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VENTURE CAPITALIST'S INVESTMENT DECISION IN HIGH TECH *START-UPS* FIRMS: AN INDIAN PERSPECTIVE

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ABSTARCT

Dependence on financing through bank for young high-tech firms is difficult. The reason being bank requires collateral as well as several information over time from the firms, which may not work well for them as these firms operate in a highly changing environment. Venture capital is one of the popular source which invest capital into "risky" ventures to obtain a very high rate of returns and invest into equities rather than loans to get a good rate of return . But in India, getting finance through venture capital for a new technology firm is a big challenge.This paper tries to answer the questions such as can the design of an efficient contract help in sustaining the two way relationship between new technology firm and venture capitalist ? If they fail, are there any signals from the formal market to help them to exit smoothly from the deal? The data for the present study was obtained from various database based upon which we can conclude that inadequate regulatory, legal and tax environment increase the risk perception of venture deals in India. It is found that most of the firms fail to convince their venture capitalist about the likelihood of success of their business projects. So despite of having patent of new technology they could not succeed to attract venture investors for funding into their projects. Moreover it can also be concluded that the success of venture deal based upon trust between investor and firm which gets offset by secretive behaviour of new technology firms.

Keywords: Venture capital financing, New technology firm, Innovation, Mutual agreement

Introduction

It is a very difficult task for a start up to get funding from bank or other formal way of finance, as bank requires colleteral against the financing amount and several information about the firm, which is difficult for start up firms to provide. After 2008 crisis bank tighten the credit facilities and found large and late stage firms more suitable for lending. According to Mani, S. (2010) in India there are three different ways available for start –ups for arranging funds. those are research grants and loans, venture capital and tax incentives. In this paper we are trying put stress on funding criteria of venture capital firms for start ups. Vernture fund refers to the fund which invested in

high risk , high return investments like biotechnology, junior mining firms which have possibilities of earning spectacular return over time or become unsucessful. In this fast changing business environment strat up firms face difficulties for funding due to the risk involvement in new business idea and its uncertain future. Venture capital firm while funding these start ups has to undertake huge risk as they allocate their fund in a business at its inception stage , whose future could not be predicted. In india

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the concept of venture capital fund gaining momentum from last two decades. as the number of new technology firm is growing day by day the popularity of these venture capital is also growing. but after 2008 financial crisis it is found that the preferd destination of these venture capitalist shifted to late stage firms rather than new start up business who actually require funds from venture capital

In this paper we are trying to conceptualise the risk perception of venture capital firms and what they actually want from start up firms and what really can helpful to compensate these risk perception of venture capitalist. The support from formal market is also an important factor of study to reduce their risk perception.

Literature Review

It has been seen that in India financing a business posses special challenges in various industries due to uncertainty. According to Ang.,Madson(2012), although firms growth depends on itsidea production but financing these innovation still facing challenges. By taking data of 77 countrie's innovative production , authors found that a strong patent protection is required by the financer to prove themselves against the future uncertainties . Again these fear of uncertainty become stronger due to country's unstable macroeconomic policies. Rafiq Dossani and Henry (2002) in their study found that the macroeconomic constarints of the country in opposite way to the investment of venture capiatlist .

After 1985 with development of of software industries , venture capital industry found a positive environment in the country to invest in , but again only chosing the software industries for investment is not proved as the real solution of the vc investment for growth. In their study Pandey, Rajan(2011) found that vc closely moniter the different situation and related outcome and also watch the agency cost associated with the firms. Many studies has been carried out to understand the venture capital investment decision criteria.

Risk perception of venture capitalist

From last few years data shows the the percentage of vc investment in different companies is not increasing trend and more surprisingly this is clearly visible from the number of vc deals in start ups, vc funds were become more cautious for funding in start up firms which might due to the following broad reasons.

3.1.Due to country related factor

As the growth opportunity of enterpreneur a country attractiveness for vc investment depends on the presence of different positive environment for the growth opportunity of start ups firms as well as for vc firms.

The Indian political unstability might be the major reason make the investor more concern about their future gain. With this the high inflation rate , low index of Industrial production growth and weakness of Indian rupee affected negatively the interest of vc investor to invest in Indian start up firms. With this the regulatory uncertainty was another issue which played a major role to scare investors away from India as in India imposed capital gain tax on VCPE investment returns this laid pressure during the time in the of the exit of vc firms . All

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this factors clearly reflects on the stastical trend of vc investment in India which falls down to 30% in this year as companies to pervious year according to report published by Bain Capital on vc investmnet in India 2013(Table-1).

As existance of venture capital industry is essential for enterprenurial growth of a country, its environment should allow the sustainance of this industry. Indian economy was dominated by few family owned business conglomerates , But the small and medium sized industry now a days possess a great imporatnce . As these firms found difficulties in arranging their fund from different traditional sources, venture capitalist could found this as an oppertunity to invest in these promising business ideas.

Venture capital industry depends upon a profitable investment oppertunity which should be contineous and could yeild a significant annula return on investment. Many reforms , after independence has been made by the Indian goverment which are reduction of foreign ownership in Indian operating firms according to Lateef (1997) and liberalisation of computer and software industry according to Evans(1992) encourage exports . This encourage the growth of software industry but till early 1990's the industry could not found more option of financial alternatives.Whereas at that time many westren country found vc as one of the efficient financial alternatives ,in India this industry remain in ignorant till 2001 due to beuracratic and highly regulated goverment . During dotcom boom in 1998 the real emergence of venture capital has started and continued afterward.

3.2.Due to technology proven business ideas

Gompers and Lerner (2001) argues that Venture capital stimulate the growth and renewal of a countrie's economy as they finance new, growing companies which posses high risk. As investment in start up posses huge risk and country's uncertain microeconomic , political and legal environment increases this risk perception many fold , which leads to distraction of vc investment in Indian start ups. The existance of vc is linked with entrprenuerial environment, as Hellman (1998) argues that due to the lack of entrpreneural activities , the venture capital investment is also lacking. So different measures fo boosting enterprenurial activity should be made . despite of presence of huge number of technology firms with their innovative ideas , India fails to attract sufficient venture capital fund due to its various legal , political rigidities.

With this many firm specific factors leads to the negative notion of vc investors.According to Denis(2004) the information assymetry between startups and investor, enterpreneur could not validate the value of their business model before investor despite of having a new patent of technology. This cause the existance of disagreement of values .With this the problem of moral hazard also cause dufficulties in obtaing external finance by entrprenuer.

In their study Tyebjee and Bruno(1984) found that product differentiation and market attractiveness of the venture are the critical factors for funding that considered by vc and they prefer those ventures from where they could realise early liquidity. As liquidity is one of the most crucial factor for investing in a venture which totally depends upon the success of the particular venture.

3.3 Factors which can reduce the perceived risk

Venture capitalist are known as profesional investor for longterm in equity of start up who can earn more in the form of captal gain. As risk contains in such investments , vc can reduce their irm specific risk by diversifying their investment portfolio (Gompers and Lerner 2004, De Clerg and Dimov 2003,Hege et all 2003). Also taking opinion from second vc firm can improve the screening for selection of strat ups which could provide better result in selection of better investment avenues(Lerner 1994, Gompers and Lerner 2004, Hege et all 2003).

Macmillan, Zemann and Narshimha (1987) identified five major classes of risk management which includes, 1)ventures where there is risk of failure due to unqualified mangement teams , 2) management with lack of experience,3)ventures where basic viability is in doubt, 4)venture where there is high exposure to competetive threats and profits get marginalised before investment in recouped, 5) ventures which lock up the investment, so that in cannot be eased out for long period of time.

So more over skilled management team, potential to servive in competitive market and ease of liquidity are major criteria of vc to select a venture to invest in, with the effort to minimise the risk factors with this , there is a need for close monitoring on venture backed companies is required to do by vc as the problem of assymetry exist between insider and outsider explained by Tykuova (2007). To resolve this information issues vc should monitor those firms before providing capital and afterwards. Different studies had suggested varities of monitoring tool which they have found out in their studies. Those are Lerner(1995), taking seat on board of directer of the firm, Gompers and Lerner (1994) suggested syndication of investment with other capital firms , stage financing over time Sahlman(1990) etc.

3.4 Signal from Market

As we are discussing on the risk factor that VC investor generally investigate in a venture before investment, the impact of public market on this investment must be noted down here to enlighten on broader aspect of venture investment. The return earned by VC industry is highly volatile as it depends upon both the profitability of portfolio companies and VC firm explained by Gompers and Lerner (2004). As IPO is most common and profitable way to exit from the deal according to Gompers and Lerner (1998), Jeng and Well(2000), the high valuation of IPO help VC to raise more fund. Various studies Cochrane (2005), Kaplan and Schoar (2005), Ljundqvisit and Richardson (2003) found this return is correlated with market as a whole. This leads to shifting the concentration of VC on more popular and visible investment areas. This may be indicated as the biasness of VC, who irrationally chose their future investment on the basis of past success. So despite of thinking in a contrary way, they follow the past consequences and go for reputed target as explained by Scharfstein and Stein (1990). This may or may not work well in real environment. As VC invests in unlisted, new entrepreneurial firm, their future could be accessed through their performance evaluation of their industry they belong to in the public market. With this the pool of flow of money to VC for their investment also depends upon the market volatility.

So in other word the market performance can impact both supply and demand side that is money flow to VC and demand side that is investment made by VC to a greater extent.

3.5 ”Trust” As A Factor to Curb the Risk Perception Of Venture Capitalist

It has been evident from the study Sorenson(2004) that the best performance is shown by experienced VC. The more they experienced in making investment decision and succeed in making the deal successful, the more efficiency they found in their decision making process. As the VC decision of investment is quite a complex procedure, but it is very essential to raise the number of VC investment in a country, specifically in new entrepreneurial firm. The risk lying in new venture cause decreasing trend in investment rate. According to Bain & Company Report on VCPE deals, year 2013 witnessed slight increase in VC investment in start -up stage but the share is very low in comparison to total investment..

This paper tries to enlighten upon some scenario which are considered to be risky for investment in start-up business by VC in India. There are some external factor which effect on the investment rate but when we consider the firm specific factors, it can be clearly visualize that , it is the trust that is lacking between VC and venture in many situation which leads to the problem like information asymmetry.

In India many entrepreneur firms come with innovative ideas and most of them have new patent of those ideas, but due to lack of trust between the firm and their VC investor, they could not convince the later. According to Tayabjee and Bruno(1984), VC shows very less interest to the business plan of an entrepreneur with whom they have low trust . Therefore they give their attention to a very few business proposal. This issue of trust could be happened with start-up firms also which make them reluctant to ask for fund from VCs. This could ultimately result into low investment of VCs in strat -up firms. Granovetler (1995) argues that the economic transaction that happens between two parties may depends upon the social network between them. It is the decision maker who make investment decision according to Sahlman(1990) largely influenced through the existence of their trust on entrepreneurial firm though they have a challenging patent of business plan.

Discussion and Conclusion

The effect of trust on VC investment in start-ups can be envisaged from above discussion highlighted in this paper. In India certain market related factors and infancy stage of VC industry causes the problem of low VC investment in Indian new technology firms. The investment pattern of VC somehow related with the market activity. There is need of developing the mechanism through which the risk factor caused by market and economic factor on VC investment could be minimized.

The number of success of venture deals with successful exit encourages the future investment. So here the factor determining success of these deals plays a crucial role from deal to deal. Kaplan and Stromberg(2004) studies on VC decision making process but yet many question about their selection process of venture is unclear.

Trust is found to play a major role between two parties involved in economic transaction. The economic value of trust is yet to be conceptualized. Under what circumstances the trust can be created and hampered badly are yet to analyzed in more details.

When the factor" trust" between VC and venture firm is discussing in this paper it is important to consider the fact that it plays a very crucial role in the designing the contract between them. Trust provides the safeguard to the both parties against violation of facts mentioned in contract. According to Lane(1998), the more existence trust between VC and firm , the less detailed contract is required to design. So again there is a scope of understanding the nature of contract in presence of the given degree of trust between them.

Many studies Bentsson and Hsu(2010), Dessein (2005), Gompers (1997) , Hellmann(1998,2006) and Kaplan and Stromberg (2003) have been made on the feature of contract between VC and entrepreneurial firm. A sophisticated contract between VC and firm determines the future and effective performance of the deal.

So from above discussion we can infer that the presence of unstable economic, political and legal environment no doubt hamper the VC investment , it is the lack of trust which cause the new technology firm less attractive in the eyes of VCs. The strong business plan is not enough to drag their fund in the business in current scenario in India as in the eyes of VC these new technologies possess more uncertainty in future. So it is the establishment of trust which can resolve this problem or else design of a sophisticated contract which can increase the trend of deal statistic.

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