership changes in more traditional manufacturing businesses.

20.6 THE INDIAN VC INDUSTRY

The Indian VC industry is of a relatively recent origin. Prior to the formation of VC institutions, Indian development financial institutions provided risk capital to industry in the form of subscription to equity, seed capital to first generation entrepreneurs and other similar forms of risk capital. They were playing the role of VCs in a way, although they did not follow the rigorous processes that a modern day VC would follow. ICICI Ventures (formerly TDICI Ltd.) was the first VC institution and was promoted as a joint venture of ICICI Ltd. and Unit Trust of India (UTI) in 1988. Several other commercial banks and development financial institutions followed with their own VC subsidiaries. With the deregulation of foreign investment into Indian companies, international investors emerged as more significant players in the Indian VC industry from the mid nineties.

Foreign investors brought with them the lessons they had learned in various other developed as well as emerging markets. They have introduced the western investment philosophy and processes into their transactions with Indian companies. Rigorous due diligence, tight contracting, active post financing involvement, and a sharp focus on timely and profitable exit are among their more important contributions. Since their investible funds were part of a global pool of capital, investment sentiments of foreign VC investors in India became closely tied into international investment and sentiments.

The investment preferences of VC investors in India have constantly evolved over the years. In the early years when the industry comprised mainly of Indian development financial institutions and commercial banks, VC investing appears to have been more or less synonymous with financing of technology and entrepreneurship development. The economic reforms of 1991 appear to have introduced a shift towards financing of innovative and/or growth oriented businesses that could sustain in an economy that was increasingly opening up to international competition. International investors appear to have added the dimension of identifiable, timely exit to the thrust on international competitiveness. These investor concerns seem to have driven the preference for specific sectors that measure well on these criteria. Thus, the current "flavours of the season" appear to be information technology and contemporary services such as new formats of retailing, to name the more visible sectors of interest. Interest in manufacturing businesses, if any, appears to be limited to businesses that are conceived to be internationally competitive in scale and quality.

Similarly, over the years, investor preference appears to have drifted in favour of financing the expansion plans of firms already in operation as opposed to greenfield ventures or startups. The lack of interest in start-ups is presumably due to the higher level of risks inherent in start-ups and the lack of willingness of investment managers to "take on" these risks in return for an attractive valuation, unlike some of their counterparts in the western world. Alongwith the emphasis on international competitiveness, the size of the average deal appears to have increased. Most investors, barring a small handful, appear to prefer investment sizes of US $5mn. (Rs 24 cr. approx. at current exchange rates). That leaves most of the smaller deals out of the sphere of interest of many a VC investor.

20.7 REGULATION OF VC INDUSTRY IN INDIA

In most countries the VC industry is subject to fewer regulations than other areas of the financial services sector. The rationale behind this appears to be that the participants in the VC industry are better informed economic agents who have the capability to obtain and process information that is necessary to arrive at rational investment decisions.

The regulation of VC investment activity in India may be examined under two broad headings : (i) Regulation of VC funds registered in India; and (ii) Regulation of foreign VC funds.

Regulation of VC Funds Registered in India

The regulation of VC funds registered in India comprises the taxation regime for VC funds and the regulation of their business activities by the Securities and Exchange Board Of India (SEBI). To get an update on SEBI regulation visit: www.sebi.com.

SEBI (Venture Capital Funds) Regulations, 1996 Broadly, the SEBI (Venture Capital Funds) Regulations, 1996 (SEBI regulations, hereafter) purport to ensure that:

- VC funds do not access public investors who may not have the capability to assess the risks underlying investment in VC funds or VC situations.
- VC funds invest in unlisted companies that are not in a position to access public financial markets.

The important provisions of the SEBI Regulations are given below.

1. A venture capital fund (VCF) may be established in the form of a trust or a company. Every VCF will have to register with the SEBI and obtain a certificate from the SEBI to engage in the business of making VC investments.
2. In order to ensure that VCFs do not raise capital from the public the SEBI regulations require that:
   - That the Memorandum of Association of the company preclude the VCF from inviting public capital subscriptions from the public.
   - That the minimum subscription per investor is Rs 5 lakh and minimum size of the corpus for a VCF to commence business is Rs 5 crore.
   - The VCF may not list its shares or units on a stock exchange for a period of three years from the date of issue.
3. The regulations seek to ensure that VCFs invest in unlisted companies by stipulating that
   - A Venture Capital Undertaking is a domestic company whose shares are not listed on a recognised stock exchange in India
   - 75% or more of the investible funds are invested in equity shares or "equity linked instruments" of unlisted companies.
4. VCFs are not allowed to invest more than 25% of the corpus in any one company. VCFs are also not allowed to invest in "associated companies". These restrictions are presumably intended to pre-empt business houses from misusing the tax concessions available to a VCF for investing in companies of the group.

Taxation of Income of Indian VC funds Section 10(23FB) of the Indian Income Tax Act, 1961 exempts the income of VCFs by way of dividend and long term capital gains from tax. In order to avail the tax exemption the VC fund will have to register with the SEBI along the lines explained above. As with the SEBI regulations, the tax provision purports to ensure that VCFs invest in unlisted companies which are not in a position to access public financial markets.

Regulation of VC Funds Registered Outside India

The investment activities of funds registered outside India and investing in India are regulated either by the foreign direct investment regime (FDI) in India or regulations governing foreign institutional investors (FIIs) who are registered with SEBI. The FDI regime requires the foreign investor to obtain approval for each individual investment transaction. So also, when investments are liquidated and the proceeds sought to be repatriated, the foreign investor is required to obtain the necessary approvals for each transaction. Foreign investors have also discovered tax efficient means of structuring their investment activity such as registering the investment company in countries that have favourable tax treaties with India such as Mauritius.

The regulatory regime governing foreign investors does not specifically address the needs of the VC investor. There are several complexities that cause delays at the time of entry and exit for the foreign investor. Sometimes these procedures can even restrict the investor from realising the best possible terms as in the case of certain exits. Notwithstanding these issues, foreign investors seem to prefer these alternate regimes to the SEBI regime.

20.8 CURRENT CONCEPTS OF THE INDIAN VC INDUSTRY

Considering the potential for the various sectors in a rapidly growing economy, the Indian market should provide many attractive investment opportunities for VC investors. However there appear to be numerous issues that could cause concern to potential investors. Some of them are discussed briefly below.

1. The common refrain among VC investors has been the *lack of deal flow* of an acceptable "quality". This could be, *inter alia,* due to a complex interaction of social, cultural, and economic issues that could possibly be inhibiting the growth of entrepreneurship.
2. Exit by IPO from VC investments has been a cause for concern due to the *lack of liquidity* for most but shares of the top hundred companies that account for more than 80 percent of the trading volumes on the stock exchanges. The poor liquidity in the shares of most other companies means that when investors such as VCs who hold sizeable blocks of shares disinvest through the market, the price of shares declines in response to the sudden increase in supply of scrips. This makes liquidation costly and time consuming.

   The buoyancy in the Indian stock markets in the post couple of years has provided a broad-based improvement in liquidity. Many VC investors have managed to liquidate their investments in the process. Offers for sale at IPOs or subsequent public offerings have also been gaining in popularity, albeit slowly. The important question is whether this liquidity will sustain or whether it is a short term window of opportunity. Equally, much of the liquidity has been noticed in the case of larger companies. For a broader development of the VC industry the market for smaller cap stocks needs to develop too. This has somehow remained a matter for debate and policy deliberations for many years.

3. There is very little data on the performance of Indian VC portfolios. There have been individual instances of spectacular investment successes. But it remains to be seen if they have resulted in the success of an entire portfolio in terms of a competitive *risk adjusted* rate of return. It is however heartening to note that many new funds, which are targetted at investment opportunities in India, have been announced in the past two years. Presumably investors have been encouraged by the visible international success of certain sectors and the huge returns that the secondary markets have provided.
4. *Contract enforcement* in India takes far too long and is fraught with too much uncertainty. This, combined with the relatively low levels of awareness of and commitment to sound corporate governance practices, appears to heighten anxiety about protecting the investor's interests in a company.
5. The *regulatory regime* is said to make entry into and exit from investments complex, time consuming and costly for foreign investors. The extant regime that provides for exemption of the profit and capital gains of VC funds from income tax are considered to be too restrictive to permit a healthy development of the business.
6. The industry also faces a *shortage of managers* with the necessary exposure to the practices of the VC industry in the western world.
7. As the VC industry shifts its focus to larger enterprises and businesses with a track record, a source of funding needs to evolve that will provide capital to enterpreneurial initiatives. In the US, individuals with high personal networth have filled this gap. They go by the popular name of angel investors. In the past decade a generation of businessmen in India has emerged who have generated considerable amount of personal wealth through businesses they have built successfully. The demand for their time from the businesses they built may be limited as those businesses are now run by professional management teams. Entrepreneurs who do not find VC could well benefit from their wealth and experience in building businesses.

20.9 HOW TO APPROACH A VC FUND

Most of the discussion above has been from the VC's viewpoint of the business. It would be useful for an entrepreneur, who proposes to raise VC, to keep some of the following considerations in mind.

Select the VCs you want to dialogue with VC funds have distinct investment focus areas in terms of industry sectors, the stage of evolution of the companies in which they would like to invest, the amount of financing and the extent of post financing involvement that the investor wishes to adopt. The entrepreneur would need to choose the VC fund, taking into account the fund's investment focus, before he sets out to have a serious discussion. This information can be acquired from brochures of various funds, their websites or by availing of the services of investment bankers who specialise in private equity fund raising.

Present an exciting and convincing story VC funds managers select a small number of companies to invest in from a large number of investment proposals they receive. In order to catch the investor's attention the entrepreneur must therefore have a business plan package that presents an exciting and convincing business story, laying out the potential size of the market for the product or service, the firm's competitive strategy, the financial return potential, and last but not the least, the competence of the management team to deliver these results.

Choose the right investment partner VC involves a closer relationship between the investor and the investee than between a lender and a borrower. This requires that the entrepreneur ensures that the VC fund

- Can develop a productive and harmonious relationship with the investee firm
- Has the organisation and personnel, with the necessary skills and experience to contribute the post financing value that the entrepreneur believes are important for growing the investee business.
- Has enough capital to meet the subsequent financing needs of the investee firm.

Be prepared for an open relationship The relationship between the investor and the investee is most productive where the entrepreneur and investee approach the relationship with a spirit of transparency and accommodate each other's reasonable business expectations. The entrepreneur has to be clear that he is prepared for such an open relationship with his financing partner when he raises VC.

SUMMARY

- A young private company that is not ready or willing to tap the public financial market may seek VC.
- VC funds are freestanding pools of capital, raised mostly from institutional investors and high networth individuals who have the ability to provide long term capital.
- VC investments involve businesses with potential for high growth in sales and profitability, equity or quasi-equity financing instruments, medium to long term investment horizons, above average investment risks and returns and active post financing involvement between investor and investee.
- Exceptionally high risks in terms of technology, management, product market and achieving liquidity increase the overall uncertainty underlying VC investments. VC investors also face the added problem of having to seek out information that they need, since unlisted firms are not subject to mandatory disclosure obligations unlike their listed counterparts.