Venture Capital and Private Equity: An Impetus to Indian Economy

There have been tremendous legal and regulatory reforms in the Venture Capital and Private Equity sectors that have led to the present state of boom in the Private Equity scenario in India

Venture Capital and Private Equity have been major drivers of innovation, economic growth, knowledge base industry and start-ups. The Venture Capital and Private Equity industry follows the concept of "high-risk, high-return". Venture Capital is generally equity investments made by Venture Capital funds, at an early stage in privately held companies, having potential to provide a high rate of return on their investments. It is a resource for supporting innovation, knowledge based ideas and technology and human capital intensive enterprises. It supports first generation entrepreneurs by providing the equity capital needed for idea based enterprises generally not available from banks and other financial institutions.

Private Equity generally refers to large investments as compared to Venture Capital, in more organised and matured companies at their expansion stage or later stages. As the Indian economy is on a fast track, Private Equity investors from all over the world are ready to provide equity capital to Indian business groups for making acquisitions and expansions worldwide. Venture Capital and Private Equity both value intangible assets while making equity investments, which generally conventional sources of financing may not consider.

Evolution and Scenario of Venture Capital and Private Equity in India

The Concept of Venture Capital and Private Equity in India is very recent as compared to USA, UK, Europe, Israel, etc., where it has been in existence since many decades, and over the period have helped many businesses to grow and expand. One of the main reasons for a matured and developed Venture Capital and Private Equity industry in other countries has been a sound legal and regulatory framework. In India major developments in Venture Capital and Private Equity

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industry have taken place in last 10 to 12 years, but maximum growth has been noticed in last 5 to 7 years.

In 1973, a committee on development of small and medium enterprises highlighted the need to foster Venture Capital as a source of funding new entrepreneurs and technology. A study was undertaken by the world bank to examine the possibility of developing Venture Capital in the private sector, based on which the Government of India took a policy initiative and announced guidelines for Venture Capital Funds in 1988, but these were restricted to setting of Venture Capital Funds by banks or the financial institutions only.

In late 1988, Technical Development and Information Corporation of India (now known as ICICI Ventures) was set up, and within a short period of time it was followed by Gujarat Venture Finance Ltd. But, there was no major Venture Capital activity till the mid 90s; unfriendly policy and regulatory framework in India being one of the reasons.

Security Exchange Board of India "SEBI", the regulator of VCF/FVCI was set up in 1992. In the year 1996 SEBI introduced the "SEBI (Venture Capital Fund) Regulations" for regulating and promoting activities of domestic VCFs. Subsequently in 2000 SEBI announced "SEBI (Foreign Venture Capital Investors) Regulations" in order to regulate and facilitate foreign Venture Capital and Private Equity funds investing in India.

At present, 100 Venture Capital Funds and 89 Foreign Venture Capital Investors are registered with SEBI. Venture Capital & Private Equity funds have played a very important role in the growth of Indian Economy and rise in mergers and acquisitions. Real estate, information technology and service sectors have attracted a significant amount of Venture Capital &

Quarter	31 Mar 07			30 June 07			30 Sep 07			31 Dec 07		
Sectors of Economy	VCF	FVCI	Total	VCF	FVCI	Total	VCF	FVCI	Total	VCF	FVCI	Total
Information technology	1238	1098	2336	734	961	1695	750	1260	2010	779	1390	2169
Telecommunications	79	876	955	99	809	908	119	779	898	118	872	990
Pharmaceuticals	519	195	714	503	294	797	532	360	892	716	360	1076
Biotechnology	289	9	298	317	31	348	361	31	392	354	31	385
Media/ Entertainment	299	59	358	402	108	510	421	59	480	401	69	470
Services Sector	725	647	1372	1075	945	2020	1130	1295	2425	1134	1341	2475
Industrial Products	472	496	968	503	421	924	574	1079	1653	735	1312	2047
Real Estate	1565	1292	2857	1900	888	2788	2133	1514	3647	4207	2141	6348
Others	6084	3184	9268	7335	6249	13584	8244	7024	15268	8881	7868	16749
Total	11270*	7856	17621	12868*	10706	20310	14264*	13401	23218	17325*	15384	28260
	*includes Rs.1505 crore of FVCI investments in VCF			*includes Rs.4449 crore of FVCI investments in VCF			*includes Rs.4447 crore of FVCI investments in VCF			*includes Rs.3264 crore of FVCI investments in VCF		

* Rs. in Crores

source - www.sebi.gov.in

Private Equity funding. The following figures provide sector wise Private Equity investment details during the last year.

Industry wise cumulative investment details of SEBI registered VCF and FVCI

Who Invests in Venture Capital/ Private Equity Fund

Venture Capital and Private Equity Funds raise money from various investors domestically and from all over the world. These investors will generally include (a) Angels Investors—meaning high net-worth individuals who have appetite for high-risk and higher-returns, (b) Institutions with diversified investment portfolios like—pension funds, insurance companies, banks, etc. and (c) Fund of funds.

How it Works

Firstly, the investors invest money in a Venture Capital or Private Equity fund (Fund). The Fund is generally formed as a trust; however, it may be a company also. The Fund may have open ended or close ended schemes. Generally close ended scheme have a fixed life—usually 5–7 years. The investments of the trust are managed by an Asset Management Company (AMC) that charges the Fund an annual operating cost, which generally vary from 2–3 percent per annum, depending on the strategy, scheme, life cycle and investment plan. The Fund makes investments in several companies.

Generally, Funds invests in a pre-decided number of companies. Some of the investments made by the Fund will miserably fail, some will break-even, some will do well and some will give extremely high returns. Venture Capital or Private Equity funds do not avoid risk but manage them by balancing the portfolio focusing on the people and by ideas, mentoring, coaching and adding value. The number of failures is hard to control, and to balance, the win must be BIG; hence all Funds endeavor to structure its each investment for high returns.

At the end of life cycle of Fund or as may be provided by the Fund the profits are distributed to the investors. If the returns are higher than the expected or minimum returns promised to investor than the upside, it is shared between the AMC and investors in a certain ratio (generally 25:75).

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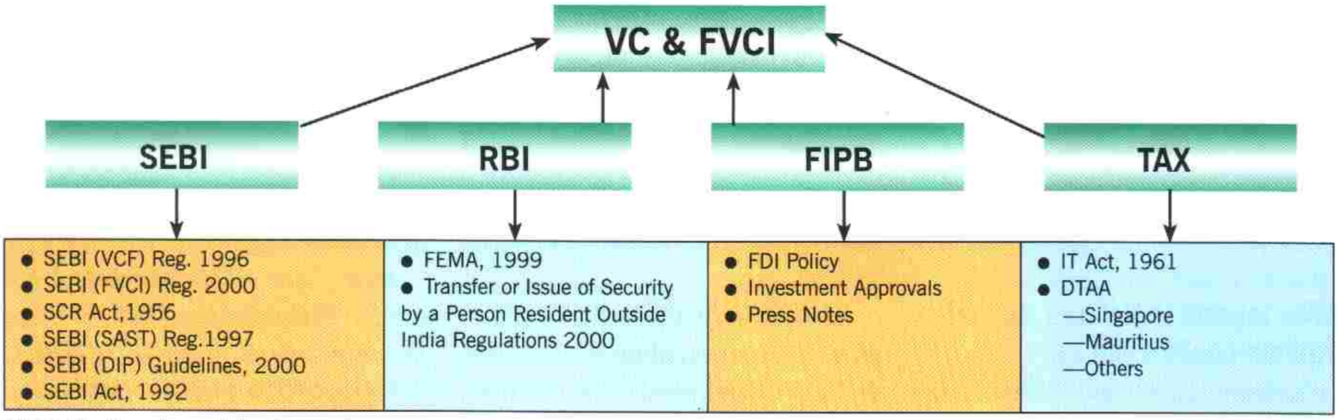
Regulatory Reforms and Framework

There have been tremendous legal and regulatory reforms in the Venture Capital and Private Equity sectors, which have led to the present state of boom in the Private Equity scenario in India. Some of the major reforms impacting this industry can be summarized as under:

- Government of India issued guidelines in September 1995 for overseas Venture Capital investment in India.
- SEBI framed SEBI (Venture Capital Funds) Regulations, 1996.
- In 1999—the Companies (Amendment) Act, 1999, dispensed with prior approval of Central Government for investment by a company exceeding 60 percent (paid-up share capital + free reserves) or 100 percent free reserve, whichever is more, and enabled the company to make investment by way of special resolution at general meeting.
- In 2000—SEBI introduced another regulation for SEBI (Foreign Venture Capital Investors) Regulations, 2000, enabling foreign Venture Capital and Private Equity investors to register with SEBI and avail certain benefits provided there under.
- In 2000—amendments were made in SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 1997; as a result, these regulations were not to apply to the shares transferred from VCF or FVCI to the promoters or to the company itself, if effected as per pre-existing agreement between VCF or FVCI and promoters of the company. If promoters buy back the shares from FVCI, then there is no requirement of public offering.
- In 2000—as per FEMA, FVCI can acquire or sell any investment held by it at a mutually acceptable price
- In 2001—The Companies (Amendment) Act, 2001, reduced the period of issue of fresh shares from 24 months to 6 months, from when the company completes the buy back of its shares.
- In 2001—The Companies (Issue of share capital with differential voting rights) Rules, 2001, allowed every company limited by shares to issue shares with differential rights (voting or dividend).
- In 2003—Qualified Institutional Buyer "QIB" status granted to VCF/FVCI, as per SEBI (DIP) guidelines. VCF/FVCI can subscribe securities at IPO of a VCU through book-building process.



Figures showing major regulatory framework.

- In 2004—VCF/FVCI permitted to invest in NBFC registered with RBI and engaged in equipment leasing or Hire Purchase. It permitted to invest in companies engaged in gold financing for jewellery. FVCI allowed to invest 100 percent in one VCU, as compared to the 25 percent earlier.
- 2005—in the press note 1 of 2005, exemption was granted from prior government approval under press note 18 of 1998.

Investment by Venture Capital Funds Outside India

SEBI registered Venture Capital Fund are permitted to invest in securities of foreign companies in terms of regulation 12(ba) of the SEBI (Venture Capital Funds) Regulations 1996. Reserve Bank of India (RBI) vide its Circulars dated April 30, 2007 and May 4, 2007, issued in this regard, has permitted VCFs to invest in equity and equity linked instruments only of off-shore Venture Capital undertakings, subject to overall limit of USD 500 million and applicable SEBI regulations. Investment would be made only in those companies which have an Indian connection (i.e. company which has a front office overseas, while back office operations are in India) and such investments would be upto 10 percent of the investible funds of a VCF.

Policy on Foreign Direct Investment in VCF in India

Off shore Venture Capital funds/ companies are allowed to invest in domestic Venture Capital undertaking as well as other companies through the automatic routes, subject only to SEBI regulations and sector specific caps on Foreign Direct Investment.

Investment Conditions and Restrictions on VCF and FVCI

a) A VCF may raise money from any investor, whether Indian, Foreign or Non-resident Indian, by way of issue of units.

> Venture Capital can be very useful in assisting the development and growth of businesses in India, and especially small scale industries and those entrepreneurs who have ideas, skills and technology but are not able to realise them due to financial problems

b) No VCF shall accept any investment from any investor which is less than 5 lacs, except from employees/ principal officer/directors/trustee of the VCF or the employees of the fund manager or Asset Management Company.

c) VCF shall have firm commitment of at least 5 crore from the investors before the start of operations by the VCF.

d) VCF/FVCI shall disclose investment strategy to SEBI before registration.

e) VCF shall not invest more than 25 percent of the funds in one VCU. FVCI can invest its total funds in one VCU.

f) VCF shall not invest in associated companies.

g) VCF/FVCI shall disclose duration of the life cycle of the fund to SEBI.

h) At least 66.67 percent of the investible funds shall be invested in unlisted equity shares or equity linked instruments of VCU.

i) Not more than 33.33 percent of the investible funds may be invested by way of

- Subscription to IPO of a VCU whose shares are proposed to be listed.

- Debt or debt instrument of a VCU in which VCF/FVCI has already made an investment by way of equity.
- Preferential allotment of equity shares of a listed company subject to lock-in period of one year.
- The equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed.
- Special Purpose Vehicle which are created by VCF for the purpose of facilitating or promoting investment.

Registration Benefits to Foreign Venture Capital with SEBI

The law does not make it mandatory for Foreign Venture Capital and Private Equity Funds to get themselves registered with SEBI. They can invest in India as per Foreign Direct Investment policy without getting registered with SEBI. They can also invest in India by getting registered with SEBI as Foreign Venture Capital Investor "FVCI". By registering with SEBI as FVCI, foreign Venture Capital and Private Equity funds can avail following benefits:

- Exemption from usual share valuation practice. It could be a negotiated price.
- SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, do not apply to the shares transferred from FVCI to the promoters or to the company itself, if effected as per pre-existing agreement between FVCI and promoters of the company. If promoters buy back the shares from FVCI, then there will be no requirement of public offering.
- The Venture Capital funds will be eligible to participate in the Initial Public Offering through book building route as Qualified Institutional Buyer subject to compliance with the SEBI (Venture Capital Fund) Regulations.
- Tax pass through status for investment in nine sectors.
- Exemption from taking prior approval from government in case a foreign investor has an existing joint venture or technology transfer/trademark agreement in the same field.

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Taxation

Prior to Finance Act, 2007, Venture Capital Funds registered with SEBI enjoyed tax pass through status on the income from all of their investments. The Finance Act, 2007, changed the definition of "Venture Capital Undertaking (VCU)" under which the benefit of tax pass through status is restricted to the following nine sectors only:

a) Nanotechnology

b) Information Technology relating to hardware and software development

c) Seed research and development

d) Bio-technology

e) Research and development of new chemical entities in the pharmaceutical sector

f) Production of bio-fuels

g) Building and operating composite hotel-cum-convention centre with seating capacity of more than three thousand

h) Developing or operating and maintaining or developing, operating and maintaining any infrastructure facility as defined in the Explanation to clause (i) of the sub-section (4) of section 80-IA

i) Dairy or poultry industry

However, foreign Venture Capital and Private Equity funds have an option to get themselves assessed under the provisions of Income Tax or as per the Double Taxation Avoidance Agreement (DTAA). Mostly, foreign Venture Capital and Private Equity funds who invest in India are located in Singapore, Mauritius or like tax preferred destination/countries, with whom India has entered into tax treaties. To take the benefit of DTAA, foreign fund shall not have permanent establishment in India.

Venture Capital can be very useful in assisting the development and growth of businesses in India and especially small scale industries and those entrepreneurs who have ideas, skills and technology, but are not able to realise them due to finance problems. This sector of risk capital has been growing rapidly in India.

Developing Private Equity market in India has helped Indian companies to think big and go global. 34 Private Equity deals were announced during March '08. The largest PE deal in March was of Singapore's Orient Global Tamarind Fund acquiring 2.6 percent stake in Cairn India for USD 278.70 million.

In future, we expect to see more Private Equity deals. We hope SEBI will make further legal and regulatory reforms and investor friendly framework. HLM

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