Challenges in Venture Capital Industry

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Lately there has been a lot of buzz in the venture capital and private equity industry. The total Venture capital investments have touched $1bn during fiscal 2003-04 from $600mn last year. Venture Capital Funding in India in calendar year 2003 was in $500-600mn range, a sharp drop from $1.1bn in 2002 and $900mn in 2001. Post 'dotcom' bust the Venture Capital industry has started its recovery. The initial push had been provided by the BPO and ITES. The BPO industry has shelved itself at the top position in the Venture Capital portfolios. However, gradually the focus of investment is shifting from IT, software and BPO to other sectors as well like retail, power infrastructure and in those manufacturing industries, where India has become globally competitive.

The PricewaterhouseCoopers 2003 report on global private equity confirms this recovery. India is the fastest growing market in the world and the 12th biggest ahead of notable rivals like Israel and China. In last five years, the private equity investments have grown at an astounding rate of 82% CAGR, while the runner up Sweden did not give much competition and managed to achieve a CAGR of only 57%. However last year more than 60% of private equity flow was invested in non-technology sectors like banks, FMCG, pharmaceuticals and telecom. In the years to come, Real estate, BPO, Entertainment, Retail and Consumer sector, Manufacturing industries like textiles and auto ancillaries and Pharmaceuticals sectors will attract more investments from VCFs (Venture Capital Funds).

Venture Capital & Private Equity Characteristics

A Private Equity (PE) investment can be defined as an investment in a company with equity securities that are generally not publicly traded. PE firms focus on active private equity investments that enable it to acquire a large or controlling interest in a firm with solid growth potential. As a result, PE firms can oversee, assist and, if necessary, redirect the company's activities or its management.

PE refers to a wide range of alternative equity linked investments, including equity investments in unquoted companies for growth, expansion and acquisition; venture investing at early and late stages; large-size and mid-size buyout investing; restructuring and mezzanine financing, etc. PE also includes privately negotiated investments in public companies.

Historically, PE funds have significantly outperformed public equities and mutual funds over the long term. That is because an active PE investor can improve returns by, among other things, developing corporate strategies with management, implementing incentive programs for management and employees, and identifying appropriate add-on acquisitions. PE funds do not generally make passive investments involving limited participation in a company's operation. In such cases, the investor has little or no influence on management's direction of the company. Naturally, the investment increases in value if the company prospers. However, the passive investor has no ability to exert influence if the company loses direction and may watch helplessly if the value of the investment is declining. Hence, PE funds negotiate either a Board seat or supermajority rights, which ensure that they have a significant, say in the company.

PE contributes significantly in nurturing the growth of an economy's manufacturing; technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness.

Investments in the PE and VC funds are characterized by long-term perspective, relatively high risk, lack of liquidity (as there are no secondary markets where these investments can be traded), and difficulty in determining their valuations on a mark to market basis, as the underlying investments are not traded.

Venture Capital Challenges In India

Venture Capital Industry in India, since its inception in late 1980's has had limited players and the track record has not been impressive till recently. The industry in India is nascent and developing. There have been issues, problems and challenges, which have been there in the industry since its inception in late 1980's. These can be enumerated as under:

A) Problems in raising of funds:

The problem of raising funds has been the most basic issue facing the industry over the period of time. There are two broad sources under which the fund raising issue can be analyzed:

<u>Institutional Investors</u>

In USA primary sources of funds are insurance companies, pensions funds, corporate bodies, hedge funds and banks; while in India domestic financial institutions, multilateral agencies and state government

undertakings are the main sources of funds for VCFs. Allowing pension funds and insurance companies to invest in the VCFs would enlarge the possibility of setting up of domestic VCFs. Further, if the mutual funds are allowed to invest upto 5 percent of their corpus in VCFs by SEBI, it may lead to increased availability of fund for VCFs.

For instance, CalPERS, Americas' largest pension fund and the third largest in the world has assets amounting to $165.8 billion (31st March 03'), of which the allocation to PE is 7%, which is approximately $11.6 billion. Allowing Pension Funds to invest in venture capital makes sense. Other than being a source of funds, it also shares the long-term-focus aspect, which is fundamental to VCFs.

Institutional investors like Banks, as a class of investors in India has not been a regular source of funds to the PE Investments. Banks are known to be risk-averse and the poor track record of VCFs and lack of awareness has contributed to their non-participation. Also while the banks have been willing to contribute to the late stage PE funds, their interest in investing in early stage VCFs is very limited, as they find the risk levels unacceptable.

Individual Investors

VCFs are an asset class, which is quite complex, sophisticated and not easily understood. It requires skill and expertise to make investments in VCFs. Hence the high net worth individuals in India are hesitant to enter into the VCFs. Presently, high net worth individuals and corporates are not provided with any tax incentives in VCFs. The problem of raising funds from these sources further gets aggravated with the differential tax treatment applicable to VCFs and mutual funds. While the income of the Mutual Funds is totally tax exempted under Section 10(23D) of the Income Tax Act, income of domestic VCFs, which provide assistance even to small and medium enterprises is not totally exempted from tax.

All these factors, together contribute towards making raising of funds for venture capital activity difficult.

B)Limitations on structuring of Venture Capital Funds

VCFs in India are structured in the form of a company or trust fund and are required to follow a three-tier mechanism- investors, trustee company and AMC. A proper tax-efficient vehicle in the form of 'Limited Liability Partnership Act', which is popular in USA, is not made applicable for structuring of VCFs in India. In this form of structuring, investors' liability towards the fund is limited to the extent of his contribution in the fund and also formalities in structuring of fund are simpler. Moreover for the foreign investors coming to India, LLP would be a familiar structure and a comfortable vehicle to invest in. Hence the need for legal structures is essential (i.e. LLP's and LLC's) which are easy to create and liquidate.

Another issue, which needs to be addressed, is the ability of listed companies to issue shares of different classes and voting rights. VCFs seek preferred liquidity clauses globally, which are difficult to achieve in Indian context. Allowing the investors to buy into preferred shares with differential rights and the controls attached than common shares that are with the promoters would help exercising effective control in the investee company.

C) Limitations of investment instruments

As per the section 10(23FA) of the Income Tax Act, income from investments, only in equity instruments of venture capital undertakings, is eligible for tax exemption; whereas SEBI regulations allow investments in the form of equity shares or equity related securities issued by company whose shares are not listed on stock exchange. As VCFs normally structure the investments in venture capital undertakings by way of equity and convertible instruments such as Optionally/ Fully Convertible Debentures, Redeemable Preference shares etc., they need tax breaks on the income from equity-linked instruments.

Harmonization of SEBI regulations and income tax rules of CBDT would provide much required flexibility to VCFs in structuring the investment instruments and also availing of the tax breaks.

D) Limitations on Exit Mechanism

The VCF's, which have invested in various ventures, have not been able to exit from their investments due to limited exit routes and also due to unsatisfactory performance of OTCEI. The threshold limit placed by various stock exchanges acts as deterrent for listing of companies with smaller equity base. SEBI can consider lowering of threshold limit for public/listing of companies backed by VCFs. The exit routes available to the venture capitalists were restricted to IPO route. Before deregulation, pricing was dependent on the erstwhile CCI regulations. In general, all issues were under priced. Even now SEBI guidelines make it difficult for pricing issues an easy exit.

E) Legal framework

Certain regulatory issues, which can facilitate the development in the Venture Capital Industry, can be enumerated as under:

1. In order to encourage India based Asset Management Companies to manage assets of foreign investors, two important steps can be taken up. First, the Foreign Funds should not be deemed to have a permanent establishment in India if they are managed by Indian Asset Management Companies and second, the Indian Fund Managers should be given tax concessions for income received from fund management activity provided they have a certain minimum number of Indian Employees etc. This would attract foreign Asset Management

Companies to set up base in India for managing their funds across the globe and also open opportunities for Indians to gain access to and to work in global fund management industry.

2. VCFs are not permitted to invest in foreign securities, blocking the potential to realize gains from the sale of portfolio companies to foreign entities in a stock swap deals.
3. VCFs are not allowed to invest in other VCFs which if allowed would encourage the development of 'Fund of Funds' industry in India.
4. VCFs are not allowed to invest in legal structures like LLCs and LLPs, etc that would provide flexibility for VCFs to finance specific projects rather than take exposure on the entire operations of the companies.
5. The Corporate laws in India should be liberalized to permit companies, especially unlisted companies, to issue shares with different rights. This would provide the VC Funds and the companies flexibility in structuring the investments.

F) Private Investment in Public Companies

Certain regulatory issues need to be taken care of to encourage VCFs investments in listed Companies such as:

1. VCFs investing in listed companies through preferential allotment at a price higher than the price computed by SEBI formula should be exempt from takeover code, as this would allow VC Funds to provide more financial resources to the target companies for their business growth.
2. VCFs should not be classified as "deemed promoters" merely because its holding exceeds 15% as it is interested in the company as a financial investor. (The concept of 'deemed promoter' has been brought up by SEBI in one of its draft amendments to takeover code.)
3. Where a company has an identifiable promoter group, sale by one VCF to another VCF in excess of 15% of a company should be exempt as it is not transfer of control, and VCFs are financial investors and do not intend to control the management of the company.
4. Investments by VCFs in listed BIFR companies being restructured should be considered a part of the 25% minimum public holding required by such restructured companies to relist in the stock exchange.
5. VCFs investing in private placements of listed companies should be permitted to gain free access to price sensitive information required by the funds to complete their due diligence, subject to restrictions on trading in securities of those companies.
6. SEBI registered VCFs are not permitted to buy shares in the Secondary markets. VCFs cannot participate in management buyouts and other transactions that would require them to acquire shares from secondary markets.

G) Buyouts and Restructuring

PE has accounted for less than 1% of overall corporate buyout activity in India. Free access to assets, labour issues, and regulatory obstacles remain a bottleneck. In India, buyout deals are often seen as jolt to shareholder's interest and an act of hostility by the, while the western counterparts view it as an opportunity of creating wealth for shareholders.

Restructuring refers to infusion of capital into companies having operating profits but whose capital structure is overburdened with debt. In India banks and financial institutions have historically been averse to negotiating settlements where they took substantial write-downs. This in turn affected the possibilities of successfully restructuring companies through capital infusion by PE investors. But this is likely to change with the coming up of Asset Reconstruction Companies. Also with the NPA levels more manageable, now lenders are willing to take haircuts and reach settlements with investors.

H) Limitation on application of sweat equity and ESOP

In the US, an entrepreneur can declare that he has nothing much to contribute except for 'intellectual' capital and still finds venture capital investors backing his idea with their money. And when they come together, there is a way to structure the investment deal in such a manner that the entrepreneur can still ensure a controlling stake in the venture. In the US, the concept of par value of shares does not exist that allows the different par value shares. Absence of such mechanism puts limitations in structuring the deals.

Further, as per present tax structure in India, sweat equity and ESOP issued to entrepreneur and employees gets taxed twice at the time of acquisition and divestment. Tax incidence at two points involving undue hassles to allottees of sweat equity of individual, as a perquisite in its income, to the extent of 33 per cent defeats the entire purpose of its issue.

Conclusion

To summarize, it can be said that the Venture Capital industry has begun to come of age in India, given the increased investments and successful exits by Private Equity funds in the last 3 years. Though the investments in the Initial-Stage or Start-Up financing have more or less been stagnant, there is increased momentum in Late-Stage financing. Certain regulatory facilitations and the prospering economy are expected to act as a healthy breeding ground for Venture Capital Industry.