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## A Study on Determinants of Investment Decisions: A Venture Capitalist's Perspective

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### **Abstract:**

*In recent period Indian economy has witnessed multi fold growth as compared to developed economies in the world. Overall growth registered by the Indian economy is the result of MSME sector's performance and specifically growth in IT and IT enabled services, bio technology, banking and financial services, healthcare and life sciences, manufacturing and retail businesses across the country. Technology driven businesses has attracted the attention of domestic and international investors due to increase in the use of IT enabled services by the majority of population in the country. Use of smartphones and internet penetration has provided ready platform for the sector to take out best of this opportunity. Ecommerce has provided the solution to the problems where the country was stacked since decades. Quality of higher education, entrepreneurial talent, risk taking ability of the younger generation and youth population in the nation has spur the growth of the sector. Information Technology industry has grown exponentially over last few years taking locational advantage of being in operation in cities like Mumbai, Bangalore, Pune, Ahmadabad and Delhi. The important factor which has contributed to the growth of the sector is availability of risk capital in the form of Private Equity and Venture Capital leveraging debt requirement of the venture in start-up phase. PE and VC has played the critical role in the establishment of technology driven businesses in developed countries. Considering the growth of start-up economy, domestic and international PE investors and Venture Capitalists are now looking towards India as world's fastest growing economy. This research analyses the growth of PE and VC investments in the country for last five years with the help of economic data. Research also highlights determinants affecting investments decision of an investor on the basis of the data collected through interview method from investment team members of Venture Capital and Private Equity Firms. This will help entrepreneurs to understand the prerequisites of raising capital from Venture Capitalists and Private Equity investors.*

**Keywords:** Entrepreneurship, Venture Capital, Private Equity, MSME's, IT and ITeS sector, E-commerce

### **1. Introduction**

Micro Small and Medium enterprise sector is the backbone of almost all national economies in the world. MSME's contribution to the overall development is acknowledged by various World Bank reports. In India, MSME sector accounts for 90% of the total industries, 45% contribution in industrial production, 44.70% in total export. MSME's contribution in GDP considering both manufacturing and service sector is around 37% as per MSME report 2014-15 (MSME, MSME Report 2014-15, 2015). Besides this sector provides employment to more than 80 million people. In spite of numerous initiatives by state and central government, 93% of the MSME's are self-financed (Kapoor, 2012). Due to the limited financial capabilities and lack of collaterals, entrepreneurs are failed to raise credit from formal or conventional credit sources (Zaidi, 2013).

Timely availability of finance at different stages of venture development defines the success journey of an entrepreneur. Most of the entrepreneurs are failed in start-up stage due to lack of financial backup required for commercialization of the product or services, marketing, research and development and many more (Jaiswal, 2014). The reason behind limitations of formal channels in provision of credit for start-ups is risk associated and volatile business environment. In early stage of venture development there is the need of risk capital which can leverage the debt requirement of the firm.

Development of techno based ventures in last few years has built the momentum in economic development of the nation (NASSCOM Z. , 2015). In next few years' high-tech start-ups will drive Indian economy to new heights. Emergence of technology based start-ups is the result of government initiatives and emergence of alternative sources of equity funds such as venture capital and private equity.

Venture Capital is the most attractive source of equity or risk finance for start-ups. It is nothing but an alternative source of equity in the form of risk capital leveraging debt requirements of the start-up (E, 1966).

In developed economies concept of Venture Capital is widely accepted and has proved as success factor for growth of technology based ventures. Research says the growth of VC backed start-ups are more than other start-ups going for an IPO. For India too, venture capital is not a new concept. Its acceptability has grown substantially over last two-three years. In Indian Context Venture Capital investment hits an all-time high in last year (NASSCOM Z. , 2015). At the end of 2015, Indian start-ups have received more than \$5.183 billion worth of VC funds (Mahajan, 2015). State and central government initiatives for start-ups leads to more VC investments, registering almost 125% growth in 2015 compared to 2014 (Trak.in, 2015).

This research intends to explore various parameters influencing decisions of investors for screening of investment opportunities in MSME's in India. Considering the growth of financial infrastructure in the nation, venture capital industry is getting prominence in channelizing funds for promoting entrepreneurship by provision of risk capital at early stage of venture development. Research aims to find out the interplay of various drivers affecting investment decisions of venture capitalists.

### *1.1. Research Objectives*

- a. To understand the growth of venture capital industry in India.
- b. To analyse venture capital investments in India to understand sectorial preferences with the help of deals and investments.
- c. To study the determinants of investment decisions by venture capital firms.

### *1.2. Scope of the Study*

- a. The study is restricted venture capital funding in India for the period Jan-2011 to July-2016.
- b. The scope is restricted to understand the supply side perspective of venture capital funding to MSME's.

### *1.3. Research Methodology*

Study is based on interview schedule of investment team members often Venture Capital firms to understand supply side perspective for determinants affecting investment decisions. Secondary data used as economic information for investment analysis is based on various reports.

## **2. What is Venture Capital?**

Venture Capital is the finance provided by professional investors in new and rapidly growing firms having potential to develop into major economic contributors. It is considered as “your ideas and our money” concept of developing business (Committee, 2013). Venture Capitalists are the investors channelizing financial resources from variety of sources like high net worth individuals, corporate, pension funds, insurance companies, etc. VC's invest in high risk- high return ventures that are unable to raise capital from formal channels like banks and capital markets due to high risk associated in early stage of venture development.

The Venture Capital industry in India has grown over last decade. Venture Capitalists provides equity capital along with their managerial expertise to an entrepreneur in exploring his ideas into a viable and successful business venture. By way of human capital, technical skills, cost competitive workforce, research and entrepreneurship in the nation, India has unleashed a revolution of wealth creation and rapid economic growth in a sustainable manner. To faster the growth of economy there is a need for risk finance and Venture Capital environment which can leverage innovation, promote techno based ventures and harness knowledge based ideas. Venture Capital is a means of equity or risk financing for rapidly-growing start-up firms and private businesses. Venture Capital as a source of Finance helps for the start-up, development/expansion or purchase of a company. Venture Capital firms invest funds in risky firms on a professional basis. Venture Capital Firms have their focused approach on a limited sector of specialization like IT & ITES, Real Estate, HealthCare and Life Sciences, Clean Technology etc.

With Venture Capital financing, the Venture Capitalist acquires an agreed proportion of the equity of the company in return for the funding. Equity finance offers the significant advantage of having no interest charges. It is equity capital that seeks a return through long-term capital gain rather than immediate and regular interest payments, as in the case of debt financing. Given the nature of equity financing, Venture Capital investors are therefore exposed to the risk of the company venture's failure in case of uncertain future incidences. As a result, the Venture Capitalist look to invest in ventures which have an ability to grow faster, successfully and provide higher returns against risk associated with investment (Mishra, 2004). When Venture Capitalists invest in a business they acquire seat in the company's Board of Directors. They handle minority share in the company and mostly do not take day-to-day control or interfere in entrepreneurial activities. Instead, professional Venture Capitalists act as mentors and aim to provide support and advice on variety of management and technical issues to assist the company to develop its full potential.

### *2.1. Concept of Venture Capital*

Venture Capital refers to the equity or risky commitment of capital as shareholding for setting up of small businesses specialized in new ideas or new technologies (Vijayalakshmi, 2006). It is not merely provision of funds into a new firm, it is a simultaneous input of skill needed to setup the firm, design its marketing strategy and organize and manage it. It is an association with successive stages of venture development with distinct types of financing, appropriate to each stage of development.

International Finance Corporation. Washington, (IFC) defines Venture Capital as equity or equity-featured capital seeking investment in new ideas, new companies, new products, new process or new services that offer the potential of high returns on investment. It may also include investment in turnaround situations.

Venture Capital is the support by investors to entrepreneurial talents with finance and business skills to exploit market opportunities to enjoy capital gains out of risky investment. Venture Capital commonly makes the provisions of start-up finance or seed capital and development of capital for later stages of business. A long-term commitment of funds is involved in the form of equity investments where the aim of Venture Capital is to gain rather than income, and active involvement in the management of customer's business.

### 2.2. Importance of Venture Capital

Venture Capital is an important or crucial source of finance for entrepreneurial business ventures in both developed and developing countries. Venture Capital financing especially is of importance in developing countries, considering its role in development of Information Technology and IT Enabled Service sector. In case of India, state owned institutional development and corruption in bureaucracy and government control over economy has impeded the growth of venture capital in earlier scenario. But situation is completely changed in last few years' government initiatives like Make in India, Start-Up India and Digital India acts as booster for entrepreneurship development (MSME, MSME at a Glance 2016, 2016). The overall start-up ecosystem in the country attracted the flow of funds from private players by way of venture capital and private equity.

### 3. Venture Capital Investment in India

Indian entrepreneurs never had it easier in raising funds as an angel or start-up. Venture capital investors put money in a start -up on an average of every eight hours in the last year. According to data from VCCEdge, the data research platform of VCCircle, angel and VC investors have sealed as many as 1,096 or even more deals in 2015, up by 68% compared to last year, a record jump and also the highest early-stage investment in India(Mahajan, 2015). Of these, angel and seed investors funded 632 deals while VC investors backed 464 deals(Trak.in, 2015).

In value terms, angel and VC firms together contributed 24.5 per cent of the total private investments in 2015, up from 17.2 per cent contribution last year. On a standalone basis, angel funding picked up speed in 2015, breaching the \$300-million mark for the first time, from \$196 million in 2014. VC funding showed a similar trend as it crossed a new milestone, clocking deals worth \$5.183 billion in the year 2015, as against \$3.87 billion last year(Mahajan, 2015). From the following Graph. 1.0 we can understand the growth of Venture Capital investment including angel, seed, early and growth investments in Indian companies.

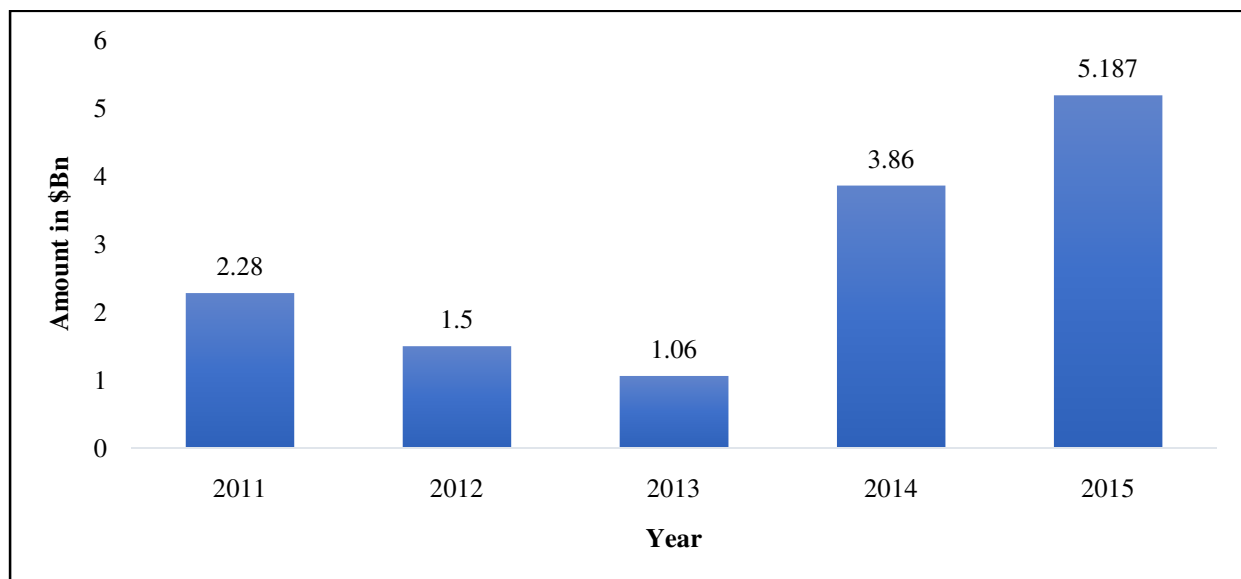


Figure 1: Venture Capital Investment in India  
Source – VCCircle Data Research Platform

#### 3.1. Analysis of Venture Capital Investments in India for the Period Jan-2011 to July 2016

From the above Figure 1 we can understand the growth of venture capital investments made at different stages and forms like angel, seed, early and growth investments during the year 2011 to 2015. Here under analysis is made on the basis of venture capital investment statistics for 2011-2016 from Venture Intelligence. Statistics considered for the analysis is related to only investments made by VC's in early stage and growth stage.

##### 3.1.1. Sectorial Analysis

Before starting with sector / industry wise analysis it will help to look at the annual figures of deals and amounts invested for the period Jan 2011 to July 2016. From the following Figure 2, primary axis indicates number of deals which are increasing gradually and the number has grown more than doubled in 2015 as compared to 2011. This is an impact of government initiatives for promoting start-ups and upscaling in India's ranking for ease of doing business as per World Bank. It shows that investors are looking for conducive environment wherein they can earn high returns from their investments in long run.

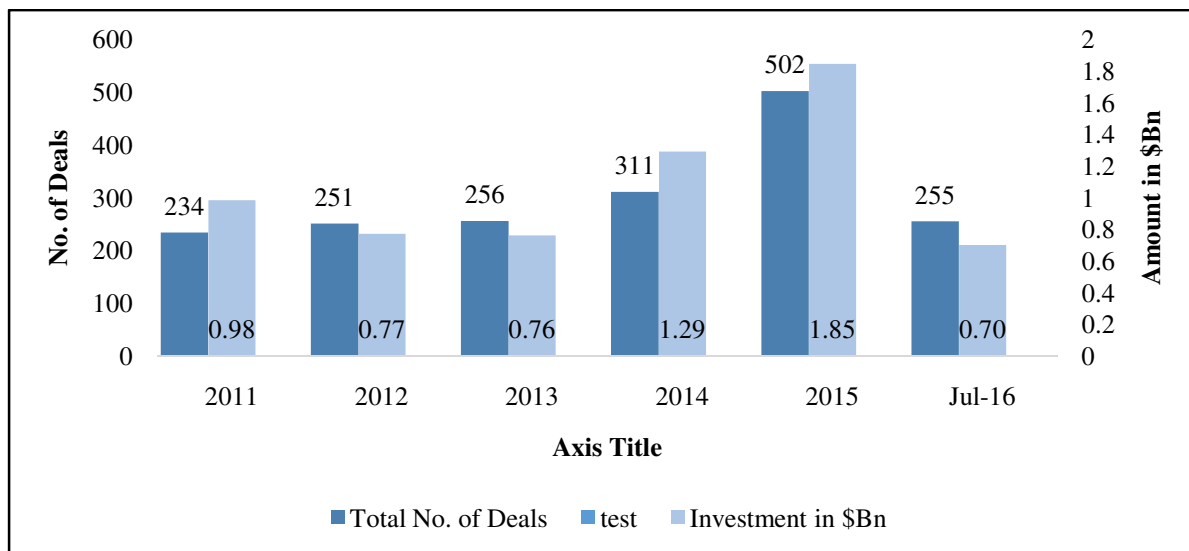


Figure 2: Year wise deals and investments

Source – Venture Intelligence

Secondary axis in the above Figure 2 is about the year wise investment made by venture capitalists in early stage and growth stage ventures. Same as no. of deals, investment has also shown increasing trend over the period. (Investment figures in Figure 1 includes total amount of investments in angel, seed, early, growth and expansion stages where as following graph indicates numbers only for early and growth stage investments).

Following Figure 3 indicates the sector wise break up of number of deals executed during the year 2011-15. Total deals executed are 1809 in the form of venture capital for early and growth stage investments.

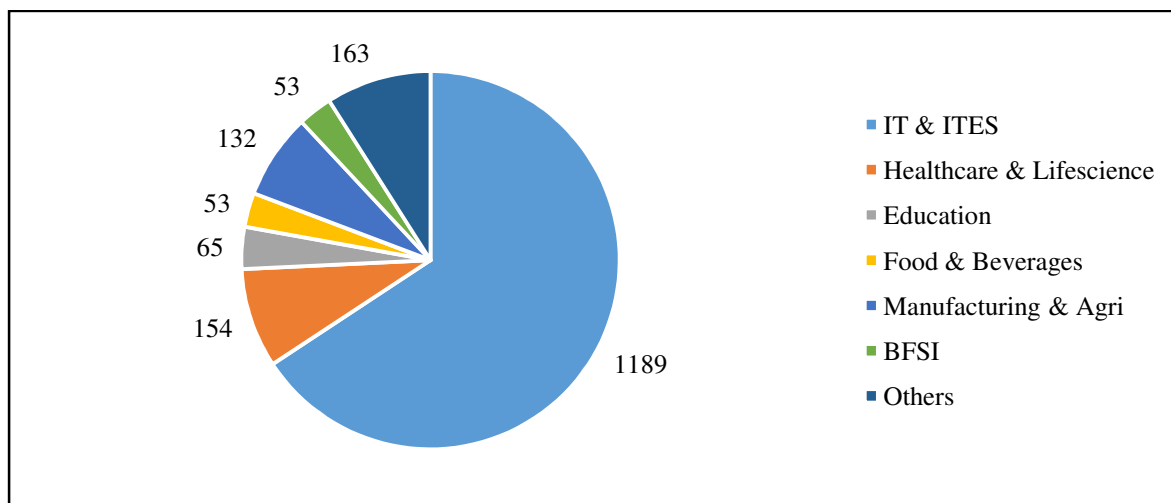


Figure 3: Sector wise Deals executed by VC's during 2011 - July 2016

Source – Venture Intelligence

IT and ITeS sector is at the top with total number of deals 1189 i.e. 65.72%. Healthcare and Life sciences at second position with 154 deals, followed by manufacturing and agri-business with 132 deals. Education, BFSI and Food and beverages executed 65, 53 and 53 deals respectively. Other industries, 163 deals include retail, gems and jewellery, Travel, FMCG, Hotels and Resorts, Marketing and Advertising, Logistics, Sports and others.

This clearly indicates that IT and ITeS is the major industry and distinctly ahead to attract more investments from venture capitalists. It is an indication of investor's choice where they are looking for high-tech and high-growth opportunity sector as information technology. Healthcare and life sciences, education, BFSI, food and beverages and manufacturing are also the top industries after IT and ITES, preferred by investors. Though the sectors have attracted the investments but still it should be noted that all the choices are having technological touch which makes them different from others to attract venture capital investors.

### 3.1.2. Sector / Industry Wise Investment Analysis

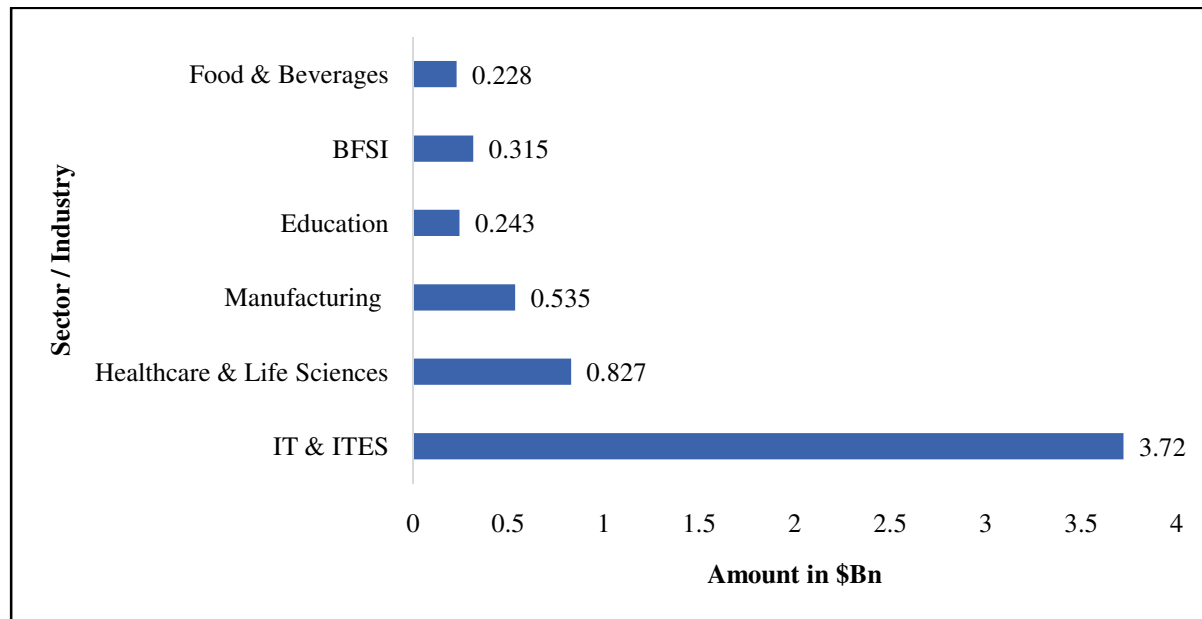


Figure 4: VC investment in major Sectors / Industries  
Source – Venture Intelligence

As per the results of Figure 4, industries attracted more deals are also leading in investment chart. IT and ITES total \$3.72Bn, Healthcare and Life Sciences \$.827Bn, Manufacturing and Agri-business \$.535Bn then BFSI \$.315Bn followed by Education \$.243Bn and Food and Beverages \$.0228Bn. Venture Capital investment clearly indicates that investors are choosy for type of industry they are investing.

The above stated investment is made collectives by foreign and domestic VC's. Some of the investments are purely made by either foreign or domestic VC's. In few cases co-investment i.e. syndication strategy is adopted by foreign and domestic VC's. Total number of foreign and domestic VC players has exceeded 500 in the year 2015. The journey of Venture Capital industry from single digit number of VC's in the year 2002-03 to three-digit figure in 2015 itself is an achievement of Start-up ecosystem developed in the country on technology as base.

#### 4. Determinants of Investment Decisions by Venture Capital Firms

Venture Capital firms are investing for making money out of their investments. Start-ups or ventures in early growth bear huge risk due to market volatility and competition. VC's investment in such cases is exposed to the future uncertainties of entrepreneurial success. What drives VC's to invest? It is nothing but the expected growth potential of high-tech businesses with unique value proposition. Certainly there are few factors considered by VC's when they screen proposals received from entrepreneurs. Intense literature review helped to understand factors or determinants affecting investment decisions of VC firms. With the help of interview schedule technique of data collection, investment team members of VC firms were interviewed to understand their perspective towards investment decision making process. Here we consider all such factors as determinants on investment decisions.

Interview schedule includes the following points which helped to gather the information for this research. Details of the points discussed with investment team members are,

- India's MSME sectors attractiveness – for Venture Capital investments.
- Investment decision – demand and supply side requirements
- Investment stage
- Venture management after investment
- Interplay of various external factors.

From the above stated points, VC's investment decisions are more or less affected by almost all forces. Every aspect involved in screening process affects the fund profitability and hence affects investor's decisions whether to invest or not?

Major influencing factors or determinants shared by investment team members in common under above stated points are discussed hereunder,

##### 4.1. India's MSME Sectors Attractiveness – for Venture Capital Investments

Investors think that overall economic indicators are key factors to attract investments. VC raise funds for investment from various sources success of fund depends on the timely repayment to investors. Hence strong economic indications ultimately foster industrial growth and hence VC's invest more to earn high returns. In case of India, it is one of the fastest growing economy around the world and MSME's are the backbone of such rising economy. Overall growth rate, industrial output and export potential of the sector are

major contributors for attraction of global VC players for investment in India. Nations younger population, intense use of technology, conducive business environment, internet connectivity and penetration, use of smartphones and government initiatives are few other factors added by the team members to which they feel it attracts investors.

#### *4.2. Investment Decision – Demand and Supply Side Requirements*

When investment team evaluates the proposal, there are two different perspectives which are need to be get considered before arriving at investment decisions viz. Demand side and Supply side perspectives. Entrepreneurs Vs Inventors. Before investment, VC's need to ensure the risk and profitability from the investment and that depends on various factors. Factors which are mostly considered by investment team are, entrepreneurial background, idea / product viability, value proposition, market potential and competition. When it comes to supply side, investors will look for ownership stake or board seat sharing in the venture, size of investment, risk, return, time horizon and most importantly exit options. Mostly all VC's consider these factors as influencer to arrive at investment decision.

#### *4.3. Investment Stage*

Provision of capital in the form of venture capital can be invested at various stages of venture development. Depending on the stage of investment or the stage at which entrepreneur raises the capital has impact on investment decision. Different stages of investment where VC's enters as partner are angel, seed, start-up, early / growth and expansion. Starting from angel to expansion risk and amount associated with investment varies considerably which affects VC's decisions about investment.

#### *4.4. Venture Management after Investment*

Generally, VC's as a major investor into the firm needs to take lead over firm's strategic decision making process. Certainly VC's expertise helps entrepreneurs for business establishment as they are experienced and have network in the market. To exhibit this level of control, investor needs to have share in board seats / ownership stake. Majority of investors are getting involved in defining system and process of the firm, selection of management team, people management, marketing activities, networking and financial activities. Entrepreneur's acceptability to the terms of investor's involvement is one of the major determinant for investment decisions of investor.

#### *4.5. Interplay of Various External Factors*

Venture Capitalist needs to manage their investors, to cope with government rules and regulations and to do the business as a partner with entrepreneur. Balanced equation of these three forces helps VC's to achieve their goals and objectives of investment. Hence these factors also have a role to play in investment decisions.

### **5. Findings**

On the basis of the above stated analysis, research findings in line with research objectives can be summarized as follows,

1. Venture Capital industry in India is growing faster due to favourable economic conditions and conducive business environment.
2. High-tech businesses are attracting more funds on the verge of potentiality of business to grow faster in the country due to technological advancement, use of smartphones, internet penetration, huge ready to serve market base etc.
3. Entrepreneurs should consider determinants of investment decisions before approaching the right investor.
4. 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.
5. Entrepreneurial background, idea / product viability, business sustainability and competition are major determinants on demand side considered by VC firms in screening of proposal for investment.
6. As an investor, VC firms are looking for involvement in important areas associated with the venture such as system and process, financial activities, people management, risk and return associated with the investment and time horizon for successful exit.

Above findings will definitely help entrepreneurs before approaching investors to raise the equity capital from venture capital firms. On the basis of stated determinants entrepreneurs can prepare the plan for successful fund raising activities and also get benefited by their expertise.

### **6. Discussion**

Development of start-up economy in the country is acting as the driver for new wave of financial resource fullness which ultimately helps entrepreneurs to meet their fund requirements. Over last five years' entry of foreign investors has channelized flow of risk capital to the start-ups and has played critical role in entrepreneurship development. Entrepreneurs should take care about the factors which are affecting investment decisions and make themselves ready for VC's intervention in the business. With mutual understanding investors and entrepreneurs can get benefitted with attainment of stakeholder's interest. As compared to the global venture capital industry, at the stage of prospering start-up ecosystem, we are in a dire need of organized venture capital industry which can help for sourcing and investing in MSMEs on the basis of financial infrastructure as a backbone.

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