Venture Capital Funds are not 'Non Banking Financial Intermediaries'

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< EXECUTIVE SUMMARY >

◆ This article focuses on the venture capital as a new type of financial intermediary. This article examines the efforts to create a venture capital industry in India. It lists the concepts of venture capital and its evolution over a period of time. It lists the venture capital industry in India and the various regulatory frameworks within which it operates. The VC investment process has variances/features that are context specific to countries/regions. However, activities in a VC fund follow a typical sequence with a number of commonalities.

The Indian financial system has another part that comprises a large number of privately owned, decentralized and relatively small-sized financial intermediaries, and which makes a more or less competitive market. While some of them are primarily engaged in fund-based activities, the other primarily provide financial services of diverse kinds. For convenience, the former may be called non-bank financial companies (NBFCs), and the latter non-bank financial services companies (NBFSCs). Venture capital is a new type of financial intermediary, which emerged during the 1970s in the U.S., in the early 1980s in the U.K., in the mid-1980s in Japan and Canada and around 1987 in India and now people talk of "venture capital industry" or "venture capital market" comprising a large number of Venture Capital Funds (VCFs).

CONCEPT OF VENTURE CAPITAL

Venture Capital means many things to many people. According to Jane Koloski Morris, an editor of the publication, Venture Economics, venture capital is "providing seed, start-up and first stage financing" and also "funding the expansion of companies that have already demonstrated their business potential but do not yet have access to the public securities market or to credit oriented institutional funding sources.." The European Venture Capital Association describes it as risk finance for entrepreneurial growth oriented companies. It is investment for the medium or long-term seeking to maximize medium or long-term return for both parties. It is a partnership with the entrepreneur in which the investor can add value to the company because of his knowledge, experience and contact base. International Finance Corporation, Washington D.C. 17C(W) defines VC as an equity or equity featured capital seeking investment in new ideas, new companies, new products, new processes or new services, that offer the potential of high returns on investment.... It may also include investment in turnaround situations. In India, the Securities and Exchange Board of India has laid down those activities that would constitute eligible business activities qualifying for the concessions available to a recognized venture capital fund. Securities and Exchange Board of India (Venture Capital Funds) Regulation, 1996 the principal

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regulation, published in the Gazette of India on December 4, 1996 defines Venture Capital Funds as "a fund established in the form of or trust a Company having a dedicated pool of capital which raises moneys through loan, donations, issue of securities or units as the case may be, and makes or proposes to make investments in accordance with these regulations". The VCFs play an important role in supplying management and marketing expertise to unlisted, new and small private businesses, especially in technology-oriented and knowledge-intensive businesses or industries which may have long development cycles and which usually do not have access to convential sources of capital because of the absence of suitable collateral and the presence of high risk. Broadly speaking, the scope of activities of VCFs include provision of

- Seed capital for industrial start-ups,
- Additional capital to new businesses at various stages of their gorowth,
- Equity financing or leverage buy-out financing to management groups for taking over other companies,
- Bridge finance,
- Capital to Mature enterprises for expansion, diversification and restructuring.

EVOLUTION OF VENTURE CAPITAL

Since its beginnings in 1946 through the American Research and Development Corporation of General Deriot, venture capital business has expanded quite fast. Presently, VC in one form or the other bas come to stay in over thirty five countries including Japan, Taiwan, India, South Korea, Singapore, Philippines, Malaysia in Asia, Brazil and Argentina in South America and Kenya and Nigeria in Africa. However barring US, UK, Japan, Canada, Germany, Sweden and Netherlands, the industry has a relatively limited activity base measured in terms of number of registered VC firms, committed capital or invested capital measured as share of GDP.

VENTURE CAPITAL INDUSTRY IN INDIA

India has a large sophisticated financial system including private and public, formal and informal actors. In addition to formal financial institutions, informal institutions such as family and moneylenders are important sources of capital. India has substantial capital resources, but the bulk of this capital resides in the banking system.

In India the VC industry had its formal introduction in the budget speech of the Finance Minister in 1988. The UTI set up a VCF of Rs 20 crore in collaboration with the ICICI for fostering industrial development in 1988-89. Technology Development and Information Company of India Ltd. (TDICI) established by the UTI jointly with the ICICI acts as an adviser and manager of the Fund. The UTI launched Venture Capital Unit Scheme (VECAUS-I) to raise resources for this fund. It set up a Second Venture Capital Fund in March 1990 with a capital of Rs 100 crore, with the objective of financing Greenfield ventures and steering industrial development.

Pursuant to the budget speech announcement acess of 5% was levied on all payments for import of technology/know-how resulting in the creation of a sizable pool of funds. The Venture Fund that was created out of this cess was to be administered by the Industrial Development Bank of India. It was started with an initial capital of Rs 10 crore for assisting projects which promote commercial applications of indigenously developed technology, or which adapt imported technology for wider applications.

The IFCI sponsored in 1985 the Risk Capital Foundation (RCF) to give positive encouragement to new entrepreneurs. The RCF was converted into RCTFC on January 12, 1988. It provides both risk capital and technology finance under one roof to innovative entrepreneurs and technocrats for their technology oriented ventures. Most of the projects it has assisted have been based either on new technology or on new usages of existing technology. They included, inter alia, manufacture of antibiotic drugs radio paging systems, pay phones, calcium silicate bricks, polymer concrete, granite and marble processing machinery, and so on.

ANZ Grindlays Bank has set up India's first private sector venture capital fund, namely India Investment Fund with an initial capital of Rs 10 crore subscribed by NRIs. Among the Indian banks, the subsidiaries of SBI and Canara bank have floated VCFs They provide either equity capital or conditional loans. The projects assisted by them belong to industries such as watches, watches, seamless metal, cement and ceramics.

REGULATORY FRAMEWORK IN INDIA

The government regulations and policy has a significant impact on the growth and development of VC industry. SEBI is the nodal agency for registration and regulation for both domestic and overseas venture capi-

tal funds. SEBI rules permit the establishment of venture capital institutions under any of the following methods.

i. Venture Capital Funds set-up Asset Management Companies (AMC) that 'screens, makes and manages individual investments'.

ii Venture Capital Company established as a company satisfy the eligibility criteria drafted by SEBI for the purpose of registration namely:

   a. Memorandum of association has its main activity of carrying out the business of venture capital fund.

   b. Memorandum and articles of association explicity prohibits invitation to the public to subscribe to its securities.

iii Venture Capital Fund established as a trust satisfy the eligibility criteria drafted by SEBI for the purpose of registration, namely.

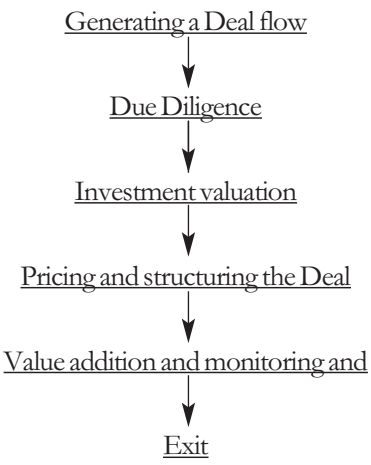
   a. the instrument of trust is in the form of a deed and has been duly registered under the provisions of the Indian Registration Act, 1908.

   b. the main objective of the trust is to carry on the activity of a venture capital fund.

The government has also sought to develop the VC industry by giving tax breaks and concessions on the income of VCF/VCC. Under the Section 10(23FB) of the Income Tax Act, any income of VCF/VCC is totally exempt from tax. However, such privileges are not available to the shareholders of a VC company.

THE VENTURE INVESTMENT PROCESS

As the name suggests, Venture Capital is a risk capital. The VCs look at various key factors while assessing a proposal. Hence, activities of a VC fund follow a typical sequence. The typical stages in an investment cycle are as below:



THE VALUATION PROCESS

The entire investment valuation process is aimed at arriving at "an acceptable price". In countries where free pricing regimes exist the evaluation process goes through the following sequence:

1. Evaluate the future revenue and profitability
2. Forecast likely future value of the firm based on expected market capitalization or expected acquisition proceeds depending upon the anticipated exit from the investment.
3. Target on ownership position in the investee firm so as to achieve desired appreciation on the proposed investment. The appreciation desired should yield a hurdle rate of return on a Discounted Cash Flow Basis.
4. Symbolically the valuation exercise may be represented as follows: NPV=[(Cash)/(Post)]* [(PAT*PER)]*K;

   Where

   NPV=Net present value of the cash flows relating to the investment comprising outflow by way of investment and inflows by way of interest/dividends (if any) and realization on exit. The rate of return used for discounting is the hurdle rate of return set by the VC investor.

   Post=Pre+Cash.

   Cash represents the amount of cash being brought into the particular round of financing by the VC investor.

   'Pre' is the pre-money valuation of the firm estimated by the investor. While technically it is measured by the intrinsic value of the firm at the time of raising capital, it is more often a matter of negotiation driven by the ownership of the company that the VC investor desires and the ownership that the founders/management team is prepared to give away for the required amount of capital.

   PAT is the forecast of Profit After Tax in a year and often agreed upon by the founders and the investors (as opposed to being 'arrived at' unilaterally). It would also be net of preferred dividends, if any.

   PER is the price-earnings multiple that could be expected of a comparable firm in the industry . It is not always possible to fund such a 'comparable fit' in VC situations. That necessitates, therefore, a significant degree of judgment on the part of the VC to arrive at alternative PER scenarios.

'K' is the present value interest factor (corresponding to a discount rate 'r') for the investment horizon

It is quite apparent that PER times PAT represents the value of the firm at that time and the complete expression really represents the investor's share of the value of the investee firm. The following example illustrates this framework:

Example

Best Mousetrap Limited (BML) has developed a prototype which needs to be commercialized. BML needs cash of Rs.2 million to establish production facilities sad set up a marketing program. BML expects that the company will go public in the third year and have revenues of Rs.70 million and a PAT margin of 10% on sales. Assume for the sake of convenience, that there would be no further addition to the equity capital of the company.

Prudent Fund Managers (PFM) propose to lead a syndicate of like-minded investors with a hurdle rate of return of 75% (discounted) over a five year period based on BML's sales and profitability expectations. Firms with comparable sales and profitability and risk profiles trade at 12 times earnings on the stock exchange. The following would be the sequence of computations.

In order to get a 75% return per annum the initial investment of Rs. 2 million must yield an accumulation of 2*(1.75)5=Rs. 32.8 million on disinvestments in year 5 BML's market capitalization in year 5 is likely to be Rs. (70*0.1*12) million.

Percentage ownership in BML that is required to yield the desired accumulation will be 32.8/84 *100=39%. Therefore the post-money valuation of BML at the time of raising capital will be equal to Rs. 2/0.39 million=Rs. 5.1 million which implies that a pre-money valuation of Rs. 3.1 million for BML.

Another popular variant of the above method is the First Chicago Method (FCM) developed by Stanley Golder, a leading professional VC manager. Under this method three probable scenarios, viz. 'success', sideways survival' and 'failure' are assumed and outcomes under these scenarios are probability weighted to arrive at an expected rate of return.

In reality the valuation of the firm is driven by a number of factors. The more significant among these are:

1. Overall economic conditions.
2. Demand and supply of capital
3. Specific rates of deals.
4. The degree of popularity of the industry/technology in question.
5. The standing of the individual VC.
6. Investor's considerations. The support provided by a V.C. to scale up could be one consideration.
7. Valuation offered on comparable deals around the time of investing in the deal.

Exit

The process of exiting from a VC investment is as important as in any other process in thc investment cycle. The three exit options are:

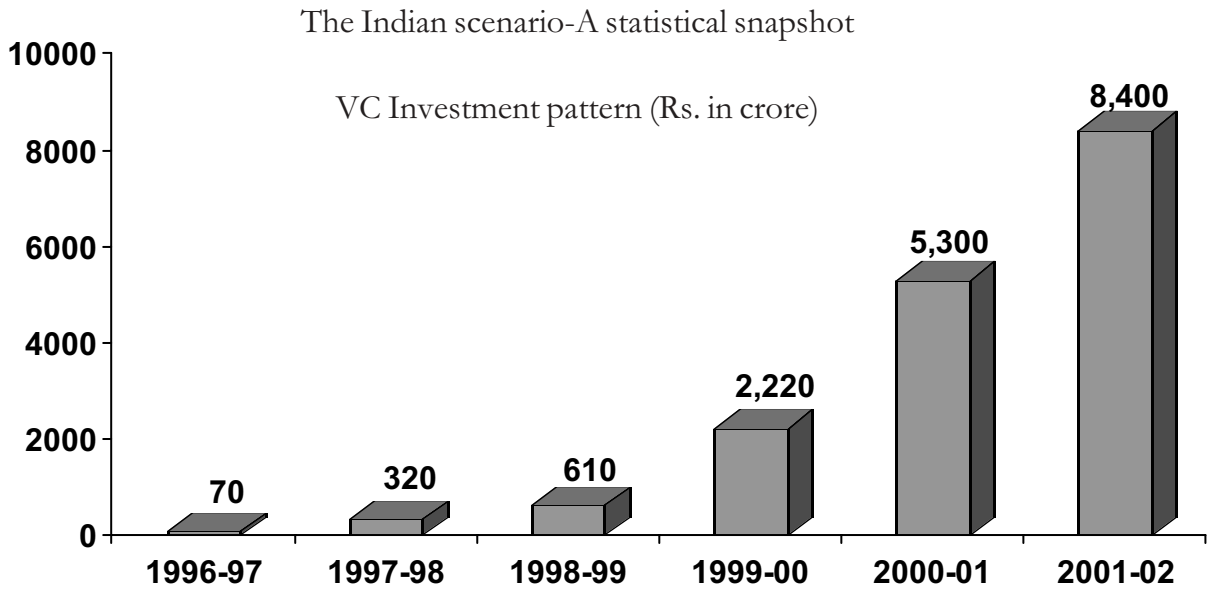
1. Sale of the VC's position either along with or subsequent to a public offering; and
2. Acquisition of the company i.e. building companies for acquisition by larger corporates.
3. Buy back by the Promoters/Management.

THE VENTURE INVESTMENT IN INDIA

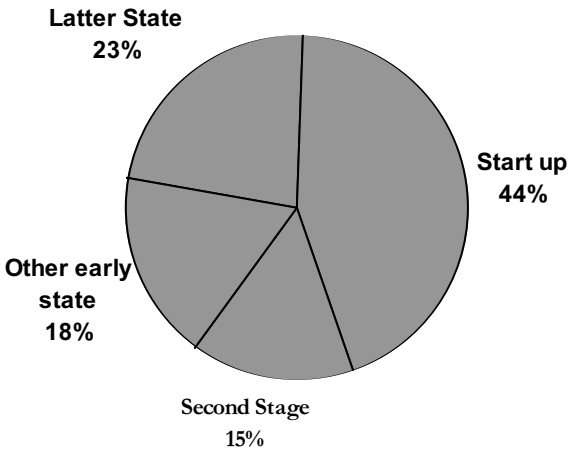
Indian Venture Capitalists constitute Foreign Institutional Investors, all India Financial Institutions, Multilateral Development Agencies and Banks. Largely India-born investors living outside the country, particularly the software and information technology sector who have played a key role in financing their native land's high-technology industry, have fueled the huge increase in India particularly the software and information technology sector. According to the resent estimate by Nasscom, the venture capital investment in India is slated to rise to a massive Rs 50,000 crore by 2008, up from Rs. 2,200 crore in 2000-01. But this is very small compared with the $105 billion the venture capital companies invested in the US in 2000-01.

PROBLEMS FACED BY VENTURE CAPITAL IN INDIA

Unlike U.S. where the largest single source of funds for U.S. venture capital funds since the 1980s has been public-and private sector pension funds, in India, there are large pension funds but they are prohibited from investing in either equity or venture capital vehicles. This means they cannot be a source of capital. For any venture idea to succeed there should be a product that has a growing market with a scalable business model. The IT industry being one of the most suited industries in India for VC funding, till recently had a service centric business model. Products developed for Indian markets lack scale. With the slump in the new economy sectors and collapse of the dotcoms, VCs are presently following a highly selective approach in financing. The selective financing has also arisen due to problem V.C. Funds are facing in making an exit from their V.C. Investments which is by way of equity/equity type instruments.



Financing by Investment stage



Also, there was absence of proper environment and policy support. The result of these various impediments was a micro management of investment, complicating the activities of the venture capital firms without either increasing effectiveness or reducing risk to any appreciable extent. Impediments to the development of venture capital also can be traced to India's corporate and currency laws. Earlier days of licensing raaj and the IPO boom also resulted in venture capital activity not on an upswing in India. Also, in the absence of seasoned institutional investors, advanced- county standards of investor protection that would normally be imposed by such investors have not developed There was not even a self-regulatory group. "Internationally, venture funds have evolved in an atmosphere of structure flexibility, fiscal neutrality and operational adaptability. And, we need to provide regulatory simplicity and structural flexibility on the same lines. There is also the need for a level playing field between domestic and offshore venture capital investors", Nasscom said

For venture capital funds, which deal in high-risk investments, structuring flexibility, is very important to meet their business strategies. In India, such structures like Limited Liability Partnership (LLP) and Limited Liability Company (LLC) are not recognized under the Indian Partnership Act and the Companies Act, which are commonly used and widely Accepted structures internationally. For development of VC industry in India on global lies and also to facilitate and attract the foreign investment in venture capital industry such alternative structures need to be provided. Further, for every investment and disinvestment, RBI approvals are required in respect of pricing of securities. In the case of venture capital fund with 100% investment by foreign investors, though the Government of India guidelines provide for only one-time FIPD approval, in practice the requirement of taking approval for pricing of securities from RBI still remains.

The investment horizon for a venture capital fund is for a longer duration Life of minimum 7 years is kept because investment is made in unlisted companies and they take time to scale up and give an exit to the venture capital fund. Typically, the venture capital fund invests in the 1st 3 years and divests from its investment from 4th year onwards which may go upto 10 years from the date of the setting up of the fund.