Venture Capital - Issues And Challenges & Varhad Incubation Model

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Introduction
The earliest discussion of venture capital in India came in 1973, when the government appointed a commission to examine strategies for fostering small and medium-sized enterprises (Nasscom 2000). In 1983, a book entitled Risk Capital for Industry was published under the auspices of the Economic and Scientific Research Foundation of India (Chitale 1983). It showed how the Indian financial systems' operation made it difficult to raise "risk capital" for new ventures and proposed various measures to liberalize and deregulate the financial market. The government's awakening to the potential of venture capital occurred in conjunction with the World Bank's interest in encouraging economic liberalization in India. So, in November 1988, the Indian government announced an institutional structure for venture capital (Ministry of Finance 1988) the investments made by Venture Capitalists consisting:

- Financing new and rapidly growing projects, enterprises or companies.
- Buying equity and other securities.
- Taking high risk expecting high return on investment.
- Having a long frame of time period, normally of more than 5 to 6 years.
- Marketing and promotions of the product/service being offered

SME private equity and venture capital funds
Venture capital is a means of equity financing for rapidly-growing MSMEs. Venture capitalists provide funds after carefully scrutinising projects. Their main aim is to earn higher returns on their investments, but their methods are different from traditional lenders. They take active part in the management of the company as well as provide the expertise and qualities of good bankers, technologists, planners and managers. As funds required by SMEs are too large for microfinance institutions and too small or too risky for commercial banks, this is one of the primal issues that the PE/VC component addresses as part of the investment promotion of the consolidated project for SME development in India.

Advantages of VC funding
Venture capital has a number of advantages over other forms of finance: It injects long-term equity finance which provides a solid capital base for future growth. The venture capitalist is a business partner, sharing both the risks and rewards. Venture capitalists are rewarded by business success and capital gain. The venture capitalist is able to provide practical advice and assistance to the company based on past experience. The venture capitalist also has a network of contacts in many areas that can add value to the company, such as in recruiting key personnel, providing contacts in international markets, introductions to strategic partners, and if needed, co-investments with other venture capital firms when additional rounds of financing are required.

Mode and criteria for investment
Venture capital provides financial assistance primarily by way of equity or equity-linked capital investment. It also endeavours to provide mentoring support and other value addition to enable funded companies to achieve rapid growth and achieve and maintain their competitive edge in domestic and international markets. The VC fund seeks a strategic stake in the funded companies with board representation and other rights as venture capital investor.

Key criteria for SME project selection are as follows:
- Strong and committed core team
- Growth potential
• Long-term competitive advantage
• Viable business plan
• A clear exit plan

**Startup, SME Ecosystem**

Most important part of Startup ecosystem is its capital requirement and VCs are bloodline. The report ‘Breaking the Village Capital’ states that the investors from India and Africa use a “one size fits all” model of venture capital - made for Silicon Valley - style consumer technology companies - to invest in markets that operate under an entirely different set of rules. As a result, investment tends to flow to entrepreneurs with strong preexisting networks, and those without are left on the sidelines. Entrepreneur needs resources to scale up its operation when customer acquisition becomes less costly. In India, despite active investment landscape, in the past two years, only five of the startups that have raised follow-on investment are focused on the underbanked. Question here is why haven’t tier II companies attracting investment if the market is positive.

Although a universal working definition of MSE has not been achieved, these businesses show universal characteristics (Hatten, 2012; Mbithi and Mainga, 2006; Sandu [1997, cited in Lobontieu, 2001). Micro and small businesses;

a) Are often owner-managed with few employees,
b) Are labour intensive because of low absorption of technology,
c) Have unpredictable cash flows and uncontrolled costs,
d) Are flexible, and
e) May advance to more sustainable businesses

**Startup ecosystem consists of:**

- Ideas, inventions and research
- Startups at various stages
- Entrepreneurs
- Startup team members
- Investors
- Mentors
- Advisors
- Other entrepreneurial people
- People from related organizations

India has 10000+ startups, is amongst the top five countries in the world in terms of startups. US ranks number one on the list with 83,000+ startups.

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>Technology based startups</th>
<th>Non-Technology based startups</th>
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<tbody>
<tr>
<td>E-commerce</td>
<td>33%</td>
<td>Engineering - 17%</td>
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<tr>
<td>B2B</td>
<td>24%</td>
<td>Construction- 13%</td>
</tr>
<tr>
<td>Consumer internet</td>
<td>12%</td>
<td>Agri products- 11%</td>
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<tr>
<td>Mobile apps</td>
<td>10%</td>
<td>Textile - 8%</td>
</tr>
<tr>
<td>SaaS</td>
<td>8%</td>
<td>Printing &amp; packaging – 8%</td>
</tr>
<tr>
<td>Other</td>
<td>13%</td>
<td>Transport &amp; logistics - 6%</td>
</tr>
<tr>
<td>TOTAL NOs</td>
<td>4,300</td>
<td>Outsourcing &amp; support – 5%</td>
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<tr>
<td>New startups annually</td>
<td>800</td>
<td>Other – 32%</td>
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<td>NA</td>
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Financing of MSMEs

MSMEs require timely and adequate capital infusion through term loans and working capital loans, particularly during the early and growth stages. Historically the MSMEs have relied on following sources for financing their needs:

Retained earnings, funding through sale of assets, Ancestral capital, personal savings, loans from relatives, loans from unregulated market, Institutional financing from scheduled commercial banks, Venture capital funds/ seed funds

Among the formal financial institutions, commercial banks constitute the largest source of financial assistance for the MSME sector at about 87% as of 31st March 2011. The key issues identified by the task force, and subsequently taken up by the Planning Commission in the 12th plan are as follows

Incubation

An incubator’s main goal is to produce successful firms that will leave the program financially viable and freestanding. These incubator graduates have the potential to create jobs, revitalize neighbourhoods, commercialize new technologies, and strengthen local and national economies. The earliest incubation programs, in the 1980s, in the United States of America focused on a variety of technology companies or on a combination of light industrial, technology and service firms – today referred to as mixed-use incubators

The TBIs in India have been quite successful over the last decade, with over 500 companies and organisations successfully graduating from their incubators to create tangible home grown impact on their local as well the national economies. However, the challenges faced by them such as a lack of sufficient follow up mentorship, continuing corruption and bureaucratic red tape, etc. continue to prevent them from achieving their fullest potential.

Incubators services

Many researchers have tried to find the service and facilities that need to be utilized by incubators in order to increase the success rate of their tenants. Incubators provide various range of services and despite the fact that incubated firms receive five times as many business services as their non-incubated firms (Stokan et al., 2015), it is still unknown which services have more impact than another, specifically regarding LoN and LoS. Services are termed as the value added in the incubator industry which means to those specific strategies that an incubator program enhances the ability of its tenants to survive and grow in business (Allen et al., 1990).

Regarding the services that incubators provide, the following are among many that are depicted in literature: strategic, value-adding intervention system (i.e. business incubation) of monitoring and business assistance (Hackett and Dilts, 2004a).

Researchers have identified three main group of elements, which seeks to provide the infrastructure for supporting the development of new technology-based firms, which are business, technical and social inputs. Usually incubators provides shared office services, business assistance including affordable rent and fostering connections with inside the incubator and in the local economy.
(Mian, 1996a). These value added contributions has been summarized by Mian (1996a) in Table below.

<table>
<thead>
<tr>
<th>Typical incubator services</th>
<th>University related services</th>
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<td>Shared office services</td>
<td>Faculty consultants</td>
</tr>
<tr>
<td>Business assistance</td>
<td>Student employees</td>
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<tr>
<td>Access to capital</td>
<td>University image</td>
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<tr>
<td>Business networks</td>
<td>Library services</td>
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<tr>
<td>Rent breaks</td>
<td>Labs and workshops</td>
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<td></td>
<td>Mainframe computers</td>
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<td></td>
<td>Related R&amp;D activity</td>
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<td></td>
<td>Technology transfer programs</td>
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<td></td>
<td>Employee education and training</td>
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<td>Sports and social activity</td>
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**Possible impact of startup incubators**

Startup incubators are companies that assist new startups in their initial phase of development by providing various services. Incubators share both tangible and intangible resources such as equipment, office space, services such as accounting, computing and legal services. They also assist startups in raising startup capital and perform various networking activities to reduce the financial burdens and resource issue. Incubators help entrepreneurs in building sustainable business environment while benefitting the broader corporate communities.

**Issues & Challenges**

Though funding in 2016-17 looks quite encouraging but there are issues. The various issues and difficulties of venture capital financing are as follows:

- Requirement of an experienced managerial team
- Requirement of high rate of return on investment
- Payback period is normally long
- Uncertainty regarding the success of the product in the market.
- Problems and issues regarding the infrastructure details of production like plant location, accessibility, relationship with the suppliers and creditors, transportation facilities, labour availability etc.
- The category of potential customers regarding products and service offerings.
- The size of the market
- Major rivals and their market share.
- Financial considerations like return on capital employed (ROCE), cost of the project, the Internal Rate of Return (IRR) of the project, total amount of funds required, ratio of owners investment (personnel funds of the entrepreneur), borrowed capital, mortgage loans etc. in the capital employed the investments made by Venture Capitalists consisting;
  - Financing new and rapidly growing projects, enterprises or companies.
  - Buying equity and other securities.
  - Taking high risk expecting high return on investment.
  - Having a long frame of time period, normally of more than 5 to 6 years.
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The results of study ‘Sustainability Issues for Start-up Entrepreneurs’ by Hildegard Schick, Sandra Marxen and Jürgen Freimann University of Kassel, Germany provide an insight into the intricacies associated with sustainable considerations in intervention in the entrepreneurial process in order to create an increasingly sustainable business culture.
Tim Mazzarol in his paper ‘Strategic Management of Small Firms: A Proposed Framework for Entrepreneurial Ventures’ states in comparison to the Fortune 500 companies, the majority of small firms lack formal business plans and a coherent approach to strategy formulation (A study of 364 small firms over their life cycle identified several common problems experienced at different stages of growth and development. These findings suggest that owner-managers face significant problems with cash flow management, accounting and inventory controls during the early years of the firm’s existence. As the firm grows in scale and scope the owner-manager is required to adapt both their managerial practices and organisational structures as the overall complexity of the business increases (Dodge & Robbins, 1992). Small firms have been viewed as the well-spring of new innovation, generating many of the key products of the past 100 years (NCOE, 2000), and continuing to produce many of the most radical innovations (GEM, 1999; Timmons, 1998). A strong small firms sector is viewed as important to the sustainability of innovation within a modern economy (Stringer, 2000).

The study done by ‘Memba S. F. Gakure W. R. Karanja K’ demonstrated that use of venture capital can be profitable in Kenya even in an inauspicious political and economic climate. The study concluded that SME that use venture capital experience improved growth and thus more SMEs should be encouraged to use this form of finance if the country has to achieve its vision 2030. Lack of access to credit is a major constraint inhibiting the growth of SMEs sector. The issues and problems limiting SMEs They further added that acquisition of financial services include lack of tangible security coupled with inappropriate legal and regulatory framework that does not recognize innovative strategies for lending to SMEs. Limited access to formal finance due to poor and insufficient capacity to deliver financial services to SMEs continues to be a constraint in the growth and expansion of the sector. Formal financial institutions perceive SMEs as high risk and commercially unviable As a result only a few SMEs access credit from formal financial institutions in the country. Venture capital not only assists SME in the provision of funds but also in the internal operations of the business especially in policy formulation. Therefore venture capital has demonstrated the business case for SME investment. Nurturing them at crucial junctures in their development and laying the foundation for an emerging generation of locally owned large enterprises. The fact that venture capitalists have exited from 50% of the SME, this has assured many managers the concern about losing control of their businesses.

Seyed Pedram Mireftekhari’s findings show that the incubated firms studied suffer from both the liability of newness (LON) and smallness (LOS). The external liability of newness was found to be more of an issue than internal. This implies that incubators need to help entrepreneurs convince external stakeholders about the potential of the new venture and overcome their lack of a track record and legitimacy. Incubators in this study have been moderately successful in helping startups overcome the liability of newness and smallness. Technical and business assistance, recruitment, networking services had more of an effect than other services in respect to LoN and LoS. In his thesis he suggest that this can be improved by providing networking services, creating specialist incubator that focuses on specific industry, and using experienced, competent and connector team at incubator staff. In conclusion that, incubator is (Mian et al., 2016, Sherman and Chappell, 1998):

- Shared office space, which is rented under more or less favorable conditions to incubatees: flexible space, shared equipment and administrative services.
- A pool of shared support services to reduce overhead costs and obtaining capital
- Professional business support or advice (‘coaching’)
- Network provision, internal and/or external such as building management team
- Leverage incubation support
  - Work with players in the ecosystem that provide expertise in development of product and services beyond the prototype and marketing it effectively to the global players.
  - Develop relationships with technology development/ implementation firms that will act as SI partners during product implementation
In The News

In the Indian startup ecosystem, Stayzilla, TVF, and Uber, in Q1 2017, 214 Indian tech startups raised about $1.46 Bn in funding. As compared to 2016 it was a 25% jump in the number of deals and 122% jump in total funding raised, as compared to the last. Early 2017 saw Indian startup ecosystem multiple deals of over $1 billion, with Flipkart, Ola and Paytm part of the billion-dollar club following a $1.1 billion fund raised from Tencent and SoftBank. Some of the big ticket deals in the quarter include Paytm, Delhivery, and Ola.

Ten companies in India have mopped up almost $8.5 billion in equity funding in 2017. Considering all equity deals put together amounted to $12 billion (across 653 deals), the top 10 companies cornered 70 percent of the entire funds raised by startups this calendar year. Flipkart, Ola and Paytm are obvious examples of trend where big companies get maximum of venture fund. Oyo may not have reached the stage of a Flipkart or an Ola, but the funding it has received puts it in that bracket.

China, India and South-East Asia, the three largest venture capital markets in Asia, together accounted for 42% or $53.8 billion of the total capital deployed during the nine months under review. The three markets continue to grow their share of the global investment pie year-on-year.

![Investment Avenue](chart)

- **INVESTMENT AVENUE**
  - The $9.6 billion investment by venture capitalists so far this calendar year is more than double the capital raised during the same period last year and almost level with the $10.5 billion raised in all of 2015, a peak year in terms of funding activity.
  - **No. of deals**
    - Jan-Mar: 130
    - Apr-Jun: 200
    - Jul-Sep: 170
  - **Value ($ bn)**
    - Jan-Mar: 1.6
    - Apr-Jun: 2.6
    - Jul-Sep: 3.2

- **Stage**
  - **2015**
    - Angel/Seed: 220
    - Series A: 230
    - Series B: 59
    - Series C: 13
  - **2016**
    - Angel/Seed: 245
    - Series A: 64
    - Series B: 40
    - Series C: 12
  - **2017**
    - Angel/Seed: 162
    - Series A: 358
    - Series B: 458
    - Series C: 272

VC interest in India was relatively strong during 2016, although deal making was slower than in 2015. The government introduced initiatives aimed at clarifying rules and regulations for startups in an effort to make it easier for companies with new business models to understand what they could and could not do in the country. The positive growth in India’s startup ecosystem has likely led to the growth of VC investments being made by successful Indian entrepreneurs, in addition to the increase of established professionals leaving their corporate jobs to start new business ventures. To put 2016’s performance in overall venture activity in context, the 859 completed financings of India based companies that year represents no less than 70% more than the total recorded in 2014 and a 296% increase over the 290 in 2012.
Minister of State for Finance Jayant Sinha had also noted that 90 per cent of funding, at present, comes from foreign venture capitals and domestic financiers could change the nature of innovation as well. A study by Grant Thornton revealed that in 2015 more than 600 such companies got funding, with over $2 billion deployed by PE and VC funds.

**Critical Analysis**

Report by Village Capital found that investors are hesitant to invest because they (often justifiably) see companies in these markets as much riskier investments than alternative sectors or geographies. But also found that investors in East Africa and India use a “one size fits all” model of venture capital - made for Silicon Valley - style consumer technology companies - to invest in markets that operate under an entirely different set of rules. As a result, investment tends to flow to entrepreneurs with strong preexisting networks, and those without are left on the sidelines. Thus, It is primarily seen that pedigree (elite schools), networking matters most to Big VCs to fund the known companies. These elites collect almost 80% of fund. This vicious network is taking toll of other 20%, thus, literally killing the competition through massive discounts. So, the competition is only for 2 or 3 big companies serving 1.25 billion people.

**How to make India great again: Varhad Incubation Model**

Following suggested model which focus on IIE – Innovation, Incubation, Entrepreneur (see below fig) is a step by step evolution model which starts from incubation to ETF.

**VARHAD INCUBATION MODEL**

![VARHAD INCUBATION MODEL Diagram](image)

**Selection of start-ups:**

Quantitative analyses will be done by all 4 investment committee members who come from very diversified backgrounds e.g. academia, sector expert, financial expert and compliance/legal expert. Every investment committee member to assign score of 1 to 5 on 20 parameters i.e. total score is 100. The start for incubation would be selected on final score of out of 400.

**Democratic Funding Platform:**

We will have sector specialized incubation centres so that industry experts as well as academia can support the start ups the best. Every incubation cum accelerator to have industry mentors who are also trying to venture into similar sectors. The funding platform of the Varhad Capital can support a seed fund of equal amount to all selected start ups. We could fund as much as 1,000 start ups a year through our 20-25 incubation centres.

**The Accelerator:**

The business accelerator expected to help start ups to get the first order to move from the proof of the concept to the revenue positive. Then EBITDA positive by giving the purchase order to scale the operations. This can be done for b2b companies. Similarly, our network could help b2c start ups to
scale to EBITDA positive as soon as possible through orders created by the network. This will enable the start up to be an SME capable of listing on ITP or SME platform of BSE/ NSE. We should be scale up 500 start ups at business accelerator with a simple success ratio of 50%.

SME/ ITP listing: the EBITDA positive company could be listed on the platform by raising INR50-250 million that could be enough to scale to the next level. If we have 500 start ups with EBITDA positive level, then we may be able to list all of them at ITP or SME platforms as appropriate depending on market conditions. If we exit through this route, we should be able to make IRR of 25%+ within first 2-3 years rather than waiting for 10 years.

**Exits:**

We should be able to exit 20-25% companies successfully through ITP/ SME routes. Our 4 cohorts per year for the particular technology will expose graduates and youth towards the technology start ups. This will continue the supply of start ups to all of our incubation centers across the nation.

Retail investors: Considering the high risk associated with SMEs and technology start ups, retail investors not encouraged by SEBI in India. But we can give some exposure to retail investors through ETF by choosing 100 successful and liquid start ups, that were listed by us. An index could be tailor made and massive retail participation could make ETF as well as constituent stocks pretty liquid. Through this route we could raise INR100-250bn for series C kind of funding through the private placement to HNI or VC investors. The platform ours could bring in funding to 4-5 start ups a day and that’s the way of funding thousands of start-ups democratically in a nation of 1.3 billion people.

**Conclusion**

Pangs of startups will never end irrespective of any model. To minimize such a situation government with the help of entrepreneur, industry & subject experts should improve and democratize model where maximum of start-up receive funding. Rather than concentrating to the priviledge few, a mass model- Varhad Incubation Model has to be adopted for the success of Make in India, Start up India like initiatives.

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