Trends in Venture Capital Investments and Entrepreneurial Ecosystem in India

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Abstract

Venture capital investmentsin India have grown over the years, particularly after 2002. A financial mechanism to support risky ventures at early stages would help in strengthening innovation and entrepreneurship. In an economy such as India, there are plenty of business opportunities for entrepreneurial ventures. An enabling environment consisting of the appropriate financial mechanism coupled with simple regulatory procedures can boost entrepreneurship in the economy. The venture capital and private equity industry in India has had a slow growth trajectory particularly in the initial stages. Government of India had undertaken several steps in 1970s for the development of early stage financial mechanism. The regulations pertaining to these investments have undergone several changes over the years to encourage investments. This article traces some of the significant trends in India in venture capital funds and investments and the start-up/entrepreneurial ecosystem from the year 2012 onwards.

KEYWORDS: Venture capital, regulations, stage of investments, entrepreneurship, start-up ecosystem

Methodology: This article is based on secondary data and is descriptive in nature. The article focuses on the trends in the venture capital and entrepreneurial ecosystem in India from the year 2012 onwards.

Objectives of the article: The government of India is undertaking a number of measures such as the 'Start-up India' initiative to strengthen entrepreneurship. Venture capital supports entrepreneurship. The main objectives of this article are:

- To trace the trends in specific aspects of venture capital investments in India
- To understand the changes in regulations pertaining to venture capital
- To examine the trends in the entrepreneurial ecosystem.

Introduction: Venture capital financing has helped in creating new industries. Google, Sun Microsystems, Compaq, etc. were funded by venture capitalists at the initial stages of their development. Businesses in the IT and ITES space have been the favourite for venture capitalists across the globe. The focus of the venture capital industry has been the high-tech sector as a result many define venture capital as a vehicle for funding new high-tech ventures. However, venture capitalists in reality do provide funding to non-tech ventures also. For instance, FedEx the world's first Courier Company was funded by venture capitalists, which is a service firm and Sun Pharmaceuticals was also financed by venture capitalists.

Chandra, Prasanna (2010), says that "Venture capital represents financial investment in a highly risky proposition made in the hope of earning a high rate of return".[i]

Gompers and Learner (2006), define venture capital as "independently managed, dedicated pools of capital that focus on equity or equity-linked investments in privately held, high-growth companies".[ii]

SEBI defines a venture capital fund as "Venture capital fund means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model".[iii]

The government of India undertook initiatives to establish the venture capital industry in India in 1970s.This financial mechanism has made significant contributions to the development of new age industries such as Information Technology, Information Technology Enabled Services, Clean Technology, Alternative Energy, Courier Service, Pharmaceuticals, Health Care Services, e-commerce etc.

The author had interviewed fund managers of 17 venture capital firms during 2008-2009. The following could be gathered through the interviews:

- All the fund managers were of the opinion that the regulations are stifling the growth of the venture capital industry in India.
- Harmonization of regulations is absolutely essential to promote investments.
- Tax incentives have to be given to venture capital funds irrespective of the sector in which investments are made (baring a few sectors that are specified by SEBI) to compensate for the risks undertaken. RBI had prepared a list of 9 sectors and investments made by venture capitalists only in the 9 sectors would be accorded pass through status for taxation purposes. None of the fund managers were convinced about the list.

In the following paragraphs the trends in specific aspects of the venture capital funds, investments and the entrepreneurial ecosystem are discussed.

Regulatory environment: In India venture capital & private equity funds are regulated by SEBI, RBI and CBDT. SEBI AIF Regulations, 2012 govern the structure and investments of venture capital funds, RBI governs the foreign capital inflows/outflows in conjunction with FEMA and CBDT governs the taxation of income/earnings of the funds and its investors. As there are multiple regulatory bodies governing venture capital funds and investments in India, there is an urgent need for harmonization of the regulations. Some important changes/trends are highlighted:

- SEBI notified the Alternative Investment Funds (AIFs) Regulations on 21st May 2012.[iv] Before 2012, venture capital and private equity Funds in India were governed by SEBI Venture Capital Regulations, 1996 and the regulations have been amended from time to time. The earlier regulations did not make a distinction between venture capital and private equity whereas as per the 2012 regulations venture capital and private equity are categorized under two different Alternative Funds and therefore the regulations are also different in some respects. Venture Capital Funds are classified under category I AIFs. This has resulted in ease of regulations and is expected to give a boost venture capital funds and investments.

- Some important changes/amendments including reduction in holding period from 3 years to 2 years for the gains from sale of unlisted shares to be treated as long term capital gains, tax pass through for all venture capital investments have had a positive effect on raising of new funds and investments.
- There are domestic and foreign venture capital funds registered with SEBI. Due to the Double Tax Avoidance Treaty that India has signed with countries that have low tax regimes such as Mauritius, Singapore, Netherlands, Cyprus to name a few, which gave an unfair tax edge to investors from these countries, domestic investor base was impacted. The government recently has, to plug such loopholes, renegotiated the agreement, which would level the playing field for domestic venture capital investors.
- India’s rank has improved considerably in recent times in the World Bank’s ‘Ease of doing business’ global rankings. The indicators that are used for the ranking are dealing with construction permits, payment of taxes, trading across borders, protection of minority investors, getting electricity connection etc. India has moved into the top 100 countries last year in the ranking. The government has taken consistent efforts to strengthen the business environment.

Venture capital funds and investments: Some prominent trends related to venture capital funds and investments are:

- There are asper records 195 domestic venture capital funds and 240 foreign venture capital funds registered with SEBI.[v]&[vi]
- Creation of the SIDBI India Aspiration Fund by the government is a very good initiative. This is a fund of funds set up jointly by RBI and the government of India under SIDBI for investments in venture capital funds that deploy at least twice the contribution made by the fund of funds or half of their own capital, whichever is higher, in MSMEs and early stage enterprises. The objective is to give a multiplier effect to the start-up ecosystem.
- US$4313 million across 41 funds and US$5774 million across 44 funds were the amount of funds raised by venture capital and private equity in the year 2016 and 2017 respectively. Investments to the tune of US$16203 million across 588 deals and US$26458 million across 595 deals were made in the two years respectively. 209 exits valued at US$6668 million and 259 exits valued at US$13013 million were made in 2016 and 2017 respectively.[vii] As venture capitalists look for exit in a 3 to 7 year time frame, exits in 2016 and 2017 are very encouraging.
- During the period 2012-2015, early stage investments, in other words venture capital investments have been exceeding later stages investments including, private equity and Private Investment in Public Equity (PIPE) deals.In 2015, venture capital investments accounted for 64% of the total investments consisting of venture capital, private equity/growth, late, buyout, PIPE, pre-IPO and other types of investments.[viii]This is a very good indicator as it shows that a major portion of the investment is being made in early stages, which is crucial for strengthening the entrepreneurial ecosystem.

- IT and ITES, BFSI and Healthcare are the sectors that are attracting maximum investments from 2012 till date.[ix] Venture capitalists typically remain invested for a period ranging from 3 to 7 years in an investee company after which they seek to make a profitable exit. They therefore look for businesses that can scale fast and become profitable. So far, businesses in the IT and ITES space have scaled and have provided profitable exits to venture capitalists. This is one of the reasons for the sector attracting maximum venture capital investments.
- Southern region led by Bengaluru continues to attract maximum investments. National Capital Region (NCR) and the western region led by Mumbai also attract good volume of venture capital investments and deals.

Start-up/entrepreneurial ecosystem: It is evident from the trends in the regulatory environment and in the investments in the last 4 to 5 years period that the start-up/entrepreneurial ecosystem is getting the much needed support from early stage financial mechanism. The entrepreneurial spirit among Indians in general has been weak. There are certain communities that have traditionally set up businesses. In other communities there has been a clear preference for lucrative and secure employment. This preference for employment can be attributed to the following:

- Indians by nature are risk averse. The preference to avoid risks associated with setting up enterprises is very high, particularly in communities such as the Tamil Brahmins.
- The focus of families is on educating their children which will equip them for good and secure jobs in the government or private sector organisations. The parental pressure to choose jobs over self employment has traditionally been very significant among Indian families.
- There is stigma attached to failure. The youth is reluctant to take up entrepreneurship as a career option as there is tremendous fear of failure. While the social support system has its merits, it can also impact career choices made by people.
- The entrepreneurial ecosystem has also been weak because of various factors including ambiguous and complex regulations, inadequate early stage financing and lack of infrastructure. There are cumbersome procedures involved for setting up as well as winding up of business ventures. There is a need for harmonization of regulations.

Changes in the start-up/entrepreneurial ecosystem

The entrepreneurial ecosystem is gradually undergoing changes. Some of the significant trends are:

- India's rank in the World Bank's ranking of 'Ease of doing business' has improved.
- Many graduates from premiere educational institutions such as the Indian Institutes of Technology (IITs) and Indian Institutes of Management (IIMs) are choosing entrepreneurship over employment as their career option.
- The mind set towards risk taking is changing.

- Venture capital and private equity funds and investments are increasing.
- Other than this, many educational institutions have set up incubation centers for facilitating product/ business development in the campus. This is a very important initiative as it encourages entrepreneurship in campuses. Incubators and accelerators are increasing in number. The government of India is undertaking a number of measures for setting up and also for funding incubators and accelerators. Another important trend in this area is that incubators and accelerators are being set up in tier 2 and tier 3 cities, which is encouraging and strengthening the start-up culture and ecosystem in these cities. For e.g. The Forge Accelerator in Coimbatore is well known for IOT Solutions (IoT stands for Internet of Things) for agriculture.[x]Such initiatives would also result in job creation in these cities.

Conclusions: Entrepreneurship leads to job creation. In a country such as India, which is today considered as an emerging market, there is no dearth of business opportunities. One of the most important components of the entrepreneurial ecosystem is venture capital. Indians have proved their mettle in the area of technological innovation particularly, in IT. There is tremendous scope for innovation and entrepreneurial ventures in the areas of Artificial Intelligence (AI), Internet of Things (IoT), Fintech etc. The right environment can strengthen and give a boost to setting up of entrepreneurial ventures in many areas including deep technology.

Suggestions: One of the preconditions for strengthening the entrepreneurial ecosystem is a vibrant early stage investment mechanism such as angel investing and venture capital. Harmonization of regulations, improving ease of doing business, setting up of incubators and accelerators, tax concessions for early stage investments etc. would encourage venture capital investments and create an enabling environment for entrepreneurship. Entrepreneurship has to be introduced in the curriculum right from eleventh and twelfth standard of school education. Government should create more fund of funds and some of them can be stage, sector and geography specific. Some fund of funds can be created for investments only in entrepreneurial ventures promoted by women entrepreneurs. All these measures are required for taking advantage of the business opportunities that India offers today as an important emerging market.

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