Post-investment Monitoring Practices of Indian Venture Capital Firms

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ABSTRACT

Venture capital is a distinguished form of financing as compared to other traditional modes of finance and the paper attempts to study the monitoring and value added practices of Venture Capitalists empirically in the Indian context.

The study begins with a brief review of earlier research work on venture capital financing activities which enabled to develop a conceptual framework and a a comprehensive research instrument for capturing relevant information on monitoring and value addition activities of Indian venture capital firms. Consistent with the objectives of the study and a robust research methodology. The research instrument comprises of 30 statements on Likert scale to elicit the perceptions of the Chief Executives of 82 Indian Venture Capital firms on critical issues such as strategic role, nature of monitoring and value added activities such as knowledge sharing and mentoring etc. The study being exploratory in nature uses qualitative approach for analyzing the information gathered.

The study finds that a significant majority (80%) of the respondents agree on matters such as membership on the Board, specialist venture capitalists (sectoral/funding stage) and positive effect of over monitoring, while there is larger perception divergence regarding providing more finance than agreed upon; information needs of venture capital firms and the extent of monitoring by them. Further, it has also been observed that the nature and type of monitoring (project based or content based) and value addition activities of Indian venture capital firms are similar to their peer firms in developed countries despite large dissimilarities in the scale and scope of economies.

The study has been conducted across the sectors and hence the practices and perceptions are aggregate in nature. However, future research on similar lines may be directed towards sector/domain specific practices and perceptions.

The paper attempts to empirically study the monitoring and value added activities practiced by Indian Venture Capitalists. A brief literature review of the monitoring activities in the context of developed countries has been presented leading to the development of a conceptual framework. Data on the monitoring and value addition activities of the venture capitalists was gathered through

A questionnaire consisting of 30 statements using Likert Scale of 1 to 5 was developed to gather information on the monitoring and value addition activities of the Indian venture capitalists. The statements attempt to elicit the perceptions of the Chief Executives of 82 Indian Venture Capital firms on many critical issues such as strategic role, over monitoring, knowledge sharing and mentoring etc. An analysis of the perception based information led to the conclusion that the monitoring and value added activities in the Indian context are more or less similar to that of developed countries as evidenced in the literature review despite dissimilarities in content and scale. The paper concludes with a few suggestions and for further research in venture capital financing domain.

Keywords: venture capital, Post-investment, monitoring, value addition, portfolio.

1. Introduction

Venture capital is a very distinguished form of financing as compared to all other traditional modes of finance. All the other financial intermediaries eg., banks, institutional or stock market investors assume a passive role while making the financial contribution in the different ventures, whereas the venture capitalists as a financial intermediaries take for granted the active role they play in the management of the enterprise. They may show a little reticence while interfering in decision making but hawkish monitoring of the performance of the enterprise is considered norm of the day. This is a given due to the huge business and financial risks venture capitalists assume on one hand and inexperience of the nascent, young, growth oriented ventures (bereft of tangible assets but having deeply invested intangibles) need on the other. Venture capital firms possess a very keen competence in selecting potentially promising ventures and once invested get very actively and skillfully involved in the ventures. The post investment process has been well researched and documented in the context of developed countries like USA and European countries.

1.1 Venture Capital Financing: Indian Scenario

India, currently a USD 3.3 trillion economy, has witnessed significant growth in venture capital financing during the past decade in terms of number of venture capital firms (both domestic and overseas VCFs), total venture capital fund size and geographical dispersion of the venture capital firms across the metro cities of the country and sectors - information technology, e-commerce business, healthcare and biotechnology firms etc.

The growth in venture capital finance (CAGR of 8% approximately) is also due to a number of factors such as increasing costs of traditional finance (institutional finance, stock market options and Public policy initiatives of the Government of India (Make in India, Start-up India etc.).

Further, it is observed that 90 to 95 percent of the venture capital financing has been in the form of preference equity with voting rights (Seema and Javaid, 2019). There exists an industry association of Venture Capitalists in the form of "Indian Private Equity & Venture Capital Association". India is pursuing ambitious economic growth plans and aims to achieve USD 5 trillion by the 2025 and the venture capital financing activity is likely to grow further in the next couple of years.

Abundant literature is available on venture capital finance including its monitoring methods in the form of research studies, articles and books in print and digital mode. Much of the available literature is in the context of developed countries, but not much literature in the domain of venture capital is available in the Indian context, though it is witnessing an increasing trend of venture capital financing in recent years and hence this study.

The present paper, focuses on the post-investment, but pre-exit phase practices of Indian Venture Capital Firms (VCFs), particularly on the interaction between VCFs and their entrepreneurs (portfolio companies). The primary focus is on the content and processes of the interaction and how these two emerge in the context of interactive dimensions.

1.2 Objectives of the Study

The study has the following objectives:

(a) To review some of the existing literature on venture capital financing and monitoring methods.

(b) To empirically study the venture capital financing and monitoring practices employed by Indian Venture Capital Firms:

2. Literature review

The existing literature into research shows a very distinct categorization in the aspects of VCs' involvement in *monitoring* activities and VCs' potential to *add value* to the portfolio companies. However, research focused on exploring the actions of VCs (Tyebjee and Bruno, 1984; MacMillan et al., 1988; Rosenstein, 1988), what roles do they play and what contribution do they make in these roles. The existing literature exhibits a kaleidoscopic variety on both counts: i.e., what actually the VCs do (i.e. content related) and actually how do they do it (i.e. process related) (Gorman and Sahlman, 1989; MacMillan et al., 1988). Of late, the body of the research work concedes that the contribution of VCs' monitoring and the extent and impact of value addition by them seems to be two dimensional. It is driven by both, the characteristics of ventures undertaken as well as that of Venture Capital firms itself.

Whereas the earlier researches laid more emphasis on the contribution made by VCFs towards the ventures and how this contribution maximizes the returns on investments, the precise dimension of *how* the value addition is created in the process of interaction between the two parties remained

under-studied, both with respect to what type of information is exchanged (i.e., content-related issues), and how the parties interact with one another (i.e., process-related issues).
Michael (1989) in his study of 100 venture capitalist firms reported that they use up almost fifty percent of their time monitoring nine portfolio firms; of these, in five firms they (VCs) represent themselves on boards. In the remaining four, they devote 80 hours of on-site time and 30 hours of phone time per year to keep in direct touch with these firms. The three most frequent services carried out by the VCs were raising additional financial resources, carrying out strategic analysis and recruiting the management. The survey also revealed that Venture Capitalists replaced an average of three CEOs during their careers and they very often considered the weak senior management to be the principal reason of venture failure.

Harry (1992) posits that larger the degree of innovation involved in the venture, the higher the frequency of contact between the lead Venture Capitalist and the entrepreneur, and the increased openness in the communication, the lesser the degree of divergence of viewpoints among the duo, the greater was the value derived from the involvement. Subsequently the value of venture capitalists' involvement was also found to be strongly positively correlated with performance of ventures.

The inferences from the dynamics of the VCs involvement are as follows: (1) value derived from involvement may differ with varying circumstances; (2) the effectiveness of VCs’ is high for those who maintain frequent, open communications while minimizing conflict; (3) opportunities value addition subsist in all ventures. Thomas and Manju (2000) examine the representation of venture capitalists on the boards of private firms in their portfolios. If venture capitalists are intensive monitors of managers, their involvement as directors should be more intense when the need for oversight is greater.

Andy et.al (2003) suggested a framework for portfolio management in terms of monitoring and value addition activities by Venture Capital Firms. Erik (2008) analyzes how an entrepreneur and an external investor allocate revenues and control among themselves and finds the predominance of preferred stock and convertible instruments in a venture capital relationship. Josh (2010) examines the representation of venture capitalists on the Boards of private firms in their portfolios companies.

Max et.al (2016) discuss the utilization of an internal control prediction market in the process of monitoring of venture capital financing. Arguably, venture capitalists (VCs) contribute immensely in the promotion of innovation and growth of portfolio firms. Shaiet.al (2016) confirm that venture capitalists’ (VCs) in-situ association with their portfolio firms leads to better understanding of companies’ activities, thus enabling increased innovation and the probability of a successful exit.
Dirk and Sophie (2017) highlight the existence of goal incongruence in conjugation with information asymmetry between the two parties, VCs and entrepreneurs, which may impact the periodicity, quality and the outcomes of interaction between them.

3. Methodology

Following the brief literature review presented above, a conceptual framework has been developed and the same is presented below in Figure 1:

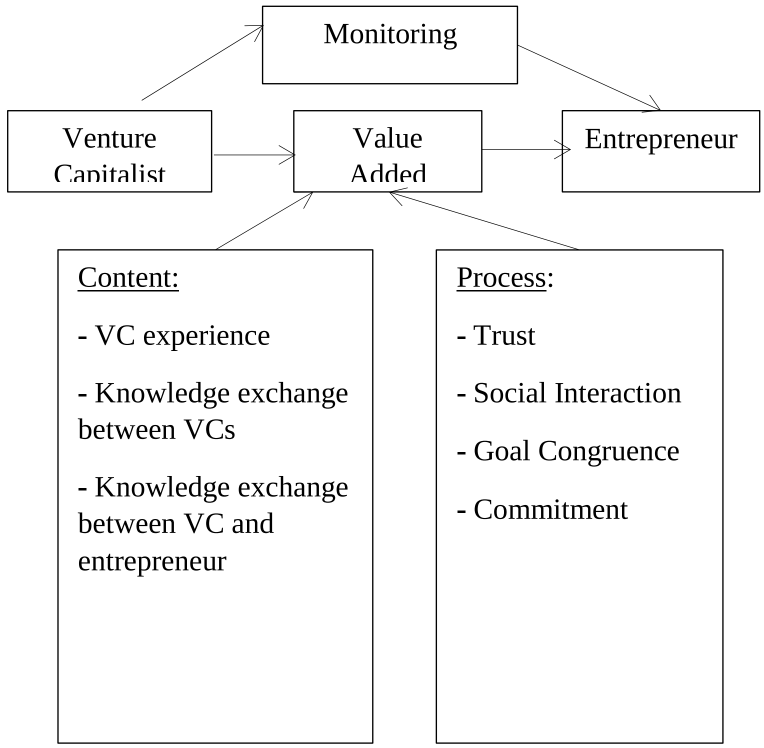

Figure 1: Conceptual Framework of Venture Capitalist Monitoring and Value Added Activities

Currently (end of 2019), 195 Venture Capital Firms registered with Securities Exchange Board of India (SEBI -, the regulator of Venture Capital Finance in India), out of which 135 are active and the rest are dormant.

Consistent with the objectives of the study and the conceptual framework presented in Figure1, the following methodology has been followed:
A Questionnaire consisting of 30 statements related to strategic role, information related to monitoring and value addition activities of venture capitalists. The statements are rated on Likert Scale of 1 to 5 (1, being Least likely to Agree and 5, being Most likely to Agree). The Questionnaire was emailed to the Chief Executives of all the 135 active venture capital firms (considered as Population for the study). Out of the 135 Questionnaires emailed 89 filled in Questionnaires were received back. However, only 82 Questionnaires were filled in completely and the 7 Questionnaires which were incompletely filled in were not considered for the study and hence the effective sample for the study is 82, which corresponds to 7% Margin of Error and 95% Confidence Level.

The respondents (CEOs of Venture Capital Firms) are required to rate each statement on the Likert Scale of 1 to 5 with the following rated values:

Most Likely Not Agree (MLNA, Value 1)
Not Agree (NA, Value 2)
Neutral (N, Value 3)
Likely to Agree (LA, Value 4)
Most Likely to Agree (MLA, Value 5)
The study being explorative in nature, no Hypotheses are formulated. The study aims at understanding the managerial practices followed by venture capital firms in India and compare with that of international practices documented in the literature. The study concludes with suggestions for further research.

4. Analysis and Discussion

The analysis of the Statements and Responses is presented in Table 1, given below:

Table 1: Responses Statement wise

No	Statements	No. of Responses				
		1 MLNA	2 NA	3 N	4 LA	5 MLA
1	Venture Capitalist (VC)–entrepreneur relationship IS about VC monitoring the entrepreneur's activities to keep track of VC investment and value added services provided by VC.	4	6	8	28	36
2	Representation on the Board empowers VC to ensure that the Portfolio firm carries out its business in a manner that serves the best interests of all its stakeholders.	6	12	7	25	32
3	As Board members, VCs get updates on business performance and strategic issues regularly.	2	3	12	27	38
4	As Board Members, VCs are empowered to seek all information including that of confidential (financial, technical and competitors etc.).	3	7	6	30	36
5	The provisions of the Contract/MOU entitles VCs to receive annual budgets, business forecasts, interim financial reports and audited financial statements.	6	8	8	30	30
6	In order to keep track of the performance vis- a- vis the pre-determined goals, VCs request additional information along with the interim financial statements.	6	6	6	22	42

No	Statements	No. of Responses				
		1 MLNA	2 NA	3 N	4 LA	5 MLA
7	VCs frequently call, send emails and visit their portfolio firms in order to gain additional management insights.	4	8	6	27	37
8	Informal communication by VCs with portfolio firms leads to useful information about business progress.	11	15	14	26	16
9	Periodic (Quarterly, Half yearly and Annual) Portfolio review sessions are conducted to assess portfolio firm's prospects, progress and current value.	6	10	6	27	33
10	Based on evaluation of performance and future prospects, a VC may alter the portfolio firm's strategy, initiatethe changes in the management team and search for a strategic partner.	4	7	23	28	20
11	If a VC perceives that a particular sector is showing more potential as compared to others, the VC may supplement more investment in the firm	16	19	10	18	19
12	The type of information sought by Venture Capitalists depends upon the stage and sector of a portfolio firm.	2	8	18	26	28
13	Generally, besides financial assistance, to add value to the portfolio company, VCs provide for networking with outside managerial talent, outsourcing agencies and important customers.	29	16	10	17	10
14	A learning relationship between VC and entrepreneur facilitates exchange of knowledge and expertise which will lead to value addition to the partnership.	14	12	18	22	16
15	The information needs of VCs varies/depends on the implementation stage of the venture - pre-revenue generation, revenue generation and Break-even stages.	21	17	12	21	11
16	VCs opt for diversification in order to reduce financial risk.	8	4	10	28	32
17	VCs are inclined to develop competence in a particular vertical or a particular development stage.	4	7	5	26	40
18	VCs' specialization has a positive effect on their (VCs) overall portfolio performance.	8	12	14	20	28
19	VCs' competence in a particular vertical makes it difficult for portfolio firms to suppress the strategic information regarding company performance	10	11	16	22	23
20	Entrepreneurs (Portfolio Companies) accept significantly lower valuations and higher dilution, if the VC has a better reputation and is expected to contribute more to the development of their venture.	9	13	12	28	20

No	Statements	No. of Responses				
		1 MLNA	2 NA	3 N	4 LA	5 MLA
21	Over monitoring reduces agency problems (conflicts between VC and entrepreneur).	2	4	4	32	40
22	Over monitoring increases costs due to greater involvement and governance	12	7	10	21	32
23	Intensive monitoring by VCs can be avoided by having detailed contracts or equity control as agreed upon prior to the investment decision.	9	13	8	28	24
24	Portfolio companies are not comfortable with over monitoring by VCs due to increased costs of information reporting.	24	16	12	12	18
25	VC monitoring has positive outcomes and leads to effective corporate governance resulting in quality reporting in financial statements from the perspective of external stakeholders.	18	22	8	15	19
26	Effective communication between the VC and entrepreneur will lead to understanding of information needs of each party and thus will lead to Goal congruence.	16	12	9	18	27
27	VCs opt to stagger their investments stage-wise in order to reduce the investment risk.	8	4	5	28	37
28	For the Portfolio firms, value adding services compensate for the high cost of Venture Capital.	18	14	9	15	26
29	It is commonly understood that there are two approaches to monitoring portfolio companies -- Project based (or Content based) and Process related. The monitoring approach depends upon the type of venture,	11	17	12	26	16
30	The trust between VC and Portfolio Company is important for success of the venture. The monitoring methods and value added services of VCs will help to build the trust between both the parties.	10	12	8	28	24

Responses Most Likely Not Agree (MLNA) and Not Agree (NA) are bunched together and are considered as Unfavorable (UF) Category, Neutral Responses are considered as Neutral Category. Responses Likely to Agree (LA) and Most Likely to Agree (MLA) are bunched together and are considered as Favourable (F) Category and the same is presented in Table 2 given below. The percentages indicate the endorsement of the respondents for a particular statement,

Table 2: Responses Category wise

Statement. No.	UF (%) Category	N (%) Category	F (%) Category	Average Score
1	12	10	78	4.0488
2	22	9	70	3.7927
3	6	15	79	4.1707
4	12	7	80	4.0854
5	17	10	73	3.8537
6	15	7	78	4.0732
7	15	7	78	4.0366
8	32	17	51	3.2561
9	20	7	73	3.8659
10	13	28	59	3.6463
11	43	12	45	3.0610
12	12	22	66	3.8537
13	55	12	33	2.4880
14	32	22	46	3.1707
15	46	15	39	2.8049
16	15	12	73	3.8780
17	13	6	80	4.1098
18	24	17	59	3.5854
19	26	20	55	3.4512
20	27	15	59	3.4512
21	7	5	88	4.2683
22	23	12	65	3.6585
23	27	10	63	3.5488
24	49	15	37	2.8049
25	49	10	41	2.9390
26	34	11	55	3.3415

Statement. No.	UF (%) Category	N (%) Category	F (%) Category	Average Score
27	15	6	79	4.0000
28	39	11	50	3.2073
29	34	15	51	3.2317
30	27	10	63	3.5366

A graphical representation of the data presented in Table 2 is presented in figures 2 to 7 given below:

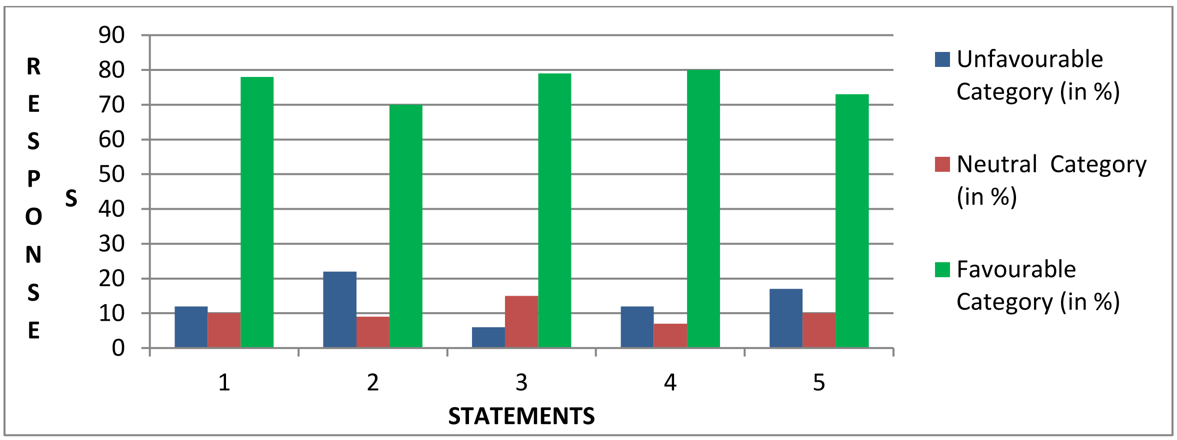

Figure 2: Response Profile of the statements 1 to 5

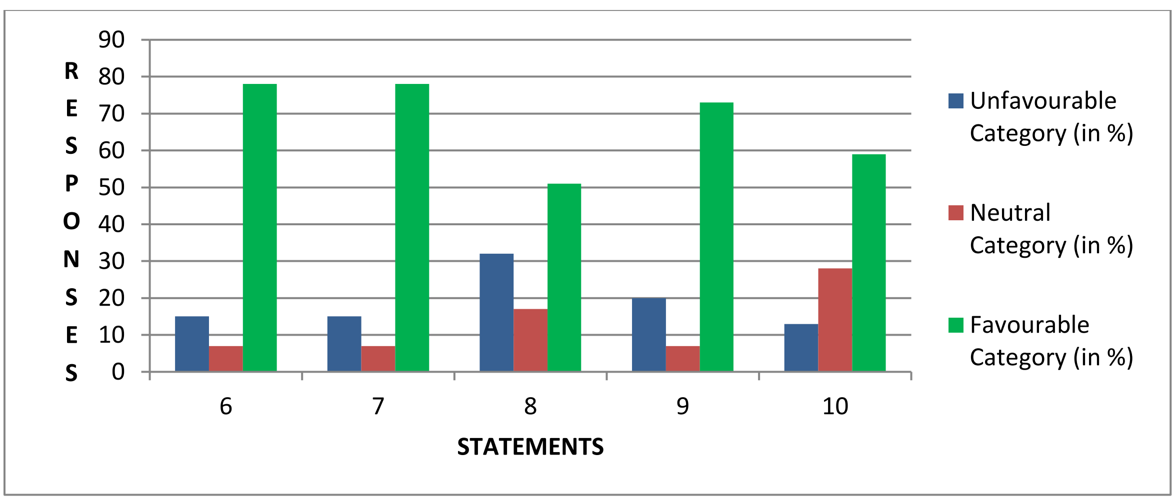

Figure 3: Response Profile of the statements 6 to 10

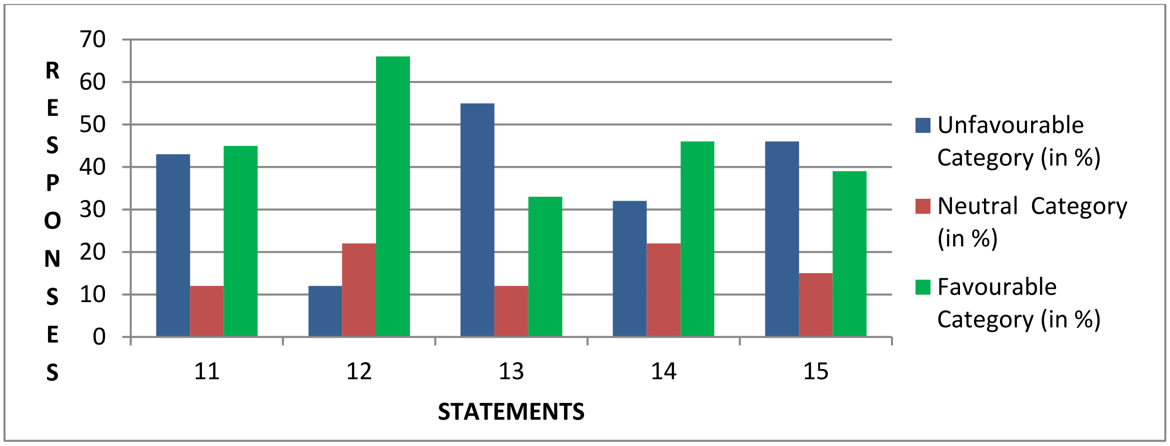

Figure 4: Response Profile of the statements 11 to 15

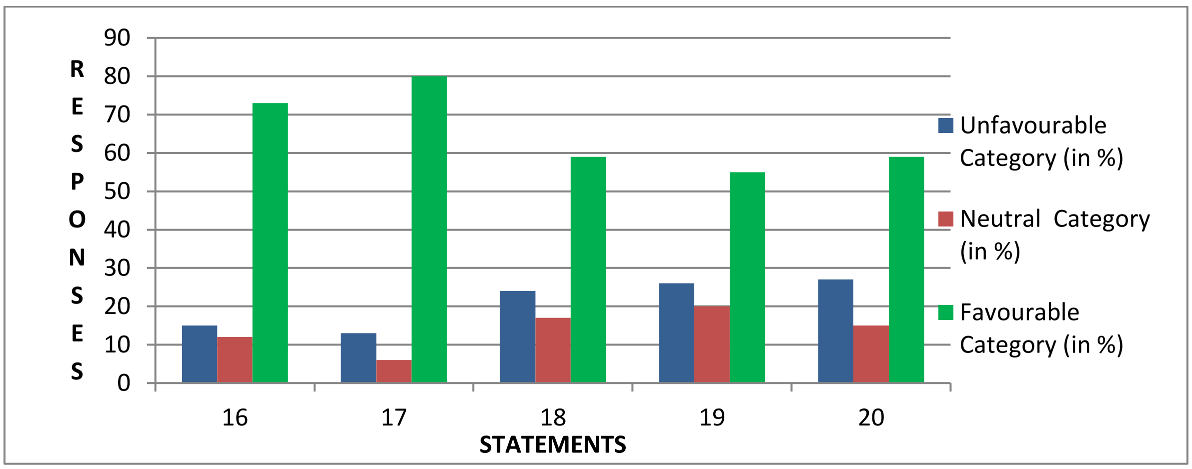

Figure 5: Response Profile of the statements 16 to 20

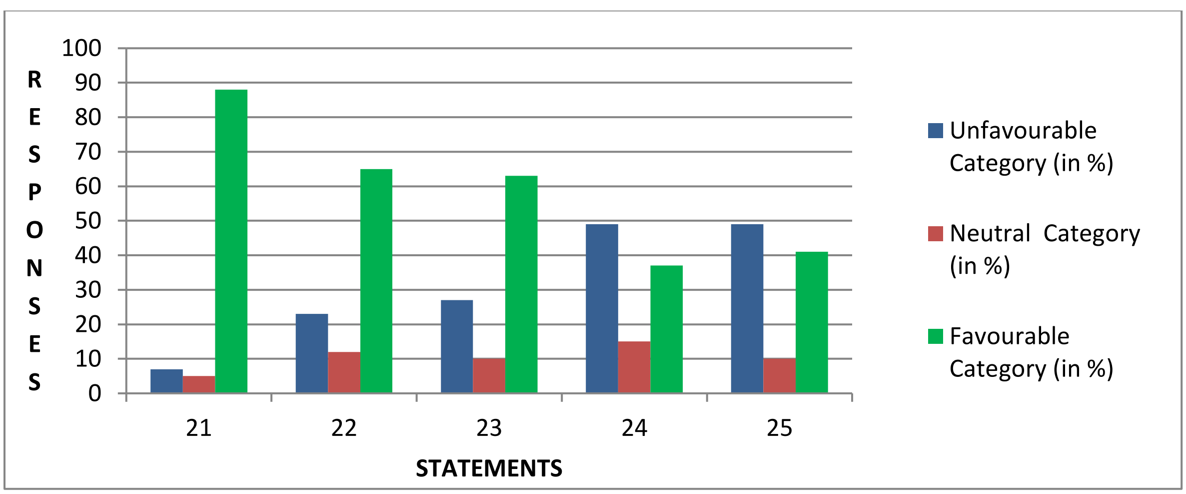

Figure 6: Response Profile of the statements 21 to 25

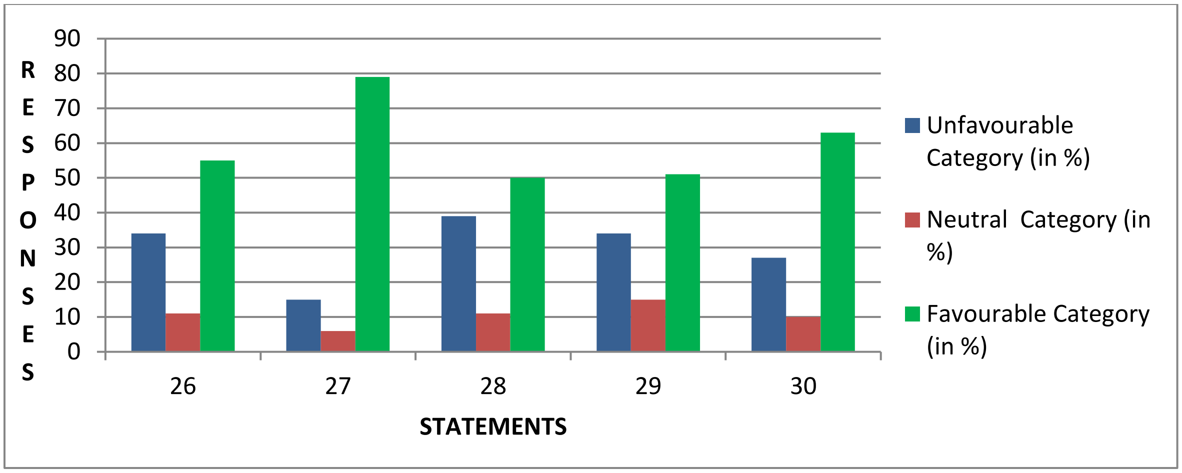

Figure 7: Response Profile of the statements 25 to 30

It may be seen from the above (Table 2), that out of 30 statements barring 6 statements (11, 13, 14, 15, 24 and 25 have less than 50 percent endorsement), the remaining 24 statements have been broadly endorsed by majority of the respondents (having endorsement of 50 percent and above). The respondents' perception is divided (less than 50% endorsement) regarding additional investment, value added services, learning and exchange of knowledge, information needs and monitoring effects which are critical to the success of the venture

There is near unanimity (greater endorsement) among the respondents (80 percent and above) regarding Board Membership (statement 4), Specialist VCs (statement 17) and positive effect of more monitoring by VCs (statement 21). Rest of the statements in this category or self-explanatory on similar lines.

It may be observed that over one fifth (1/5) of the respondents had been Neutral in their responses regarding informal communication (statement 8), strategy change (statement 10), learning relationship (statement 14), VC specialization (statements 18 and 19).

Analysis of the Unfavorable category responses indicates that more than half of the respondents did not respond favorably to statements pertaining to additional investment (statement 11), value added services (statement 13), Portfolio companies not being comfortable with more monitoring by VCs (statement 24)) and VC monitoring has positive outcomes and leads to effective corporate governance in portfolio companies (statement 25).

Analysis of the total values scored by each statement indicates that 8 out of the 30 statements, each have a total value more than 4, leads us to surmise that the respondents have broadly agreed these statements, since a value to Most Likely of over 4 falls in the spectrum of LA (Likely to Agree) to MLA (Most Likely to Agree).

18 out of the total 30 statements, that is, 60% of the statements, each have a value more than and is falling the spectrum of 3 (Neutral) to 4 (Likely to Agree),it may be understood that the respondents generally endorse these statements.

A little over 10% of the total statements (4 statements) each have values ranging between NLA (Not Likely to Agree) to Neutral. The statements pertain to Value Added Services (statement 13). Information needs (statement 15), over monitoring (statement 24) and monitoring for better governance. It may be inferred that the respondents hold a contra view to these statements.

5.0 Conclusion & scope for further research

The analysis of monitoring and value added activities of Indian Venture Capitalists presented above is more or less in line with their peers of developed countries despite having several dissimilarities, This study focused on across the sectors and there is ample scope for future studies to focus on sector specific (for example Information Technology, Health Care, Biotechnology etc.) monitoring and value added activities performed by Indian Venture Capitalists.

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