VENTURE CAPITAL

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Venture capital basics

- Starting and growing a business always require capital.
- There are a number of alternative methods to fund growth. These include the owner or proprietor’s own capital, arranging debt finance, or seeking an equity partner, as is the case with private equity and venture capital.
- Finance may be required for the start-up, development/expansion or purchase of a company.
- New companies or ventures that have a limited operating history and hence may find it difficult to raise funds through an equity or debt offering.
- In such a scenario, VC investors play a pivot role in investing in unfinanced areas to promote new ventures.

- Venture capital is most attractive for new companies with limited operating history that are too small to raise capital in the public markets and have not reached the point where they are able to secure a bank loan or complete a debt offering.

What is Venture Capital

- Venture capital is a means of equity financing for rapidly-growing private companies.
- Venture Capital firms invest funds on a professional basis, often focusing on a limited sector of specialization (eg. IT,Bio Technology, infrastructure, health/life sciences, clean technology, etc.).
- The venture capital investment helps for the growth of innovative entrepreneurships.
- Venture capital is an investment in the form of equity, quasi-equity and sometimes debt - straight or conditional, made in new or untried concepts, promoted by a technically or professionally qualified entrepreneur.
- Venture capital means risk capital.

What is VC

- It is developed as a result of the need to provide non-conventional, risky finance to new ventures based on innovative entrepreneurship.
- It refers to capital investment, both equity and debt, which carries substantial risk and uncertainties.
- The risk envisaged may be very high.
- Venture capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms
- Provider of seed money for start-ups, midstage firms on the brink of success but needing additional capital, or successful firms capable of expansion to a regional or nationwide platform.
- VC also can include managerial and technical expertise.

VC- Definition

- Venture capital is a type of private equity capital typically provided for early-stage, high-potential, growth companies in the interest of generating a return through an eventual realization event such as an IPO or trade sale of the company.
- A pool of risk capital, typically contributed by large investors, from which allocations are made available to young, small companies that have good growth prospects but are short of funds.
- It is developed as a result of the need to provide non-conventional, risky finance to new ventures based on innovative entrepreneurship.
- Venture capital means risk capital.

VC- Definition

- Venture capital means many things to many people.
- It is in fact nearly impossible to come across one single definition of the concept.
- **Jane Koloski Morris**, editor of the well known industry publication, Venture Economics, defines venture capital as:

  '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’.

SEBI Venture Capital Funds (VCFs) Regulations, 1996

Definition:

- **A Venture Capital Fund means** a fund established in the form of a trust/company; including a body corporate, and registered with SEBI which

  (i) has a dedicated pool of capital raised in a manner specified in the regulations and

  (ii) invests in venture capital undertakings (VCUs) in accordance with these regulations.
- All VCFs must be registered with SEBI and pay Rs.25,000 as application fee and Rs. 5,00,000 as registration fee for grant of certificate.

The Origin of Venture Capital

- In the 1920's & 30's, the wealthy families and individual investors provided the start up money for companies that had ability to become famous.
- General Doriot, a professor at Harvard Business School, in 1946 set up the American Research and Development Corporation (ARD), the first firm to finance the commercial promotion of advanced technology developed in the US Universities.
- Among the early VC funds set up was the one by the Rockfeller Family which started a special fund called VENROCK in 1950, to finance new technology companies.
- While in its early years VC may have been associated with high technology, over the years the concept has undergone a change and as it stands today **it implies pooled investment in unlisted companies.**

The Origin of Venture Capital- 20th century

- During the 1960s and 1970s, venture capital firms focused their investment activity primarily on starting and expanding companies in electronic, medical or data-processing technology.
- As a result, venture capital came to be almost synonymous with technology finance.
- The public successes of the venture capital industry in the 1970s and early 1980s gave rise to a major proliferation of venture capital investment firms.
- 90s witnessed world wide economic progress, wherein new ventures started expanding with that the scope for VC funds.

Venture Capitalists generally:

- Finance new and rapidly growing companies
- Purchase equity securities
- Assist in the development of new products or services
- Add value to the company through active participation.

Characteristics

- Long time horizon
- Lack of liquidity
- High risk
- Equity participation
- Participation in management

Structure of Venture Capital Firms

- Venture capital firms are typically structured as partnership;
- This comprises both high net worth individuals and institutions with large amounts of available capital, such as state and private pension funds, university financial endowments, foundations, insurance companies, and pooled investment vehicles, called fund of funds or mutual funds
- VC firms in the United States may also be structured as limited liability companies, in which case the firm's managers are known as managing members.

Advantages

- It injects long term equity finance which provides a solid capital base for future growth.
- The venture capitalist is a business partner, sharing both the risks and rewards. Venture capitalists are rewarded by business success and the capital gain.
- The venture capitalist is able to provide practical advice and assistance to the company based on past experience with other companies which were in similar situations.

Advantages (Cont.)

- The venture capitalist also has a network of contacts in many areas that can add value to the company.
- The venture capitalist may be capable of providing additional rounds of funding should it be required to finance growth.
- Venture capitalists are experienced in the process of preparing a company for an initial public offering (IPO) of its shares onto the stock exchanges or overseas stock exchange such as NASDAQ.
  They can also facilitate a trade sale.

Venture Capitalists and Business Angels

- **Venture Capitalists** are investment firms that makes venture investment, providing capital for start-up or expansion.

- They are looking for higher rate of return, bringing their managerial abilities to small businesses with great potential growth.

- **Business Angels** are private investor with huge personal capital, looking forward to invest their money in business which are not helped by financial institutions because are too risky.

Stages of financing

1. Seed Money:

   Low level financing needed to prove a new idea.

2. Start-up:

   Early stage firms that need funding for expenses associated with marketing and product development.

3. First-Round:

   Early sales and manufacturing funds.

4. Second-Round:

   Working capital for early stage companies that are selling product, but not yet turning a profit .

5. <u>Third-Round</u>:

Also called Mezzanine financing, this is expansion money for a newly profitable company

6. <u>Fourth-Round</u>:

Also called bridge financing, it is intended to finance the "going public" process

Risk in each stage

Financial Stage	Period (Funds locked in years)	Risk Perception	Activity to be financed
Seed Money	7-10	Extreme	For supporting a concept or idea or R&D for product development
Start Up	5-9	Very High	Initializing operations or developing prototypes
First Stage	3-7	High	Start commercials production and marketing

Financial Stage	Period (Funds locked in years)	Risk Perception	Activity to be financed
Second Stage	3-5	Sufficiently high	Expand market and growing working capital need
Third Stage	1-3	Medium	Market expansion, acquisition & product development for profit making company
Fourth Stage	1-3	Low	Facilitating public issue

VC investment process

Deal origination

Screening

Due diligence (Evaluation)

Deal structuring

Post investment activity

Exit plan

THE FUNDING PROCESS

1.Business Plan Submission

- 1. a description of the opportunity and market size;
- 2. resumes of your management team;
- 3. a review of the competitive landscape and solutions;
- 4. detailed financial projections; and
- 5. a capitalization table.

2.Introductory Conversation/Meeting

- If your firm has the potential to fit with the VC's investment preferences, you will be contacted in order to discuss your business in more depth.

3: Due Diligence: The due diligence phase will vary depending upon the nature of your business proposal. The process may last from three weeks to three months.

4: Term Sheets and Funding : If the due diligence phase is satisfactory, the VC will offer you a term sheet. This is a non-binding document that spells out the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which you should expect a wait of roughly three to four weeks for completion of legal documents and legal due diligence before funds are made available.

WHAT DO VCs LOOK FOR?

- Venture capitalists look for businesses that have the potential to grow quickly to a significant size, yielding a significant return on the VC's investment in a relatively short period of time. VCs are not just interested in start-ups. Your company's current size is less important than its future aspirations and growth potential. A target company for a VC is one that may be capable of becoming a large market leader in its industry due to some new industry opportunity and competitive advantage.

1. ***Commercially viable.*** *Does the company have a product or service that can be* reproduced efficiently to generate revenue?

2. ***Identifiable market***. *Is there a clearly defined market for the company's product* or service? Does the company's product or service meet an identifiable need in that industry? Does the company have a reasonable plan to meet the identified need in an efficient, revenue-generating manner?

3. ***Strong management***. *Does the company's leadership inspire confidence? Do* they have the vision, expertise, and the ability to propel a business to a significant level of growth? Does the team consider best practices of those that have gone before them?

4.***Sustainable competitive advantage.*** *Has the company hit upon an idea that's truly* unique to the industry, one that has significant barriers to entry that will inhibit others from encroaching upon its market? Has the company considered economic and technological change that may affect the business model?

Objectives of venture capital

VC in that it commonly strives to advance both strategic and financial objectives. Strategically driven VC investments are made primarily to increase, directly or indirectly, the sales and profits of the incumbent firm's business. A well esthablished firm making a strategic VC investment seeks to identify and exploit synergies between itself and the new venture. The Goal is to exploit the potential for additional growth within the parent firm. For instance, investing firms may want to obtain a window on new technologies, to enter new markets, to identify acquisition targets and/or to access new resources. The objective is to exploit the independent revenue and profit in the new venture itself.

Methods of Venture Financing

The financing pattern of the deal is the most important element. Following are the various methods of venture financing:

- Equity
- Conditional loan
- Participating debentures
- Quasi equity

Exit strategy

- VCs would be more interested in listening to entrepreneurs who have a perfect exit strategy planned for investors. There are various exit option for VC to cash out their investment:

Exit route

- Initial public offer(IPOs)
- Trade sale
- Promoter buy back
- Acquisition by another company

-) **Initial Public Offering (IPO) :** IPO is about offering company shares in the market for public to buy or sell. IPO constitutes the most preferred route for VC exit as it offers flexibility to investors in terms of time, price and quantity. Through this route, investors can decide when to sell, at what price to sell and in what quantity to sell depending upon the market scenario. IPO gives a perfect opportunity to reap benefits for their investment.

Merger and acquisition

- **Mergers & Acquisition:** M&A offers an opportunity to investors to sell company shares (partially /fully) to another company. In this case, investors doesn’t have enough flexibility since pricing,timing and quantity are decided simultaneously during the process and thereby investors don’t have control over the exit.
- Entrepreneurs and investors can sale the business to either strategic partner for a stake or allow bigger players in the same industry to acquire.

- **Shares buyback:** Company promoters or entrepreneur can buy back the company's shares from Investors on a fixed price after negotiation. For investors, this is the least preferred route since ROI in this case is capped. However, investors would like to go for this VC exit option only when IPO & M&A route is not available to them and company is not doing well in terms of meeting expectations of investors.

- **Sale to Other Strategic Investor/Venture Capital Fund:** It is quite possible that VC prefer to offload their shares to other strategic investors which could be either bigger angel investors or venture capital funds who are ready to put more money into the business.

Reason for exit strtegy

- Venture Capital partners always prefer exit option which not only gives them their investment back but also offer minimum protected return which they could have earned easily by putting money into the open market investment opportunities.

DEVELPOMENT OF VENTURE CAPITAL IN INDIA

- The concept of venture capital was formally introduced in India in 1987 by IDBI.
- The government levied a 5 per cent cess on all know-how import payments to create the venture fund.
- ICICI started VC activity in the same year
- Later on ICICI floated a separate VC company - TDICI

Venture capital funds in India

VCFs in India can be categorized into following five groups:

1) Those promoted by the Central Government controlled development finance institutions. For example:
   - ICICI Venture Funds Ltd.
   - IFCI Venture Capital Funds Ltd (IVCF)
   - SIDBI Venture Capital Ltd (SVCL)

2) Those promoted by State Government controlled development finance institutions.

For example:

- Punjab Infotech Venture Fund
- Gujarat Venture Finance Ltd (GVFL)
- Kerala Venture Capital Fund Pvt Ltd.

3) Those promoted by public banks.

For example:

- Canbank Venture Capital Fund
- SBI Capital Market Ltd

4)Those promoted by private sector companies.

For example:

- IL&FS Trust Company Ltd
- Infinity Venture India Fund

5)Those established as an overseas venture capital fund.

For example:

- Walden International Investment Group
- HSBC Private Equity management Mauritius Ltd

Rules & regulations of VC in India

- AS PER SEBI
- AS PER INCOME TAX ACT,1961

Rules by SEBI:

- VCF are regulated by the SEBI (Venture Capital Fund) Regulations, 1996.
- The following are the various provisions:

- A venture capital fund may be set up by a company or a trust, after a certificate of registration is granted by SEBI on an application made to it. On receipt of the certificate of registration, it shall be binding on the venture capital fund to abide by the provisions of the SEBI Act, 1992.

Continued…

- A VCF may raise money from any investor, Indian, Non-resident Indian or foreign, provided the money accepted from any investor is not less than Rs 5 lakhs. The VCF shall not issue any document or advertisement inviting offers from the public for subscription of its security or units

Continued…

- SEBI regulations permit investment by venture capital funds in equity or equity related instruments of unlisted companies and also in financially weak and sick industries whose shares are listed or unlisted

Continued...

- At least 80% of the funds should be invested in venture capital companies and no other limits are prescribed.

- SEBI Regulations do not provide for any sectoral restrictions for investment except investment in companies engaged in financial services.

Continued…

- A VCF is not permitted to invest in the equity shares of any company or institutions providing financial services.

- The securities or units issued by a venture capital fund shall not be listed on any recognized stock exchange till the expiry of 4 years from the date of issuance .

Continued...

- A Scheme of VCF set up as a trust shall be wound up

(a) when the period of the scheme if any, is over

(b) If the trustee are of the opinion that the winding up shall be in the interest of the investors

(c) 75% of the investors in the scheme pass a resolution for winding up or,

(d) If SEBI so directs in the interest of the investors.

As per provision of income-tax rules:

- The Income Tax Act provides tax exemptions to the VCFs under Section 10(23FA) subject to compliance with Income Tax Rules.

- Restrict the investment by VCFs only in the equity of unlisted companies.

- VCFs are required to hold investment for a minimum period of 3 years.

Continued…

- The Income Tax Rule until now provided that VCF shall invest only upto 40% of the paid-up capital of VCU and also not beyond 20% of the corpus of the VCF.
- After amendment VCF shall invest only upto 25% of the corpus of the venture capital fund in a single company.
- There are sectoral restrictions under the Income Tax Guidelines which provide that a VCF can make investment only in specified companies.

Indian Venture Capital and Private Equity Association (IVCA)

- It was established in 1993 and is based in Delhi, the capital of India
- It is a member based national organization that
  - represents venture capital and private equity firms
  - promotes the industry within India and throughout the world
  - encourages investment in high growth companies and
  - supports entrepreneurial activity and innovation.

- IVCA members comprise venture capital firms, institutional investors, banks, incubators, angel groups, corporate advisors, accountants, lawyers, government bodies, academic institutions and other service providers to the venture capital and private equity industry.
- Members represent most of the active venture capital and private equity firms in India. These firms provide capital for seed ventures, early stage companies and later stage expansion.

How does the Venture Capital work?

- Venture capital firms typically source the majority of their funding from large investment institutions.
- Investment institutions expect very high ROI
- VC's invest in companies with high potential where they are able to exit through either an IPO or a merger/acquisition.
- Their primary ROI comes from capital gains although they also receive some return through dividend.

Venture capital industry wise segmentation

Percentage

9.03
6.94
3.36
7.73
12.92
11.5
4.32
11.43
4.82
27.95

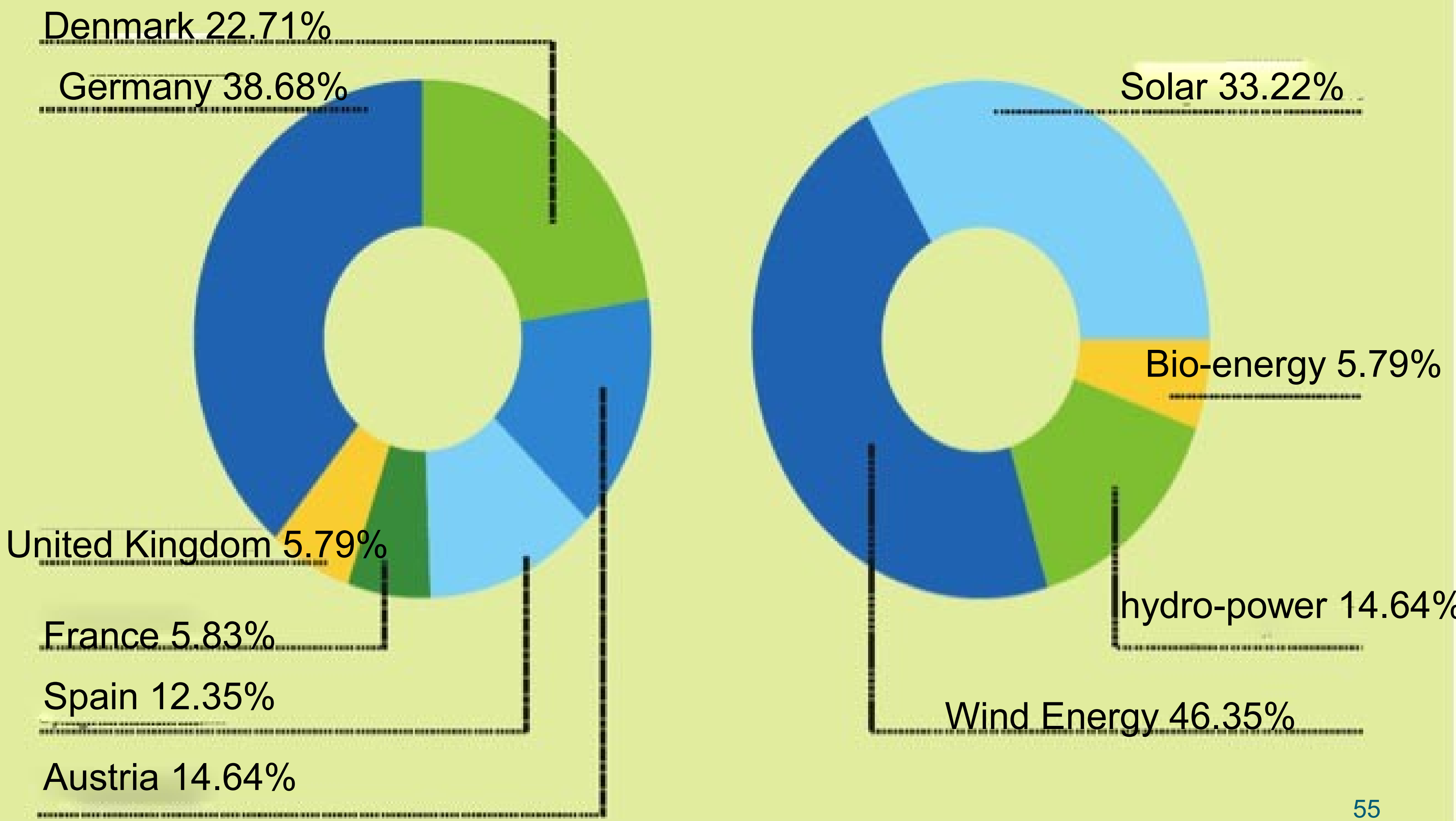
IT & ITES
Energy
Manufacturing
Media & Ent.
BFSI
Shipping & logistics
Eng. & Const.
Telecom
Health care
Others

Percentage calculated on the total VC investment- 14,234 USB (fig. of 2007)

Top cities attracting venture capital investments

CITIES	SECTORS
MUMBAI	Software services, BPO, Media, Computer graphics, Animations, Finance & Banking
BANGALORE	All IP led companies, IT & ITES, Bio-technology
DELHI	Software services, ITES , Telecom
CHENNAI	IT , Telecom
HYDERABAD	IT & ITES, Pharmaceuticals
PUNE	Bio-technology, IT , BPO

New Sectors of Investment



Renewvables energies: an opportunity to catch for venture capital

- Venture capitals put their eyes on renewvables energies;
- They sat special teams or branches to focus better on this special kind of investment;
- U.S and Europe kept investing a lot over the years on this new market in order to find new sources of energies.

Renewvables energies:an opportunity to catch for the venture capital

Three reasons of attractiveness :

1. Governments keep increasing deregulation of the market energy;
2. Enviromentalists put the attention on the need of the world of new sources of energies;
3. Increasing costs of the oils.

The goals

- Venture capital energy companies invest on projects long the value chain,focusing on two directions:

1. Increasing efficiency of the energetic system;

1. Decreasing the use of fossil fuel put down the values of the pollutions.

In recent years

- 2006:venture capital invested $7.4 billion on renewvables energies winth an increasing of 146% respect the last year;
- 2008:in the last months of the year a drop in the market occured
- 2009/2010:investments increase again supported by the developing countries (China)and U.S.

Problems of Venture Capital Financing

- The various problems/ queries can be outlined as follows :
- 1. Requirement of an experienced management team .
- 2. Requirement of an above average rate of return on investment .
- 3. Longer payback period .
- 4. Uncertainty regarding the success of the product in the market .

Continue..

- 5. Questions regarding the infrastructure details of production like plant location, accessibility, relationship with the suppliers and creditors, transportation facilities, labour availability etc.
- 6. The size of the market .
- 7. Skills and Training required and the cost of training.
- 8. Major competitors and their market share.

Critical factors for the success of venture capital

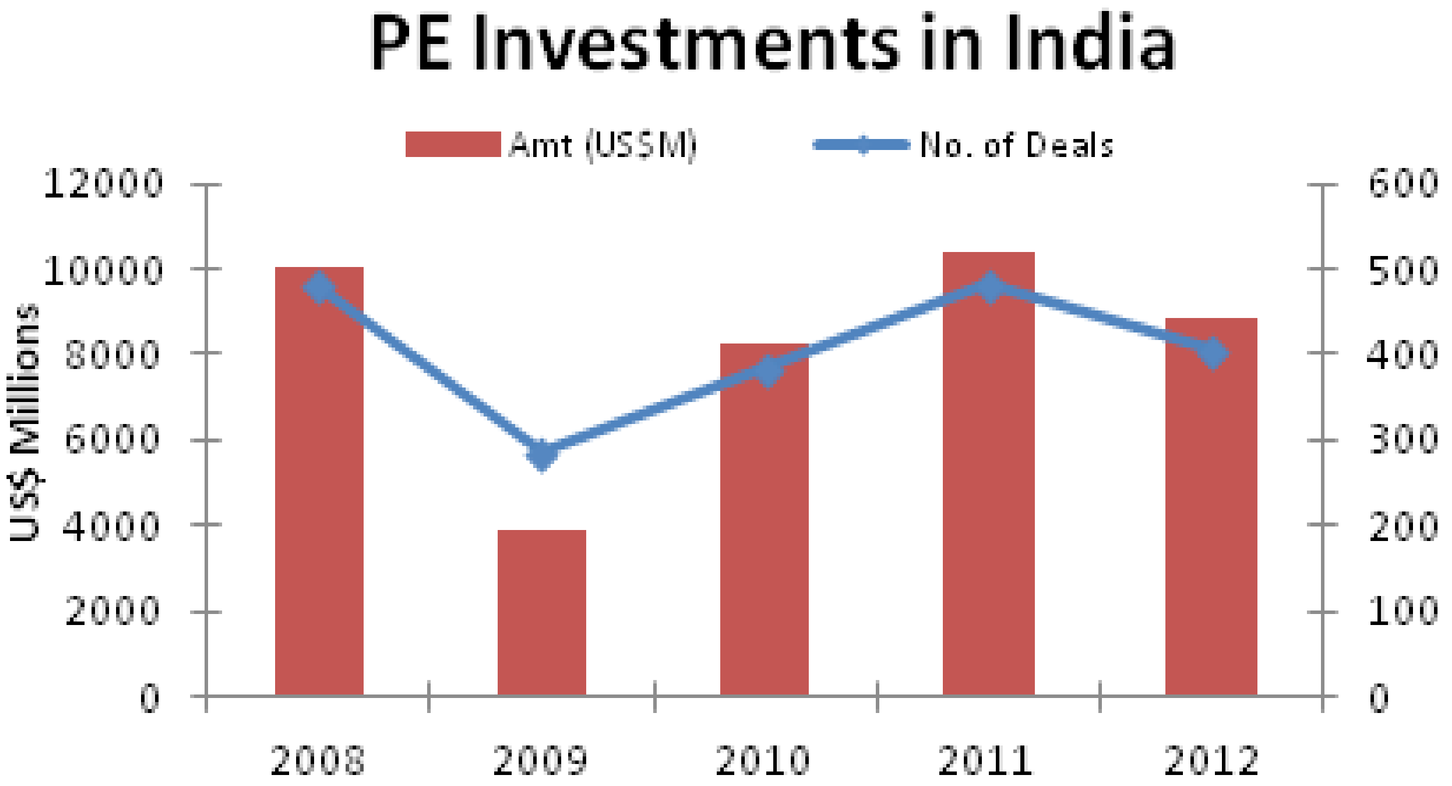
- The regulatory, tax and legal environment play an important role as international venture funds have evolved in an atmosphere of structural flexibility, fiscal neutrality and operational adaptability.
- Resource raising, investment, management and exit should be as simple and flexible as needed and driven by global trends.
- Venture capital should become an institutionalized industry that protects investors and investee firms, operating in an environment suitable for raising the large amounts of risk capital needed and for innovation through start-up firms in a wide range of high growth areas.

- In view of increasing global integration and mobility of capital it is important that Indian venture capital funds as well as venture finance enterprises are able to have global exposure and investment opportunities

- Infrastructure in the form of R&D need to be promoted using government support and private management as has successfully been done by countries such like US, Israel and China etc. This is necessary for faster conversion of R&D and technological innovation into commercial products.

Factors Determining Venture Capital Requirement:

- Nature of Business
- Size of Business
- Length of Production Cycle
- Seasonal Variations
- Working Capital Cycle


PE Investments in India
Amt (US$M)
No. of Deals
US$ Millions
12000
10000
8000
6000
4000
2000
0
600
500
400
300
200
100
0
2008
2009
2010
2011
2012

Recent Global Activities:

- In 2012 global VC investment declined by 20%.

- The amount raised via IPO declined globally by **27%** from U**S$22.1b** in 2011 to **US$16.1b** in 2012.

- VC investment remains strongest in the US and Europe – falling only 15% in 2012, compared to more than 40% in Israel and China. India was the only country to see an increase in the number of investment rounds.

- VCs are increasingly directing investment at the generating revenue stage and focusing less on product development, pre-revenue business, seeing this as a less high risk option.

Impact of recession on the VC industry in India

- The down market virtually closed the IPO market for emerging companies.
- With less opportunities for getting ROI investors tend to scale back, adjust their investment focus and/or get more picky in funding companies.
- The investors that put money into their funds became less aggressive during recession so it was harder for the VCs to raise money.

Case Study

- Druva Software, a Pune-based start-up that makes proprietary backup software solutions for laptops, has raised $5 million in Series A funding (funding that follows seed funding) from Sequoia Capital India and Indian Angel Network (IAN).
- The money will be used to expand the three-year old company's marketing and sales footprint overseas, including in Europe and the US. So far, it has relied largely on Web-based channels to sell its products in those markets.
- 80 per cent of data is duplicated,". Druva, therefore, developed a software that would allow companies to cut out this duplication and enable laptops to work faster as well as increase storage capacity.

- Druva had earlier raised seed funding from the Delhi-based Indian Angel Network and Hong Kong-based Accord International.
- Druva was developing a continuous data protection product, which is the next level of back-up technology, we decided to fund them," says Rehan Yar Khan, who represents IAN on the Druva board.
- Some of the company's earliest clients include NASA and the US Marine Corps. Druva Phoenix, Khan says, is now beginning to gain traction in the market.

Future prospects of VC in India

- VC can help in the rehabilitation of sick units.
- VC can assist small ancillary units to upgrade their technologies
- VCFs can play a significant role in developing countries in the service sector including tourism, publishing, health care etc.
- They can provide financial assistance to people coming out of universities, technical institutes, etc thus promoting entrepreneurial spirits


Thank You !