A STUDY ON

"VENTURE CAPITAL"

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ABSTRACT

In this chapter, we introduce venture capital, a subset of the private equity asset class that focuses on investments in new or growing privately-held companies with high potential. We specifically address why venture capital markets exist; what the different venture capital models are; what venture capitalists do; how venture capital investors influence the development of their portfolio companies; and how venture capital as an asset class creates value for investors. For this purpose, we rely on an extensive and growing, but largely fragmented, stream of research on venture capital from respectively the finance, entrepreneurship and management fields.

KEYWORDS: Venture capital; information asymmetry; business model; value chain; portfolio company performance; venture capital fund returns

INTRODUCTION

Although private equity currently represents a major component of the alternative investment universe (EVCA, 2004; Metrick and Yasuda, 2011), its functioning is not always well understood. Private equity refers to unregistered equity and equity linked securities sold by private (and sometimes public) companies or partnerships to financial buyers. It encompasses an array of investment activities, including venture capital, buyout financing or restructuring capital. Venture capital is hence a subset of private equity and specifically refers to equity or equity linked investments made for the launch, early growth or expansion of companies. It is distinctive from buyout which refers to investments in more mature companies with established business plans to acquire equity stakes from existing shareholders such as families or corporates (EVCA, 2004). This chapter is exclusively dealing with venture capital, thereby leaving the discussion of buyout investments for Chapter 13. Driven by technological developments in ICT, Internet and biotechnology, the venture capital industry experienced an extraordinary growth over the last decades and is now broadly accepted as an established asset class within many institutional portfolios worldwide (EVCA, 2004). Funds committed to venture capital increased dramatically from $2.3 billion in 1990 to a record of $104.8 billion in 2000 in the United States (NVCA, 2011). While the burst of the Internet bubble halted this phenomenal development, funds committed to venture capital still equaled $12.3 billion in 2010 (NVCA, 2011). Similar trends are observed in Europe and Australasia, where venture capital markets have grown significantly over the last decades. China, for

instance, nowadays represents one of the fastest growing venture capital markets in the world (Ahlstrom et al., 2007). In addition, while the venture capital industry had long been a local industry, the last decade has witnessed a remarkable growth in the international flows of venture capital worldwide (Alhorr et al., 2008; Meuleman and Wright, 2011; Manigart et al., 2010). As local markets become increasingly competitive, venture capital investors have broadened their geographic investment criteria to include overseas companies so as to increase their portfolio diversification and search for higher returns. In Europe, for instance, the share of inflows of venture capital from non-domestic sources was just over 50% of the market between 2005 and 2009 and the share of total outflows accounted for by cross-border investments equaled close to 35% of the market over the same time period (EVCA, 2010). 3 In this chapter, we review the academic literature on venture capital. While we do not minimize the importance of the numerous research papers that have studied various aspects of venture capital over the past decades, we have decided to emphasize some key questions. We apologize in advance to the researchers not cited. More specifically, we address the following questions: why do venture capital markets exist; what are the different venture capital models; what do venture capital investors do; how do venture capital-backed companies perform and how does venture capital as an asset class create value for investors? For some other excellent surveys on venture capital see, for instance, Sahlman (1990), Barry (1994), Berger and Udell (1998), Wright and Robbie (1998) or Metrick and Yasuda (2011). Our review of the literature is distinctive from these previous studies in that we combine insights from the largely fragmented finance, entrepreneurship and management literatures.

WHY DO VENTURE CAPITAL MARKETS EXIST?

vidence on the financing of entrepreneurial companies indicates that most of their financing needs are addressed by traditional sources of financing, such as internal finance (including retained profits and owner funds) and bank finance (e.g., Berger and Udell, 1998; Brav, 2009; Cosh et al., 2009; Ou and Haynes, 2006; Vanacker and Manigart, 2010). One of the most fundamental questions to ask is hence why entrepreneurial companies need a specialized set of investors such as venture capital firms? Put differently, why do venture capital firms exist as separate financial intermediaries? Venture capital investors have a comparative advantage over traditional financing sources, such as banks and public equity investors, in working in environments characterized by high information asymmetry and high uncertainty (Amit et al., 1998; Chan, 1983). The main reason why venture capital firms exist is their superior ability to reduce the cost of informational asymmetry related to investing in entrepreneurial companies and their ability to display investment strategies that allow them to cope with high uncertainty. 4 Two types of informational asymmetry may arise in an entrepreneur - investor relationship: "hidden information" and "hidden action" (Amit et al., 1998). Hidden information refers to the fact that parties hold different information. A classic example of hidden information is the lemons problem (Akerlof, 1970). In the market of used cars, for instance, well-informed sellers generally have more information on the quality of their car compared to less informed buyers, who can only assess the average quality of cars on the market. Given the information disadvantage of buyers, they are only willing to pay the price charged for average quality cars. But sellers of above average quality cars have no incentive to sell at average prices and withdraw from the market, thereby lowering the average quality

of the cars still offered for sale. Hidden action refers to the fact that parties cannot fully observe each other"s behavior. A classic example of "hidden action" is the behavior of car insurance buyers (Pauly, 1968). Insurance companies cannot force owners to be careful because car owners" actions are largely unobservable. Insurance buyers, however, will act in their own self-interest and probably neglect the interest of insurance sellers, for example, by not caring about their car as much as they would in the case they were not insured.

REVIEW OF LITERATURE

A Study on Determinants of Investment Decisions: Venture Capitalist's Perspective by Prashant T. Patil, Dr. V. N. Sayankar, and Dr. Madhulika A. Sonawane. (2016), Venture Capital industry in India is growing faster due to favourable economic conditions and conducive business environment. Entrepreneurial background, idea / product viability, business sustainability and competition are the major determinants on demand side considered by VC firms in screening of proposal for investment. And finally the study also reveals that investors are looking for managerial control in the venture where they are going to invest as their investments are at risk in early and growth stage of investments. Groh, A. P. and Von Liechtenstein, H. (2011), contributed to the knowledge of the capital flow from institutional investors via venture capital (VC) funds as intermediaries to their final destination, entrepreneurial ventures. They found the top criteria to be the expected deal flow and access to transactions, a VC fund's historic track record, entrepreneur local market experience, the match of the experience of team members with the proposed investment strategy, the team's reputation, and the mechanisms proposed to align interest between the investors and the VC funds. Selvakumar and Ketharaj, (2009) has given the inherent strength by way of its human capital, technical skills, cost-competitive workforce, research and entrepreneurship. India can unleash a revolution of wealth creation and rapid economic growth in a sustainable manner. There is a need for risk finance and venture capital environment which can leverage innovation, promote high-fi technology and harness knowledge based ideas. Subbulakshami (2004) has published an edited volume on venture capital industry in India. The book compiles various research articles in relation to the role of venture capital in fostering entrepreneurship leading to overall economic growth. The origin and the regulatory framework of Indian venture capital industry as well as the development of venture capital in US, Taiwan and China. Kumar and Kaura (2003) this study found out that a sustained effort was continuously required in the target market which was highly meticulous. This research concluded that Indian venture capitalists do not seemed to be biased in favor of high technology ventures and also the numbers of successful ventures were not hi-tech. Mason and Harrison; (1999), Mishra et al.; (2005) venture capital plays a key role in the entrepreneurial process by providing equity capital and managerial support for young, rapidlygrowing, high risk and high tech private companies with the potential to develop into significant global businesses. Fried and Hisrich (1994) described that venture capitalists eliminate the proposals that are unable to meet the venture capital firms' investment criteria. Some ventures were previously unsuccessful in certain sectors, and seems generally unpromising. Some quick and broad criteria were frequently used to select the deals that will be later on subjected to an in-depth evaluation. Bygrave and Timmons, (1992) the nature of venture capital process involves transactions between investors (limited partners), venture

capital firms (general partners) and the portfolio companies/entrepreneurs was highlighted in this study.

OBJECTIVES OF THE STUDY:

1. To get a new insight and to be familiarize about venture capital funds.
2. To identify the top ten performing Venture Capital funds in India.
3. To know about the present scenario of venture capital funds in our nation.
4. To analyze growth of venture capital investment in different sectors of our economy.

METHODOLOGY OF THE STUDY

F-test (One Factor Model): This statistical tool will assist in accomplishing the above mentioned objectives that is whether there is a significant difference or not in the number of Equity-Backed deals by Regions, i.e. North America, Europe, Asia and Rest of World during the period 2006-15 and selected sector-wise investments in India during the period 2010-2015. The selected sectors are: Information Technology; Telecommunications; Services Sector and Industry Products. Analysis of Time Series (Method of Semi-Average): With the help of this method it will be helpful to comprehend the trend of investments by Venture Capital Funds and Foreign Venture Capital Investors during the period 2010-2015 in four selected sectors of Indian economy Information Technology; Telecommunication; Services Sector and Industry Products.

THEORETICAL FRAMEWORK

Entrepreneurship and its significance The theory of entrepreneurship has been substantially researched by many people. Bull and Willard (1993), based on a detailed review of literature in the field, have classified the entire discussion about entrepreneurship into five broad categories. The first category is concerned with the definition of the word 'entrepreneur'. The second category analyses the psychological traits of people identified as entrepreneurs (trait approach). Another is the study of success strategies and reasons for success of enterprises. The fourth category is the studies on the formation of new ventures and the last category examines the effect of environmental factors on entrepreneurial actions. Webster's Dictionary defines an entrepreneur as "the organiser of an economic venture, especially one who organises, owns, manages, and assumes the risk of a business". On similar lines, Oxford Dictionary states that an entrepreneur is "a person who starts or organises a commercial enterprise, especially one involving financial risk".

A widely accepted definition of entrepreneurship has been the one suggested by Schumpeter. While discussing the fundamental phenomenon of economic development in his seminal work (1934), Schumpeter explains the destabilisation process of equilibrium in the economy. He argued that economic development emerged when "new combinations appear discontinuously". According to him "new combinations might include : (i) the introductions of a new good, or a new quality of a good, (ii) the introduction of a new method of production, (iii) the opening of a new market, (iv) the conquest of a new source of supply of raw materials or components, or (5) the reorganization of any industry"5. While discussing the organising function Schumpeter states that the carrying out of new combinations is called

"enterprise"; and the individuals whose function it is to carry them out is called "entrepreneurs".

The term 'entrepreneur' was defined for the first time by Richard Cantillon (1755). He observed that the entrepreneur is someone who exercises business judgment in the face of uncertainty. Drucker (1985) defined entrepreneurship as an act of innovation that involves endowing existing resources with the wealth-producing capacity. Leibenstein (1968) sees the entrepreneur as one who marshals all resources necessary to produce and market a product that answers a market deficiency. On the similar lines, Kirzner (1985) describes the entrepreneur as one who perceived profit opportunities and initiated action to fill currently unsatisfied needs or to improve efficiencies. A host of authors have defined entrepreneurship. However, many of these definitions appear to be complementary rather that competitive, each seeking to focus attention on some different features of the same phenomenon.

Baumol (1993) classified these definitions by looking into their substance. He observed that one uses the term to refer to someone who creates and then perhaps, organizes and operates a new business firm, whether or not there is anything innovative in those acts where as the second takes the entrepreneur as the innovator as die one who transforms inventions and ideas into economically viable entities, whether or not, in the course of doing so they create or operate a firm. Accordingly, he classified the first variety of entrepreneur as 'firm organising entrepreneur1 and very close to manager and the second variety of entrepreneur as 'the innovating entrepreneur.

ENTREPRENEURSHIP AND SMALL AND MEDIUM SIZED ENTERPRISES (SMES)

Significance of SMEs

This study is more concerned with the innovative nature of entrepreneurship rather than firm organising aspect. The potential of innovative entrepreneur for revolutionising the economy is tremendous. This breed of entrepreneurs possess more creativity and imagination in assessing the future. However, a clear cut distinction between these two types of entrepreneurs is not pretty easy. It is a matter of degree of newness and unpredictability involved in a project. For example, a person who opens a duplicating shop is an ordinary entrepreneur. To apprise this project for him, the time tested discount cash flow method could be applied with reasonable level of accuracy in risk estimation. But setting up a plant to commercialise an idea to manufacture duplicating machinery itself for the first time can be a crazy project. The conventional appraisal tools may not be of great utility here. The projected cash flows are mostly hypothetical. It makes the task formidable. Foreseeing the future by digging out from vacuum is the hall mark of this second venture whereas the first is the usual investment decision. An innovating entrepreneur, would act swiftly to create opportunities. Naman and Slen, describe the characteristics of him in these words; "the entrepreneurial firm is generally distinguished in its ability to innovate, initiate change, and rapidly react to change, and rapidly react to change flexibly and adroitly".

The study conducted by Roy Rothwell (1985) listed the advantages of SMEs. According to this study, in the United States, between 1969 and 1976, firms/establishments employing less

than 20 people created 66 percent of all new jobs, half of which were created in independent firms. The same study also revealed that almost 70% of all the workers are employed by companies that are less than five years old and employ fewer than 250 people. In India too, the fact remains more or less the same. On an average, almost two-thirds of the employment in the industrial sector have been generated by small enterprises. 0.S. Juneja, 1995).

DATA ANALYSIS AND INTREPRETATION:

The goal of our data analysis was to glean essential insights by abstracting a manageable collection of interview data, while still reflecting the interviews. This methodological technique is known as content analysis [36]. Our coding was based on the descriptive coding scheme derived from the stages and impact of the investment process model and underlying technologies. The coding was conducted independently by two researchers to ensure quality data analysis. Both researchers read all the transcripts in preparation for the coding, then familiarized themselves with the interview data guided by the fundamental principles of the hermeneutic circle [37]. After completing the initial coding, we used a consensual approach to reduce obvious differences between the researchers and to refine the coding scheme.

Venture capital-relevant data and related systems

Our interviews reveal that VC firms use both transactional IT systems and web-based data services as groups of data sources to leverage their investment activities. The transactional system, often in the form of a CRM system, is the backbone of the VC IT system. "[It is used] to track our deal flows and contacts in the firm," one interviewee stated. In the VC context, it is also used to log meetings, maintain client contact details and structure marketing and sales leads. The web-based data services include various types of external data and data-driven service providers.

Data from both types of systems interact in two ways: a) data from web-based services enrich existing, internal data from transactional systems and b) various data within web-based services are combined within the external platform for further insights for the VCist. We interpret this finding as two types of complementary interaction. Based on our interviews, we found that VC firms typically integrate social media data, such as contact information and related activities, into their internal VC CRM systems. This makes it possible to "reach people more easily and faster" according to many interviewees and provides further insights about the general opinions (e.g., political opinions) and preferences of entrepreneurs, which, in turn, may influence the investment decision. Many of the VC firms also synthesize external market and customer information from market intelligence platforms (e.g., Mattermark, Statista, Gartner) with their internal market information. This sheds light on potential consumer trends and new market opportunities, which cannot be validated without external market information.

A further insight emerged from our interviews when we investigated the usage of web-based services: VCists typically have access to various crowdfunding websites and investment networks. Here the objective is not necessarily to integrate these data sources into their internal systems, rather, VCists analyze and combine data directly on the crowdfunding sites or investment networks for further insights. Analyzing data from crowdfunding

sources helps to keep track of new deals in the VC sector and innovative products and services that are being started or generating significant traction. Additionally, investment network services allow for insights on team structure, team expertise, money raised up to now, the success or failure of previous startups of the entrepreneurs, etc. Moreover, web-based benchmarking services allow VCists to evaluate their portfolio companies against relevant peer groups in e.g., benchmarking financial performance.

As an interim result, Table 4 summarizes the data and VC related systems.

Table 4. Overview of venture capital- relevant web-based services

	Groups of Data Sources	Data (excerpt)
a) Synthesize data with trans- actional systems	Social media platforms, e.g., LinkedIn	Contact information, social graph, founders' opinions
	Market intelligence platform, e.g., Mattermark, Statista Crowdfunding sites & blogs, e.g., Producthunt	Consumer trends, market opportunities New deals, product and company launching
b) Combining data within web-based service	Investment networks, e.g., Crunchbase, Pitchbook	Team and related expertise, money raised
	Benchmarking platforms, e.g., Social Capital	Business data from market and competitors

Impact on the investment process

Based on the insights from the previous section that VC firms use primarily transactional data systems and web-based data services, we show in this section how data usage impacts each of the five investment stages [5]. Deal origination: In the beginning stages of any investment, VCists face the challenge of identifying prospective investment deals. Our interviews reveal that in the past, next to typical digital inbound services (such as emails and company website forms), various intermediaries (such as lawyers) played an important role in shedding light on potential startup companies.

However, the deal origination process fundamentally transforms from   an   inbound orientation to an outbound orientation by means of the usage of data. By accessing investment networks such as Pitchbook or Crunchbase, VCists combine company information with market research for a better overview of newly founded startups, which are

potential investment deals. Typical crowdfunding websites (e.g., Producthunt) further support the deal origination of VCists by providing data about the existence of new crowdfunded startups and underlying products or service ideas. Nowadays, VCists have access to market intelligence platforms, e.g., Mattermark, for data-driven insights on market dynamics and related participants. By combining information from various sources, such as website traffic, employee counts, time since last funding, co- investors and total amount of funding, these services allow VCists to predict the growth and success of a startup.

We conclude that the usage of data, especially from web-based services, has a fundamental impact on deal origination. It reduces the effort required to search for new investment deals and simultaneously provides a broader and more sophisticated basis for decision making.

Screening: During the screening stage, VC firms screen a large number of potential deals based on pre- defined criteria, concerning, for instance, the technology, product or market of the startup. In the pre-big data era this step was less data-driven.

Structuring: During this step, the investment deal is structured in detail to reach a mutual acceptable investment agreement between the entrepreneur and the VC firm that includes the price of the deal and further contract details (e.g., management salaries). Our interviews reveal that this step is less data driven overall than manually determined on a case by case basis.

Post-investment activities: Once an investment deal between the VC firm and a startup has been realized, the role of the VC firm transforms from being a pure investor to a being collaborator. Hereafter, the VC firm plays a new role as a formal representative on the board of directors of the startup, and it exchanges market and supplier information informally with the startup.

In the pre-big data era, VCists typically gathered internal data from various portfolio companies to compare a startup performance vis-à-vis its peer- group.

Usage of data for each investment stage

Investment Stage	Data Usage	Groups of Data Sources
Deal origination	High	Web-based services - Crowdfunding data - Investment network data - Market intelligence data
Screening	High	Web-based services - Social media data - Market intelligence data - Investment network data Transactional systems - Customer and deal flow data
Evaluation	Low	None
Structuring	Low	None
Post-inv. activities	Low	Web-based services - Benchmarking data

Generating value with data

The usage and combination of transactional and web-based data systems generate a wide range of both tangible and intangible business value for VC firms. We see that the majority of these benefits can be classified as informational or transactional benefits, which especially impact the first two investment stages, deal origination and screening.

By adding further information regarding a potential startup or its market situation from external, web-based services, the VC firm is able to check a larger number of potential startups on a broad data basis in a shorter period of time. The usage of external web-based services, in addition, enables a broader discovery of business models currently emerging and respective products and services in the startup sector, This, in turn, allows for more fact-based decisions about potential investments. Typically, the data-driven approach during the deal origination and screening stages leads to efficiency gains in the short term and greater return on investments in the long term.

The data-driven transformation from an inbound orientation (e.g., receiving e-mails from entrepreneurs) to an outbound orientation (e.g., actively scanning and analyzing new companies online) leads to an automation of the deal origination and may significantly reduce the time of work needed to identify promising startups.

In addition to the primary outcomes (informational and transactional benefits), our interviews also revealed a potential strategic benefit. Some VC firms not only synthesize external data to gain better insights and improve decision making but also focus on building their own data platforms (e.g., benchmarking platform), which portfolio companies and external startups can use to compare company performance with peer groups. In the long

term, this new data source leads to valuable data assets with in- depth information about the VC sector overall.

FINDINGS:

1. Totally there are 180 venture capital finance company are available as of now which is listed by SEBI.

2. Kalaari Capital stands top one among all the venture capital finance company in our country.

3. The internet software and services stands number one in venture capital finance.

4. The venture capital finance increased tremendously from the year 2012 to 2015, i.e $ 1.0 billion to $ 2.0 billion.

CONCLUSION:

From the study we can get a clear idea about the venture capital financing in India and also its challenges and prospects. Entrepreneurs are unfamiliar with venture capital because they feel that venture capital is seeking an extraordinary high return on the investment. However, it is important to understand that, even under the best of circumstances, only a minority of the companies in which the venture capitalists investments will be successful. Keeping this in the eyes of investors must be cautious before investing in venture capital finance.

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