IMPACT OF PRIVATE EQUITY & VENTURE CAPITAL ON INDIAN ECONOMY

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Introduction

Indian Private Equity continues to grow and evolve, but the path hasn't always been upwards and to the right. Many have seen a number of global firms shutter their Indian offices and few have successfully raised new money. Ironically, India's investment themes have never been stronger. Entrepreneurship is in many ways the cornerstone of the nation's economy. The private equity market has continued to grow as a means of financing, and making real, the dreams of these creative spirits. The challenges of the last few years have demonstrated that imagination must be coupled with a solid understanding of economic realities. Investors continue to seek innovative, promising business ideas; inventors, institutions and universities continue to seek the financing necessary to commercialize discoveries that will enhance our quality of life.

Meaning

India has the potential to become an industrial country thanks to the boom in the Private Equity (**PE**) and Venture Capital (**VC**) Industry. India continues to attract substantial portion of the global private equity capital. Backed by a strong IT services sector and the more recent IT enabled services (more commonly understood as business process outsourcing), India continues to be on the radar screen of most global private equity players. Venture capital is an equity or equity featured capital seeking investment in new ideas, new companies, new production, new process or new services that offer the potential of high returns on investments. As defined in *Regulation 2(m) of SEBI (Venture Capital Funds) Regulation, 1996* "venture capital fund means a fund established in the form of a company or trust which raises monies through loans, donations issue of securities or units as the case may be, and makes or proposes to make investments in accordance with these regulations. Thus venture capital is the capital invested in young, rapidly growing or changing companies that have the potential for high growth. The VC may also invest in a firm that is unable to raise finance through the conventional means.

The Beginning

The first ever Venture Capital Fund Management Company in India was Technical Development and Information Corporation of India (TDICI) which is now commonly known as ICICI Venture Funds Management Company Limited. The TDICI was formed in the year 1988 when the Government recognized the need for Venture Capital. Then other

financial institutions followed the suit of the Venture Capital Concept and launched their own Funds. These institutions initially invested in the small and medium size enterprises for almost a decade. Then the funding for Venture Capital activity was limited to small or medium size short term projects. Today, the Indian venture capital/private equity industry has developed even further. From funding small start up ventures with emphasis only on new age companies, the industry has now matured to cover the entire spectrum of private equity products. This progress was a result of SEBI Committee formed for the purpose of the growth of the Venture Capital Industry. This committee laid down clear guidelines for Venture Capital funds which encouraged the existing financial institutions to venture into private equity and venture capital industry.

Need for PE & VC

People in developing countries are poor in part because they have far less capital than people in industrial countries. Because of this shortage, workers have little in the way of specialized machinery and equipment, and firms lack money to obtain more equipment. As a result, productivity of workers in developing countries is low compared with that of workers in industrial countries. Financial-resource flows from industrial to developing countries are an obvious means to overcome this inequality. But financial resources are not enough. Some developing countries have natural resources such as oil or minerals that, when sold on world markets, have provided large amounts of money. In many cases the money has failed to stimulate sustained economic growth or increased productivity and income for the average person. In part, failure to use capital productively results from the way these resources flow. In some countries the government gets the money, which it uses to perpetuate itself through military spending or through increased consumption spending. In other cases, resources flow to wealthy individuals who use them to maintain high levels of conspicuous consumption.

Role of Venture Capitalist

The Venture Capitalist Companies play a key role in the growth of a developing country. The main objective of a Venture capitalist Company is capital appreciation. The Venture Capitalists are usually specialists in one or a few industries. Their sole motivation is to seek out and invest in high value-added companies, to influence as much profitable growth as possible in the shortest amount of time and to profit from that investment through stock market divestiture or any other viable exit strategy, though venture

capitalists may appreciate the need for economic development in third world countries. They make their investment decisions solely on the basis of the profit potential they see in business proposals. Thus they channel all their energies into choosing investments that, with technical and financial oversight, can grow in sales and profits to the point that the equity stake increases in value and can be converted into cash or liquid assets.

The Venture Capitalists believe in the principle of “High Risk-High Reward”. This nature often steers the fund managers toward high-margin industries that can benefit from value-added management and technical and financial assistance. High margin and profit potential usually come in the form of a company with new technology but little knowledge of how to finance, produce, market, or distribute it. Accordingly, venture capitalists often play a major role in moving newly developed technologies into the commercial sector. A fund manager sees the commercial potential of a new product and can translate that potential into a viable and highly profitable business undertaking.

On the funding side of the private equity business – it may be worth noting that till the recent past, a substantial portion of venture capital and private equity money in India has flowed from pension fund managers / investment institutions from the US, Far East, World Bank, other quasi governmental organizations, and multilateral development bank. What is striking, however, is the limited presence of domestic Indian investors. The peculiarity of this situation gets accentuated when one views it in the context of a robust banking and financial system present in the country. The availability of investible surplus and paucity of investment opportunities ought to have resulted including private equity funds in the portfolio of large financial institutions.

A low inflation environment creates a focus on growth stocks as a means of out-performance. One of the core skills of the successful Venture Capitalist is to pick companies with growth potential and actively to create the conditions for growth in those companies. Since PE & VC funds own large, often controlling, stakes in companies, few, if any, other private equity managers will have access to the same companies. Venture Capitalists are therefore true "stock pickers". This contrasts to mutual funds, which will often hold largely the same underlying investments as their peer group, with variations in weightings being fine-tuned to a few basis points.

Present Scenario

Recent months have witnessed a dramatic shift in the composition of

foreign investment flows coming into the country. According to figures released by *the Department of Industrial Policy and Promotion of the Ministry of Commerce and Industry,* foreign direct (equity) investment inflows during the first ten months (April-January) of financial year 2006-07 touched $11.19 billion, as compared with $16.5 billion over the whole of the 1990s and an annual average of $2.2-3.2 billion during 2002-03 to 2004-05. The current surge in inflows had begun modestly in 2005-06, when FDI inflows stood at $5.5 billion.

There are two messages that are being read into these new figures. First, that post-liberalization India, like China, is finally becoming a manufacturing hub for international firms that are making long-term productive investments in the country. Second, that India is finally moving out of the phase when it was largely the target of speculative foreign portfolio investments into the country, to one in which it is attracting productive investment flows.

There are reasons to believe that these judgments may not be warranted. It needs to be noted that the distinction between portfolio and direct investment flows is based purely on an arbitrary cut-off line defined in terms of the proportion of equity in a firm held by a single foreign investor. After liberalization India had adopted the international definition of foreign direct investment as any investment in which a single foreign investor acquires 10 per cent or more of the paid-up capital in a firm. If the acquisition by a single entity is less than 10 per cent, the investment is classified as a portfolio flow.

Portfolio diversification by financial investors in developed countries seeking new targets, higher returns and/or a hedge has over the last quarter of a century taken them into new and ostensibly "innovative" and "alternative" asset classes. One such is private equity, which, as originally and broadly defined, involved investment in equity linked to an asset that is not listed and, therefore, not publicly traded in stock markets. More recently, private equity firms have invested even in listed companies, though the buyout by the investor occurs through a negotiated process, with the buyout being friendly or hostile depending on whether the negotiation is with the controlling interest or not. In sum, private equity is acquired either through the private placement of new shares or the sale of pre-existing shares by the controlling interest or minority shareholder and, therefore, has features that characterize most takeovers.

Importance of Investments in PV & VC Funds

The fundamental reason for investing in private equity is to improve the risk and reward characteristics of an investment portfolio. Investing in private equity offers the investor the opportunity to generate higher absolute returns whilst improving portfolio diversification. The long-term returns of private equity represent a premium to the performance of public equities. Most private equity funds are offered only to institutional investors and individuals of substantial net worth. This is often required by the law as well, since private equity funds are generally less regulated than ordinary mutual funds.

In the past the performance of private equity funds has been relatively difficult to track, as private equity firms are under no obligation to publicly reveal the returns that they have achieved from their investments. In the majority of cases the only groups with knowledge of fund performance were investors in the funds, academic institutes and the firms themselves, making comparisons between various different firms, and the establishment of market benchmarks to be a difficult challenge.

Conclusion

PE & VC are becoming a major mechanism for stimulating innovation and entrepreneurial growth. In India, this is catalyzed by the rapid growth in information technology. There is a strong need to enhance availability of venture capital in developing countries as most of these risks averse but awareness about the role of venture capital has been very limited. There has to be systematic initiatives for simulating entrepreneurship through use of venture funds. The distortions in the capital market due to over regulations and multiple controls are also a problem that is hindering the growth of PEs & VCs.

Developing countries have to regularize the private equity requirements and venture capital needs so that they can incite entrepreneurial firms that focus on high-tech innovations. Though most of venture funds state that high technology is their priority only firms started by experienced persons find support by PE & VC funds. Capability for assessing venture projects continues to be a weak area in the case of developing countries such as India because of the lack of prior experience. Enterprise funds do, however, provide a means for developing instruments adapted to a country’s private sector financial needs to improvise the economy of that developing country.