SEBI's important role to bridge India's job deficit

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The telephone took 75 years to reach 50 million users. Radio took 38 years. Television took 13 years. Facebook took 1 year. The mobile phone game Angry Birds took 35 days. Since the time the telephone exchange was invented in 1876 for people to communicate with each other easily to the time Facebook was founded for ostensibly the exact same purpose, the time taken to "achieve scale" has been compressed from 75 years to 35 days. In a striking example of this in our own country – Tata Consultancy Services, India's largest private sector employer took 40 years to employ 2 lakh people. Ola Cabs, a three year old upstart employs 2.5 lakh drivers across 120 cities and town. This very notion of scale and speed is what defines that seemingly all-encompassing term – StartUps. Technology plays a critical role in helping these companies achieve such gargantuan scale in lightning speed. Much has been written and talked about India's mobile phone penetration and the speed at which that happened. In this new paradigm of "babies to adults", capital allocation and flows to these companies are as crucial as use of technology.

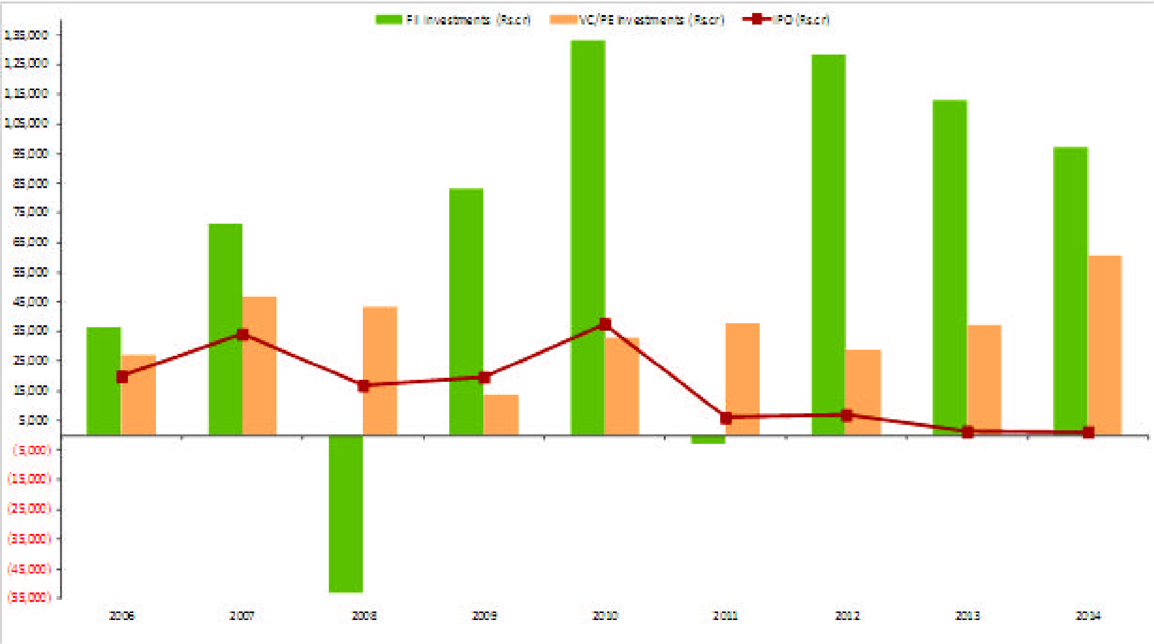
The numbers and slangs are now well known – Rupees 3 lakh crores ($60bn) invested in roughly 3000 startups in the last decade. India is already the third largest Start Up ecosystem in the world, boasting of more than 15000 StartUps. 40% of these StartUps are in the city of Bengaluru. A relatively new form of financing called 'venture capital' has been the catalyst behind this Start Up boom. More than 90% of funding in StartUps is by foreign venture capital funds. StartUps in India received nearly 50 times more venture capital in 2015 vis-à-vis 2000. In 2015, venture capital investments in India were higher than net foreign investments in stock markets, for the first time in history, leaving out the global financial crisis years. Venture capital financing for Indian Start Ups have grown at a compounded rate of 30% over the last 15 years. That there is a thriving and growing private venture capital industry for providing risk capital to Start Ups in India is very evident. StartUps that are valued at more than a billion dollars are called unicorns. 8 out of the 107 unicorns in the world are India originated or domiciled. These StartUps range from food technology in idlis (ID Foods) to space technology (Lunar X).

Prime Minister Narendra Modi through his StartUp India initiative has now ensured this StartUp boom is no longer one of India's best kept secrets. To be sure, this spurt in venture capital backed StartUps began during the UPA days of Dr. Manmohan Singh. StartUp India initiative is a rightful recognition of the inordinately important role of the venture capital and private equity asset classes in India's economy. It is also a rightful recognition of the unique needs of these classes of companies that thrive on technology, innovation and scale. Yet, the lingering question is what should the government do to foster start-ups, if any.

The $60bn in venture capital funding over the last decade in over 3000 new StartUps is three times more than the funding that 350 companies have received through our stock markets via IPO in the same period. It is nearly half of all money invested by foreign investors in big companies in the stock markets. If we assume that these 3000 companies on average employ 100 people directly and an additional 50 indirectly, that is 4.5 lakh (0.5mn) new jobs in the economy. Most of these are innovative companies with disruptive technologies that create new markets. The business models of these companies are unique, tend to be revenue focused rather than profits in its first decade of existence and do not fit the traditional valuation frameworks. All of this has been fuelled predominantly by foreign venture capital and private equity flows. These venture capitalists traditionally generate their returns through public listing of these companies in the stock exchanges. These returns then typically get routed back to funding newer start-ups and the cycle continues. However, the bottleneck for this virtuous cycle in the Indian context has been the near demise of the IPO markets. Illustratively, one company, Ola Cabs has received Rs.4200cr ($700mn) in venture capital funding to provide jobs to more than 2 lakh drivers across 100 cities and towns of India in less than two years. This is more than what the entire IPO market raised over the last two years put together, which was Rs.2500cr ($400mn). This bizarre imbalance between large amounts of venture capital and a drought of IPOs, over the past decade has been bubbling up and threatens to blow over if not addressed imminently. There were both regulatory and market factors contributing to this malaise.

The erstwhile SEBI framework for IPOs required a stringent definition of promoters, profitability conditions, detailed articulation of use of IPO proceeds, long lock-in periods, textbook justification of valuation etc. These were incompatible with today's venture capital backed fast growing start-ups. SEBI was quick to recognise this incongruence. SEBI launched a revamped set of rules for IPOs of this new category StartUps that removed or modified all the hurdles to listing of StartUps in India. This new framework has lightened up rules regarding promoter definition, profitability, valuation rationale, market making restraints and has allowed market forces to determine these. This new platform for venture backed new economy businesses will continue to be overseen by SEBI and will see wider participation by institutional investors without exposing retail investors overtly to the high risk nature of such companies. This new framework should enable these venture capital funded StartUps to access the IPO markets, provide exits to their investors which in turn can be funneled into newer companies.

To be sure, IPOs have performed terribly over the past decade with nearly 80% of the 350 IPOs since 2000 under-performing the broader index, which can be attributable to lofty valuations, poor diligence by merchant bankers and greedy entrepreneurs. But these are market factors that are to be addressed by market forces. SEBI has done well to ease the regulatory hurdles to uncork the pent up venture capital backed IPO demand bubbly.



Amid all the acrimonious cacophony on the state of the economy, the true picture of GDP figures, lack of economic reform etc., all of this raging rhetoric can be capsuled down to one core issue – ability to generate jobs. A FDI in retail debate is a debate about jobs. A land acquisition problem is a problem of lack of jobs. That sweeping phrase “economic reform” in its roots is about jobs. That India needs legitimate jobs of all shapes, sizes, colours and origins is an incontestable idea. It is well established that nearly 60 million micro and small enterprises employ 120 million people but is still not enough. On a smaller but a very crucial scale, the venture capital asset class has been slowly and quietly de-clogging capital constraints to create hundreds of thousands of direct and indirect jobs over the past 15 years. It is imperative to let this asset class flourish so they can nourish newer companies that can grow fast and generate millions of jobs. That will be possible only when we see more StartUps providing good returns to these venture capital funds through an IPO in the stock market. SEBI’s reforms in this aspect are extremely laudable. It is now time for StartUp promoters, merchant bankers, stock exchanges and venture capital funds to make full use of this relaxed framework to launch more StartUp IPOs.

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