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VENTURE CAPITAL IN INDIA

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There is need as also vast scope for venture capital financing in order to augment India's technical progress. The paper examines the improper application of the concept of venture capital in India. It makes suggestions for tapping the full potential of venture capital financing in India after highlighting the existing fiscal and institutional limitations on the promotion of venture capital.

I

Introduction

Venture Capital is a financing technique to finance hi-tech projects involving high risk and having strong potential of high profitability. To be more specific, venture capital is financing of small or medium businesses promoted by individuals or firms having sound project ideas generally involving new products and/or processes but lacking financial resources. Normally, such projects have potential of high return if the venture succeeds but the chances of failure are also high because they involve new technology which may never have been commercially tested.

This form of financing functions on the logic that an investor group contributes capital to the new corporation in return for an equity position in that corporation. As the business grows and prospers, the value of equity would rise. At this stage, the venture capitalist would make his exit by disinvesting his holdings in the capital market or sale to the promoter at a substantial premium. Conceptually, the role of a venture capitalist is not restricted to financing the venture only but it extends to managing the venture and providing inputs needed to set up the firm and for its successful functioning.

This new concept of venture capital is now being recognised in different parts of the world as a vital means to foster industrial development in a country because of the crucial role it plays in technological innovation and its commercial exploitation. By actively associating themselves with budding firms specialising in new ideas or new technologies and supplying capital, knowledge and efforts to the entrepreneur, venture capitalists contribute significantly in enlarging the range of commercial exploitation, outstretching the frontiers of knowledge to unbounded dimensions, opening up new vistas and offering hitherto unheard of opportunities to a new generation of entrepreneurs.

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II

Need for Venture Capital

The need to promote venture capital firms in India can be explained in view of the following:

1. Today, an Indian entrepreneur with a good project or idea but no previous track record finds it very difficult to raise the capital as he has got limited avenues for attracting required capital. The public investors are sceptical to invest their funds in start-ups and early stage ventures. So far as the means of raising resources from relations and friends is concerned, the quantum of funds is limited. Then the entrepreneur has to move towards the financial institutions and banks for support. But these institutions also cannot serve the purpose of such new entrepreneurs always because of the limitations of their financing like procedural delays, rigidity of Government announced parameters for priority lending and strict standards about security and collaterals.
2. Besides, rapidly changing economic environment coupled with socio-cultural changes and the high technology explosion point to the necessity of development of venture capital funds in the country to exploit fully the existing scientific knowledge and develop new processes and products. Today, India is on the threshold of high technology revolution providing sufficient scope for the development of venture capital financing. Not only knowledge but a whole new generation of relatively young, technology-oriented entrepreneurs is available. They are willing to launch the businesses and risk entrepreneurial ventures in new products and processes involving application of new technologies in preference to holding secure jobs or living on comfortable family incomes. A substantial percentage of them are non-resident Indians, who wish to introduce new knowledge or new ideas in their home country and in that process create an income base for themselves back home. The only thing required for availing the benefits of advanced technology, therefore, is to set up institutions of the type of venture capital firms which are specially charged with the responsibility of meeting the financing requirements of the new generation of entrepreneurs. Absence of venture capital facilities is likely to hamper the blooming of new entrepreneurs to exploit the full potential.

Thus, venture capital financing has come to assume significance to develop entrepreneurship and exploit technological potential in India. It will not only act as a financial catalyst but also provide a strong impetus for entrepreneurs to develop and commercialise newer technology. All this will go a long way in broadening the industrial base, creation of jobs, flushing of exports and overall enrichment of the economy.

III

Schemes Existing in India

Though venture capital is of very recent origin in India, there are a few schemes prevalent for financing of this kind.

Firstly, I.F.C.I. set up 'Risk Capital Foundation' in 1975 to supply special capital to new entrepreneurs. Lately, this scheme has been converted into a new body viz. 'Risk Capital & Technology Finance Corporation' specifically charged with providing venture capital on soft terms to entrepreneurs, particularly technologists & professionals who do not have adequate resources of their own. This fund aims at providing financial assistance to company in the form of an interest-free loan to meet any short-fall in promoters' contribution which was a stipulated portion of project cost. The assistance was limited to Rs. 15 Lakhs.

The 'Long Term Fiscal Policy' of the Government of India declared in 1986 proposed to set up a Venture Capital Fund with an initial capital of Rs. 10 crores to provide equity capital for pilot plants attempting commercial applications of indigenous technology and to adapt previously imported technology to wider domestic applications. The task of magnifying this venture capital scheme was entrusted to I.D.B.I. However, the scheme came into effect from the later half of 1987. Under the scheme, funds to be disbursed could be equity without any interest and voting rights. After commercial production starts, part of it will get converted into equity and part into loans with high rate of interest and a part of it can also be written off if a significant proportion of equity fails due to risking nature of the projects. (The assistance could range from Rs. 5 lakhs onward).

In 1986, I.C.I.C.I. launched a venture capital scheme to encourage new technocrats in new fields of high technology with inherent risks. To undertake this task on a continuous and systematic basis, the Corporation has flagged up with U.T.I., a new venture capital company called 'Technology Development and Information Company of India Limited' (TDICI) in 1988. TDICI has started providing venture capital, R&D funds and technical & managerial services, including technology and information. For the first time, ICICI established in 1988 with U.T.I. the 'Venture Capital Fund' with Rs. 20 crores. Subscribed equally by I.C.I.C.I. and U.T.I., the fund is being used for providing assistance mainly in the form of equity, conditional loans and convertible debentures to set up technological ventures which have potential for fast growth and to encourage new technocrats in private sector in high risk areas. The scheme shall provide finance through equity or loans up to Rs. 2 crores and the investment would be retained for a period of 5 to 8 years from the date of establishment of the venture after which the shares may be sold back to the promoter or through the stock exchange. The conditional loans are repayable through royalty payments on commencement of commercial production. I.C.I.C.I. and U.T.I. also jointly launched second Venture Capital Fund for Rs. 100 crores in January 1990. In addition to these schemes, certain nationalised banks in India such as State Bank of India and Canara Bank have shown interest in this area. They have launched Venture Capital Schemes through their subsidiaries – S.B.I. Caps and Can. Bank Financial Services Limited. Grindlays Bank has launched 'The India Investment Fund' which involve funds raised abroad from N.R.Is. to be used for projects which need venture capital financing.

In July 1990, the 'Gujrat Industrial Investment Corporation Limited' (GIIC) launched a venture capital finance scheme through a newly registered subsidiary, with the help of Capital Trust Fund worth Rs. 24 crores to cater to the projects which will enhance the growth of the national economy. The new subsidiary, Gujrat Venture Finance Limited, would financially support the entrepreneurs having both indigenous and imported technologies not tried before in the country.

Finally, in the private sector the first venture capital company 'Credit Capital Fund India Limited' was set up in April 1989, with Rs. 10 crores to be subscribed by the international financial agencies, i.e. Asian Development Bank and Commonwealth Development Fund to the extent of Rs. 6.5 crores and the remaining through public subscription.

These financial institutions (FIs) through their multifarious schemes do meet a part of venture financing. However, their concept of venture financing is lacking in some respects:

First, their concept has been restricted to a narrow definition embracing seed capital or gap filling capital support. Seed capital helps an entrepreneur to meet his contribution to the project and does not distinguish between proven projects and high risk technology projects.

Secondly, size of existing funds schemes is too small. Also the private sector involvement in this field is negligible as only credit capital venture fund is one good example of what undoubtedly carries great potential for the development of venture capital financing. Further, keeping in mind the mammoth tasks to be performed by venture capital finance in India, the size of the existing funds/schemes appears to be too small. It will, therefore, be desirable to broad-base the operations of existing venture capital funds and set up several new venture capital funds both in public and private sectors so as to take care of the current as well as forthcoming capital needs of entrepreneurs engaged in technological innovation and its exploitation.

Thirdly, these schemes are essentially in the nature of equity assistance schemes. They are not the full-fledged venture capitalists who could offer a broad spectrum of multi-faceted specialist services like the venture capitalists in the U.S. & U.K. Fundamentally, the venture capitalists should be actively associated with the firm right from its inception to operations & management. They should provide in addition to equity capital a comprehensive package of technical, commercial, financing and managerial success to the entrepreneurs and be in a position to offer innovative solutions to the varied problems faced by them in business promotion, technology transfer and innovation. To this end, venture capital funds should have at their disposal adequate resources & at their command multi-disciplinary technical expertise.

IV

Suggestions

Besides these drawbacks which are due to improper application of the venture capital concept, there are certain inherent limitations in the promotion of venture capital concept in India. The presence of some fiscal measures and institutional infrastructure is required before we take up the task of promoting venture capital financing. But the present fiscal system and institutional set up is not in accordance with the desired set up. Though, hundreds of professional and technical entrepreneurs wishing to set up their own projects in hi-tech areas are available providing scope for the growth of venture capital in India, conditions are not ripe enough for the growth of venture capital financing. Therefore, some suggestions have been made to cope with this inherent limitation.

First, tax policies need to be carefully scrutinised so as to provide for special incentives for risks the investors undertake in investing in the equity shares of new firms to enable the venture capital financiers as well as the enterprises assisted by them to attract more & more resources. In this regard, the following points need to be considered:

(a) The tax system should differentiate between the income earned on risky investments from that on risk-free investments. For this purpose, the relief under Section 80-CC of the Income Tax Act can be liberalised. That means this section should allow deduction in the taxable income of those people who invest in venture capital companies. This may be an added attraction for investments in such areas which can also facilitate resource mobilisation for the financiers. Also, this relief could be extended to investments by the venture capital companies in assisted enterprises.

(b) The tax system should offer concessions for compensating the non-receipt of dividend from new firms during their gestation period. One way is to exempt the dividend on venture capital investments. This exemption can also be extended for the dividend income earned by the share-holders of venture capital companies.

(c) Concessions on lines of Section 80-HAC should be permitted for venture capital group; say 50 per cent of such profits should be exempted from tax.

(d) Capital gains should be taxed at substantially reduced rates, since most of the earnings in venture capital financing are likely to be in the form of capital gains.

Secondly, there has to be some institutional arrangements which offer the venture capitalists the opportunity to offload their investments. Such arrangements include:

(a) An unlisted securities market in the country can be established to enable venture capitalists to easily disinvest their holdings. This could be achieved by allowing venture capitalists to sell securities over-the-counter at such market.

(b) Provisions of the Companies Act can be suitably amended. For example, provision regarding managerial remuneration requires relaxation bearing in mind the requirement of venture capital companies and their managerial personnel who would like to have appropriate reward or compensation for high risk. Similarly, Section 77 of the Companies Act, 1956, prohibits companies from buying their own shares. In a venture capital operation, when the venture capitalists wants to disinvest their holdings, the companies may have to buy their own shares as there may not be individuals to buy the shares. Hence, suitable amendments should be made in this section to permit companies buying their own shares in specified circumstances. The listing guidelines provide that atleast 60 per cent of the public issue should be offered to the public. This rule should be relaxed for venture capital assisted companies as private limited companies and at a later date may issue 20 to 30 per cent of the issue to the public and the balance to the promoters; this will enable venture capitalists to disinvest the shares easily.

Thirdly, provisions of adequate insurance facilities against the risk of assisted ventures will give fillip to sound and broad-based venture capital movement in India. Fourthly, an entrepreneurial tradition must be more broad-based and less family-based. This calls for imparting education and training in entrepreneurship to aspiring and potential entrepreneurs.

Finally, the Indian Partnership Act should be amended to permit the formation of limited partnership and the Income Tax Act should extend fiscal benefits, applicable to companies, to such partnerships also. This would be relevant as many venture capital companies may be formed as partnerships.

V

Conclusion

It is evident that there is a need for venture capital financing in India. There are vast opportunities for investing in connection with new ideas, new products and new processes. India has started experimenting with the concept of venture capital financing for accelerating her technological development. The success of the experiment, however, will depend on the right kind of fiscal and institutional environment.

However, venture capital financiers do not participate in pilot efforts, much less in R&D efforts & as a consequence their exposure to risk is less. So the actual venture capital financing is not in accordance with the basic concept of venture capital. Therefore, concerted efforts should be made to tap the full potential of this concept which can provide a significant impetus to the country's industrial and technological development.