

Introduction

Historically venture capital investors have provided high risk equity capital to start-up and early stage companies whereas private equity firms have provided secondary tranches of equity and mezzanine investments to companies that are more mature in their corporate lifecycle. Again, traditionally speaking, venture capital firms have higher hurdle rate expectations, will be more mercenary with their valuations and will be more onerous in their constraints on management than will private equity firms.

While the above descriptions are technically correct and have largely held true to form from a historical perspective, the lines between venture capital and private equity investments have been blurred by increased competition in the capital markets over the last 18 - 24 months. With the robust, if not frothy state of the capital markets today there is far too much capital chasing too few quality deals. The increased pressure on the part of money managers, investment advisors, fund managers and capital providers to place funds is at an all time high. This excess money supply has created more competition between investors, driving valuations up for entrepreneurs and yields down for investors.

Venture Capital

Introduction

The venture capital investment helps for the growth of innovative entrepreneurship in India. Venture capital has developed as a result of the need to provide non-conventional, risky finance to new ventures based on innovative entrepreneurship. 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. It refers to capital investment, both equity and debt, which carries substantial risk and uncertainties. The risk envisaged may be very high may be so high as to result in total loss or very less so as to result in high gains.

Venture Capital in India

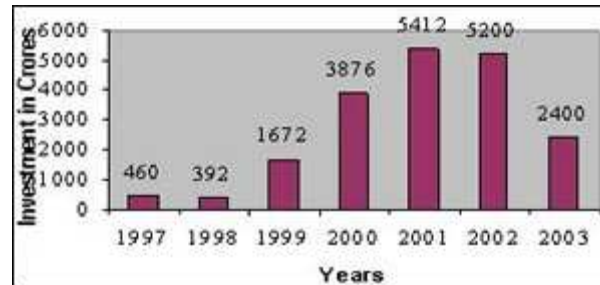
In India the Venture Capital plays a vital role in the development and growth of innovative entrepreneurship. Venture Capital activity in the past was possibly done by the developmental financial institutions like IDBI, ICICI and State Financial Corporations. These institutions promoted entities in the private sector with debt as an instrument of funding. For a long time funds raised from public were used as a source of Venture Capital. This source however depended a lot on the market vagaries. And with the minimum paid up capital requirements being raised for listing at the stock exchanges, it became difficult for smaller firms with viable projects to raise funds from public. In India, the need for Venture Capital was recognised in the 7th five year plan and long term fiscal policy of GOI. In 1973 a committee on Development of small and medium enterprises highlighted the need to foster VC as a source of funding new entrepreneurs and technology. VC financing really started in India in 1988 with the formation of Technology Development and Information Company of India Ltd. (TDICI) - promoted by ICICI and UTI. The first private VC fund was sponsored by Credit Capital Finance Corporation (CFC) and promoted by Bank of India, Asian Development Bank and the Commonwealth Development Corporation viz. Credit Capital Venture Fund. At the same time Gujarat Venture Finance Ltd. and APIDC Venture Capital Ltd. were started by state level financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high net-worth individuals.

Venture Capital Investments in India

The venture capital investment in India till the year 2001 was continuously increased and thereby drastically reduced. Chart I shows that there was a tremendous growth by almost 327 percent in 1998-99, 132 percent in 1999-00, and 40 percent in 2000-01 there after venture capital investors slow down their investment. Surprisingly, there was a negative growth of 4 percent in 2001-02 it was continued and a 54 percent drastic reduction was recorded in the year 2002-2003.

Chart I

Venture Capital Investments



Source: The Economic Times

SEBI Venture Capital Funds (VCFs) Regulations, 1996

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.

A Venture Capital Undertaking means a domestic company (i) whose shares are not listed on a recognised stock exchange in India and (ii) which is engaged in the business of providing services/production/manufacture of articles/things but does not include such activities/sectors as are specified in the negative list by SEBI with government approval-namely, real estate, non-banking financial companies (NBFCs), gold financing, activities not permitted under the industrial policy of the Government and any other activity which may be specified by SEBI in consultation with the Government from time to time.

Registration

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.

Types of Venture Capital Funds

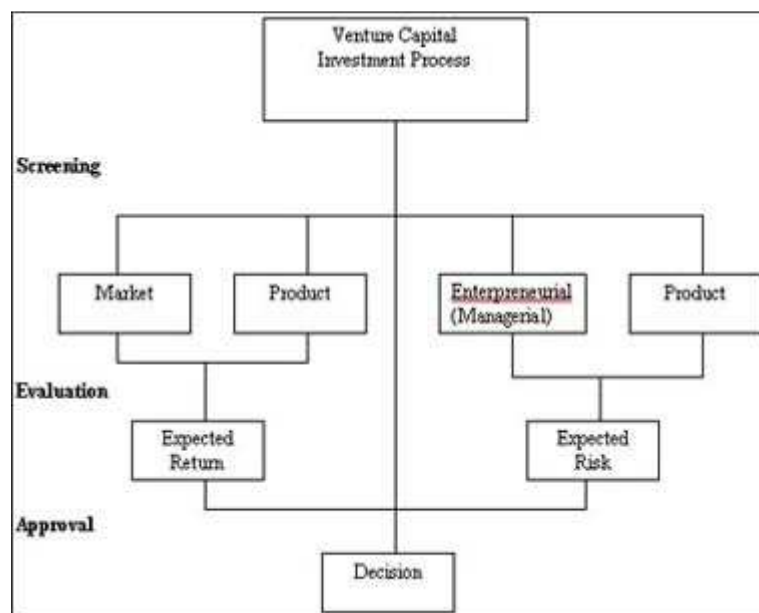
Generally there are three types of organised or institutional venture capital funds: venture capital funds set up by angel investors, that is, high net worth individual investors; venture capital subsidiaries of corporations and private venture capital firms/ funds. Venture capital subsidiaries are established by major corporations, commercial bank holding companies and other financial institutions. Venture funds in India can be classified on the basis of the type of promoters.

1. VCFs promoted by the Central govt. controlled development financial institutions such as TDICI, by ICICI, Risk capital and Technology Finance Corporation Limited (RCTFC) by the Industrial Finance Corporation of India (IFCI) and Risk Capital Fund by IDBI.
2. VCFs promoted by the state government-controlled development finance institutions such as Andhra Pradesh Venture Capital Limited (APVCL) by Andhra Pradesh State Finance Corporation (APSFC) and Gujarat Venture Finance Company Limited (GVCFL) by Gujarat Industrial Investment Corporation (GIIC)
3. VCFs promoted by Public Sector banks such as Canfin by Canara Bank and SBI-Cap by State Bank of India.
4. VCFs promoted by the foreign banks or private sector companies and financial institutions such as Indus Venture Fund, Credit Capital Venture Fund and Grindlay's India Development Fund.

The Venture Capital Investment Process:

The venture capital activity is a sequential process involving the following six steps.

1. Deal origination
2. Screening
3. Due diligence Evaluation)
4. Deal structuring
5. Post-investment activity
6. Exit



Venture Capital Investment Process

Deal origination:

In generating a deal flow, the VC investor creates a pipeline of deals or investment opportunities that he would consider for investing in. Deal may originate in various ways. referral system, active search system, and intermediaries. Referral system is an important source of deals. Deals may be referred to VCFs by their parent organisations, trade partners, industry associations, friends etc. Another deal flow is

active search through networks, trade fairs, conferences, seminars, foreign visits etc. Intermediaries is used by venture capitalists in developed countries like USA, is certain intermediaries who match VCFs and the potential entrepreneurs.

Screening:

VCFs, before going for an in-depth analysis, carry out initial screening of all projects on the basis of some broad criteria. For example, the screening process may limit projects to areas in which the venture capitalist is familiar in terms of technology, or product, or market scope. The size of investment, geographical location and stage of financing could also be used as the broad screening criteria.

Due Diligence:

Due diligence is the industry jargon for all the activities that are associated with evaluating an investment proposal. The venture capitalists evaluate the quality of entrepreneur before appraising the characteristics of the product, market or technology. Most venture capitalists ask for a business plan to make an assessment of the possible risk and return on the venture. Business plan contains detailed information about the proposed venture. The evaluation of ventures by VCFs in India includes;

Preliminary evaluation: The applicant required to provide a brief profile of the proposed venture to establish prima facie eligibility.

Detailed evaluation: Once the preliminary evaluation is over, the proposal is evaluated in greater detail. VCFs in India expect the entrepreneur to have:- Integrity, long-term vision, urge to grow, managerial skills, commercial orientation.

VCFs in India also make the risk analysis of the proposed projects which includes: Product risk, Market risk, Technological risk and Entrepreneurial risk. The final decision is taken in terms of the expected risk-return trade-off as shown in Figure.

Deal Structuring:

In this process, the venture capitalist and the venture company negotiate the terms of the deals, that is, the amount, form and price of the investment. This process is termed as deal structuring. The agreement also include the venture capitalist's right to control the venture company and to change its management if needed, buyback arrangements, acquisition, making initial public offerings (IPOs), etc. Earned out arrangements specify the entrepreneur's equity share and the objectives to be achieved.

Post Investment Activities:

Once the deal has been structured and agreement finalised, the venture capitalist generally assumes the role of a partner and collaborator. He also gets involved in shaping of the direction of the venture. The degree of the venture capitalist's involvement depends on his policy. It may not, however, be desirable for a venture capitalist to get involved in the day-to-day operation of the venture. If a financial or managerial crisis occurs, the venture capitalist may intervene, and even install a new management team.

Exit:

Venture capitalists generally want to cash-out their gains in five to ten years after the initial investment. They play a positive role in directing the company towards particular exit routes. A venture may exit in one of the following ways:

1. Initial Public Offerings (IPOs)
2. Acquisition by another company
3. Purchase of the venture capitalist's shares by the promoter, or
4. Purchase of the venture capitalist's share by an outsider.

Methods of Venture Financing

Venture capital is typically available in three forms in India, they are:

Equity : All VCFs in India provide equity but generally their contribution does not exceed 49 percent of the total equity capital. Thus, the effective control and majority ownership of the firm remains with the entrepreneur. They buy shares of an enterprise with an intention to ultimately sell them off to make capital gains.

Conditional Loan: It is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India, VCFs charge royalty ranging between 2 to 15 percent; actual rate depends on other factors of the venture such as gestation period, cost-flow patterns, riskiness and other factors of the enterprise.

Income Note : It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales, but at substantially low rates.

Other Financing Methods: A few venture capitalists, particularly in the private sector, have started introducing innovative financial securities like participating debentures, introduced by TCFC is an example.

A Case on Technology Development & Information Company Of India Ltd.

TDICI was incorporated in January 1988 with the support of the ICICI and the UTI. The country's first venture fund managed by the TDICI called VECAUS (Venture Capital Units Scheme) was started with an initial corpus of Rs.20 crore and was completely committed to 37 small and medium enterprises. The first project of the TDICI was loan and equity to a computer software company called Kale Consultants.

Present Status: At present the TDICI is administering two UTI –mobilised funds under VECAUS-I and II, totaling Rs.120 crore. the Rs.20 crore invested under the first fund, VECAUS-I, has already yielded returns totaling Rs. 16 crore to its investors.

Some of the projects financed by the TDICI are discussed below.

MASTEK , a Mumbai based software firm, in which the TDICI invested Rs.42 lakh in equity in 1989, went public just three years later, in November 1992. It showed an annual growth of 70-80 percent in the turnover.

TEMPTATION FOODS, located in PUNE, which exports frozen vegetables and fruits, went public in November 1992. The TDICI invested Rs.50 lakh in its equity.

RISHABH INSTRUMENTS of Nasik got Rs.40 lakh from the TDICI. It manufactures a range of meters used in power stations in collaboration with the ABB Metra Watt of Germany. After making cash losses totaling Rs.25 lakh in two bad years, it turned around in 1989 and showed an increase of over 70 percent in the turnover.

SYNERGY ART FOUNDATION, which runs art galleries in Mumbai and Chennai and plans to set up in Pune and Delhi too, had received Rs.25 lakh from the TDICI as convertible loans which were converted into equity on march 31, 1994. Most of this money has been used for the company's innovative art library scheme at least paintings to corporate clients.

Conclusion

In recent years the growth of Venture Capital Business has been drastically decreasing due to many reasons. The regulator has to liberalize the stringent policies and pave the way to the venture capital investors to park their funds in most profitable ventures. Though an attempt was also made to raise funds from the public and fund new ventures, the venture capitalists had hardly any impact on the economic scenario for the next few years. At present many investments of venture capitalists in India remain on paper as they do not have any means of exit. Appropriate changes have to be made to the existing systems in order that venture capitalists find it easier to realize their investments after holding on to them for a certain period of time.

Private Equity

Characteristics of Private Equity (PE)

- PE investors generally seek companies that are perceived to enjoy high growth potential over the long-term,
 - because the target company is in industry with long-term, high-growth potential,
 - because the target company is developing new products or services that when introduced are likely to garner a significant market share,
 - because the target company is an active force in a rapidly consolidating industry, or
 - because of any combination of these characteristics
- With respect to the original shareholders, a private equity investment will often involve having to learn to manage the company with certain restrictions on decision making.
- Investors frequently request representation on the board of directors and rights to veto actions relative to certain key management and operating issues.
- In some cases, the investors will even seek direct participation in the day-to-day management of the company. Investors may also wish to provide technical assistance, technology or management services to the company.
- To take care of the illiquidity of shares, and in order for the investor to be able to realize an acceptable return on its investment, the investor will insist upon negotiating an acceptable exit strategy at the outset of the investment.
- Such strategies may include taking the company public (IPO), selling the company to a third party (trade sale), selling the shares back to the original shareholders (pursuant to a put provision in the agreements of the private equity investment) or selling the shares to a third party.

Private Placement Process

Preparation of PPM

- Once the company has decided to seek private equity, the first step will be the preparation of a detailed business plan or private placement memorandum ("PPM") that describes the Company's business and operations, summarizes its business strategy, describes the relevant market, includes financial statements and detailed financial projections.
- The drafting of PPM should be a comprehensive but concise presentation. Investment banks take an active part in preparing PPM.

- Simultaneous with drafting of the PPM, investment bank usually develops a detailed contact plan based on a selective premarketing process. The heart of the plan consists of a list of potential "lead" and "follow-on" investors that may include venture capital investors, mezzanine funds, pension funds, insurance companies and high net worth individuals.

Due Diligence

- The due diligence review is essential to formulating a valuation by potential investors. It involves verifying the assets, liabilities and contractual obligations (including any existing or potential contingent liabilities) and financial condition of the company.

In order to prepare for the due diligence to be carried out by interested Investors, the company, with advice from its legal counsel, will be responsible for selecting, organizing, and making available for review all relevant documents. In addition, the company will typically arrange for investors to meet at length with management and tour the company's facilities.

Term Sheet

- Typically, after a potential investor has performed due diligence and has indicated a serious interest in making an investment, the parties will want to negotiate a term sheet or equivalent letter of intent which sets forth, in detail, the principal terms and conditions on which the investment will be made.
- Those terms and conditions will be influenced by the amount to be invested, the level of ownership the investment represents, the type of business the company operates, the company's financial situation, and the type of investment (development stage, strategic investment in an ongoing business, recapitalization, or troubled company turnaround).
- The single most important issue to be addressed in the term sheet is determining the value of the company.
- Other important issues relating to the financial terms of the investment, including the schedule on which capital is to be invested and the nature of the investment (convertible debt, debt with warrants, common stock, preferred stock, etc.), are resolved at this term sheet stage. In most cases, the term sheet also addresses issues relating to company governance and the relationship between the Investors and the original shareholders.
- The amount of negotiation on these issues and the extent of the detail included in the term sheet or letter of intent will influence, in an important fashion, the negotiation of the relevant agreements. To the extent the parties are able to reach a detailed agreement at the term sheet stage concerning these issues, there will be a corresponding reduction in the amount of time required to negotiate the documentation of the investment.
- Typically, there is significant negotiation between the principals that occurs at the term sheet stage. Once the terms and conditions have been agreed to by all the parties, legal counsel will incorporate the terms into draft documentation.

Securities purchase agreement and Shareholders' agreement

- This generally includes both a securities purchase agreement (containing the price, the nature and terms of the shares, the conditions to closing the investment, the representations of the parties and any indemnity obligations), and a shareholders' agreement, which regulates all aspects of the relationship among the company's shareholders, including the resolution of any controversies that may arise among the parties.
- Therefore, because of the pivotal role it plays in the success of the investment, the shareholders' agreement should be drafted in such a way so as to protect all shareholders, represent their interests, and anticipate any kind of controversy by providing an adequate mechanism for its resolution.
- It will be the lawyers' responsibility to produce documents that set forth, in a clear manner, all the terms and conditions negotiated by the parties and provide a workable arrangement for the management of the company.