Supporting Entrepreneurship through Capital Markets

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Overview

In June 2013, Redbus was acquired by Naspers for around $100mn, marking the end of a long exit drought in the Indian start-up ecosystem since the Nasdaq IPO of Make My Trip in 2010. The transaction instantly turned Founder CEO Phanindra Sama and his Co-founders into multi-millionaires. Currently, there are several VC-funded tech companies in India that are clear candidates for multi-billion dollar exits over the next 12 to 24 months. These include MuSigma, Flipkart, and InMobi, to name but a few.

Successful entrepreneurial value creation, while strongly correlated with the idea, business model and execution capability of smart entrepreneurial teams, also requires financial resources. Whilst the financial resources required to scale companies has declined significantly over the last decade, especially for internet and digital businesses, successful businesses need significant funding over their lifecycle. In India, while quality human capital is cheaper than in western economies, the sheer size, diversity and structural inefficiency of the market imposes both obvious and hidden friction costs that can be significant over time.

The objective of this article is to explore various ways in which timely access to capital markets can enable great entrepreneurs to create great companies, thus creating significant wealth. This, in turn, generates the right conditions for some of that newly-created wealth to be funnelled back into the entrepreneurial ecosystem in the form of angel funding, thereby facilitating the creation of the next generation of successful entrepreneur-led companies. This can be a virtuous cycle as the Silicon Valley experience shows. In India, we are at the cusp of creating such a sustainable virtuous cycle.

Entrepreneurship and Capital Markets

As an entrepreneur starts out, he needs access to early risk capital. This is typically the riskiest capital in the lifecycle of the Company. Total loss of capital is likely. Such seed capital has historically not been available in a cash-strapped economy like India's, which made it all but impossible for first-time entrepreneurial aspirants to consider entrepreneurship. The bank loan market has been largely closed to Indian entrepreneurs without collateral. Unsecured bank debt remains extremely hard to access in India but the situation has improved slightly in recent years.

While there is now "non-dilutive" grant funding available from government and government agencies for start-ups engaged in solving important, complex problems touching upon national interest such as from the Biotechnology Industry Partnership Programme (BIPP) of the Department of Biotechnology from the Ministry of Science and Technology to eligible biotech start-ups, the vast majority of Indian start-ups are ineligible for this type of funding.

The insufficiency of available capital from the bank loan market and non-dilutive sources such as grant funding makes the existence of liquid, well-regulated, stable, private and public capital markets imperative. By the late 1990's as the gradual liberalisation of the Indian economy created surplus wealth that could in part be deployed towards backing exciting young entrepreneurs. This trend was further underpinned by the experience of NRI's who tasted success in the US knowledge economy and were returning to India with exciting scalable ideas and skill sets. The liberalisation of Indian capital markets that accompanied the reforms of the early and mid 1990's was critical as investors will only take risk if there is at least a theoretical likelihood of an exit via an IPO or sale of the Company to a strategic acquirer.

At the top of the funding funnel, there are now several established Indian angel groups such as the Indian Angel Network (IAN), the Mumbai Angels, Chennai angels, Hyderabad Angels etc, angel networks associated with alumni of institutions, private and corporate incubators, and several funds that focus on providing seed-stage capital such as Kae Capital and Blume Ventures. The individuals backing these pools of seed/angel capital tend to be seasoned executives and entrepreneurs with significant domain expertise and deep global networks in the knowledge economy,

which makes them extremely valuable partners for the entrepreneur seeking capital.
Once the entrepreneur scales his company to achieve significant operating and financial milestones, he appears on the radar of large institutional providers of private capital such as VC/PE funds. PE/VC funds will typically provide significant amounts of capital, take significant minority positions, and seek to provide deep operational and strategic support to scale the business towards an exit either via a strategic acquisition, an IPO, a promoter buy-back or a secondary sale of shares to another PE/VC fund.

According to the Bain India Private Equity Report (2014), between 2005 and 2013, India attracted total VC/PE investments of approximately $92.0 Bn. Over the same time period, total exits totalled $ 32.7 Bn, which strongly suggests that there has been significant wealth creation over the last decade for promoters and management teams. This conclusion is further bolstered by the fact that there are now 175,000 $ millionaire households and 284 households with assets in excess of $100mn in India (*'Riding a Wave of Growth: Global Wealth 2014' – BCG*)

While the Bain Report was published pre-election, prospects for a more benign exit environment have improved, with the IPO market coming back into the reckoning. The Report also highlights a deepening emphasis by PE funds on building operational teams to support portfolio companies' operating and market expansion plans. A deeper focus on governance is also highlighted. If these statements of intent by funds are actually implemented, we could see better exits, and more sustainable and greater wealth creation for investors and entrepreneurs alike over the next 3 to 5 years.

The Indian primary market has done a commendable job over the last 10 years in creating wealth for exciting first-time entrepreneurs and early employees while producing investable assets for the retail investor. A few illustrative, notable IPO success stories in the recent past are InfoEdge (2005), Genpact (2007), MakeMyTrip (Nasdaq 2010), and Justdial (2013)

Sanjeev Bikhchandani of InfoEdge and Deep Kalra of MakeMyTrip, in particular, have been prominent and highly active angel investors with the IAN for several years now, highlighting how the virtuous cycle of entrepreneurial wealth creation can arise and sustain.

Liquidity & Wealth Creation

While to an outside observer, exits may all look the same, the actual type of exit has important ramifications for founders and management. A mature, well-run company can choose to remain privately-held. In this case, over time as the Company grows, financing rounds led by existing or new PE investors may occur to accommodate primary funding needs of the Company and exit/liquidity needs of the existing PE investors and founders.

While it is not uncommon for PE investors to consent to founders gaining some liquidity in new financing rounds, these secondary founder liquidity events fall short of the kind of liquidity options an IPO represents for the founder. The crucial distinction is that in the case of an IPO, the founder's residual stock has liquidity which he can unlock (after the lock-in date) either by selling the stock outright or by pledging it as collateral to a bank to get the equivalent of a collateralised loan. In both instances, he is reducing his net exposure to his Company.

Typically, outright sales of stock are eschewed to avoid sending negative signals to the market (Ex: Infosys Founders). Stock pledging is a very common form of diversification for Indian founders though the success of this strategy is predicated on the stock appreciation being greater than the interest cost of servicing the loan. For wealth creation to result in the virtuous cycle as we described above, founders need to be able to unlock their wealth and diversify it over time.

Another approach is the Infosys approach wherein the Company conceived and maintained a well-defined and predictable dividend policy over many years that allowed founders and employees to unlock value from their shareholding every year without selling stock. For instance, for FY13-14, the Company has announced a dividend payout of 40% of net income. As promoters and their families comprise nearly 16% of the shareholding, this equates to a tax-free payout to promoters of nearly INR 700Crs. Some of this money will doubtless find its way back into the entrepreneurial ecosystem through various investment vehicles/family offices that the founders have set up in recent years such as Mr Murthy's Catamaran Ventures. It is well-documented that Mr Premji makes a proportion of his annual Wipro dividend available to his family office Premji Invest.

Infosys pioneered the broad-basing of equity ownership beyond its founders. Several hundred Infosys non-founder employees, both former and current, receive significant dividend payments from their Infosys stock every year, which many redeploy either by starting their own ventures or by becoming angel investors.

To get a sense of how powerful and transformative the virtuous entrepreneurial cycle can be, let us reflect on the experience of that quintessential Silicon Valley powerhouse Google.
Google was funded as a nascent idea by Andy Bechtolsheim (Founder of Sun Microsystems), and subsequently by Kleiner Perkins and Sequoia. This investment turned Bechtolsheim into a Billionaire, and he has gone on to invest in dozens of technology start-ups since. The sheer scale of Google's success created massive wealth events for not just the Founders but also for thousands of employees, many of whom have subsequently contributed some of that wealth and their knowledge to support start-ups in SV.

For instance, one of Aarin Capital's co-investors in Counsyl, a SFO-based clinical genomics pioneer, is Felicis Ventures, a respected SV- based VC fund founded by Google's first international product manager Aydin Senkut. Perhaps up to one-third of the leading angel investors in Silicon Valley have at some stage worked for Google. That is the power of networks and collaborative wealth creation. The key insight is that for virtuous cycles to flourish at scale, one needs broad-based wealth creation. In other words, not just the founders of break-out companies but also employees must have the opportunity to create significant wealth. Wealth begets Wealth.

In India, a sustainable entrepreneurial virtuous cycle is finally emerging. The emergence of the Indian angel investor is a healthy signal with successful entrepreneurs such as the Flipkart Bansals and Ronnie Screwvala of Unilazer Ventures showing willingness to pay their wealth and knowledge forward by providing angel funding to technology start-ups. Further accentuating this trend, the recently launched ExFinity fund seeks to act as a strategic partner to its investee companies by providing operational and strategic support and not merely capital. ExFinity has been promoted by seasoned and proven technology business leaders, which serves to provide credibility to their stated value proposition.

One critical area that needs attention is the creation of alternative exit paths for investors. SEBI must take the lead and create conditions that make it easier for founders, investors and employees to monetise their equity. The onerousness of pursuing an IPO listing in India makes it an unviable option for all but a handful of companies, which heightens the challenge for pure play financial investors to exit profitably.

In that context, the decision by SEBI in 2013 to approve the amendment of regulations to permit listing of startups and SMEs in a separate Institutional Trading platform (ITP) without having to file for IPO's is a promising move as this can boost liquidity options for early investors and VC firms. Access is restricted to 'informed investors' with the minimum amount for investment on the ITP as Rs 10 lakh. Eligible companies need be less than 10 years old with revenue of less than Rs 100 crs and more than Rs 25 Crs of paid-up capital. They also need to have raised investments of at least Rs.50 lakh from an alternative investment fund, VC fund, or angel. Small companies that have received project finance from a scheduled bank can also list on the ITP after three years and full utilization of funds. SEBI has however not yet given an official time line for implementation.

Companies will be exempted from the standard requirement to offer up to 25% of share capital to the public. This reduces the cost burden whilst allowing the Companies to dilute less, and raise more later potentially at higher valuations. Apart from providing exits to early investors, the ITP can also help with price discovery such that later financing rounds via private placement involve less negotiation. Another potential benefit is that listing on the ITP allows company shares to qualify as collateral, providing further headroom to equity holders for diversification while retaining upside.

While it may be tempting to believe that the ITP will evolve into an institutional trading market for shares of young companies, which can potentially create a broader retail investor base beyond angel investors and VC firms who typically make such investments, access to retail investors should be restricted at least initially until the platform stabilises and proves its value. It also appears unlikely that sufficient two-way liquidity will be available to provide exits to VC funds with larger holdings. While the ITP is a step in the right direction, SEBI should consider the creation of a (regulated) marketplace along the lines of AIM (London) that combines some of the benefits of the ITP with greater two-way liquidity (especially on the buy-side). Greater two-way liquidity is critical to creating the right environment for retail investors to enter the market as they typically suffer the most due to the information asymmetry inherent in illiquid markets.

On a heartening note, the current trend within technology start-ups in India, particularly product companies, is to reserve between 5% and 15% of the share capital for ESOP awards to employees. This should hopefully lead to massive, unprecedented broad-based wealth creation 5 to 7 years hence when the exits occur. Indeed, as successful VC-funded companies such as MuSigma, InMobi, and Flipkart hopefully navigate towards successful exits over the next 12 to 24 months, the most meaningful data point to track to predict the evolution of our ecosystem may well be how much non-founder employees make!