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Risk Capital Financing of MSMEs in India – A Look into VC Funding and Its Prospects

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Abstract

Venture Capital has emerged out as an important source of finance for both existing and emerging source of Capital. An entrepreneur needs funds to start as well as to continue its business for long run. For this entrepreneurs need funding from own source as well as from financial institutions. In both the cases they find it difficult to source funds. During expansion projects also these funding need is in high. Traditionally SMEs are dependent on banking finance because it is easiest source to get funds. VCs are emerging as the source of equity funding for MSMEs. Projects are funded in a very secured manner after scrutinizing every aspect because there is no guarantee that these investments are secured enough. The aim is to record a higher Return on Investment (ROI) not in very long term time perspective. The VCs take active part in management of the MSMEs as well as they have active participation in management and operation of the enterprise. They also take active interest in the business functioning of the enterprise as the budding entrepreneurs don't have enough skills to take responsibility in efficient functioning of the business. That is why not only capital investment but also technical support is needed for the MSMEs to grow in this competitive market. Government's initiative of "Make In India" paved the way for small businesses to venture out for new opportunities as well as to avail export promotion benefits. As small in size these companies also enjoy advantage of lower start up cost. VC funding is best suitable for emerging areas of business like Information Technology, Pharmaceuticals, Food Processing units etc. where growth rate is high and also fierce competition for survival is very prominent. The intention of this paper is to highlight the prospect as well as future of the Venture Capital funding in the SMEs in India.

Keywords: *Micro Small and Medium Enterprises (MSMEs); Venture Capital (VC); Make In India; Equity and Debt Financing; Securities and Exchange Board of India (SEBI).*

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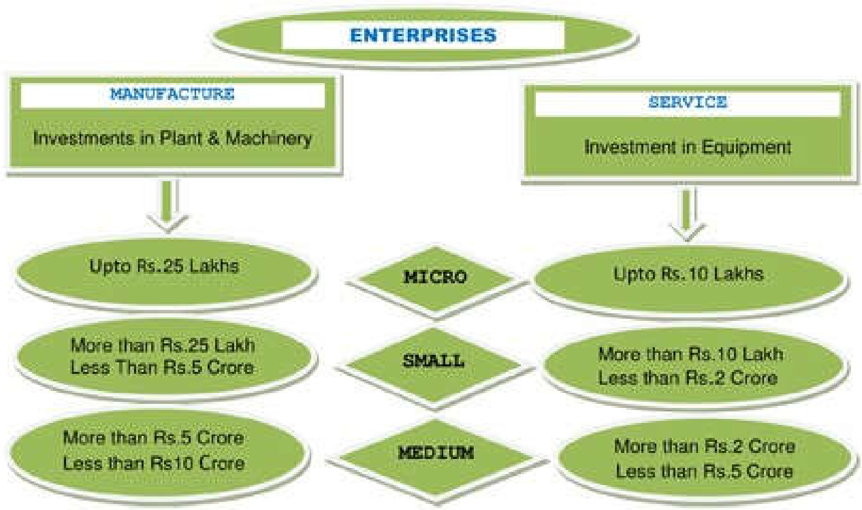
1. Introduction

The MSME sector has a very heterogeneous character in Indian perspective. This heterogeneity can be found in the nature of size of the enterprise, variety of the products produces, and nature of the technology used for production. The MSMED Act, 2006[1] specified the following categorization of the MSMEs –

Figure 1: MSME Categorization



The MSME sector in India has contributed significantly in Indian economy. It has a huge network of 633.92 lakh enterprises out of which merely 4000 are large enterprises.[2] It creates more than 75 million jobs and manufactures more than 6500 products.[3] This huge amount of product also includes more than 40% exportable goods which also strengths the economic backbone of the country. It is indeed an well known fact that MSME sector can help to achieve the target of the proposed National Manufacturing Policy to raise the share of the GDP of the manufacturing sector from present 16% to 25% by 2022 end.[4] Venture capital means the funds available for seed finance as well as finance for growth and expansion for those enterprises that have excellent growth opportunity. In general venture capital funding is done not only to provide finance but also it helps to add value to its products and to maximize the market share of the firm and thus ensuring a good Return on Investment of its employed capital. VCs really work as

[1] *MSMED Act, 2006, Ministry of MSME, Government of India*
[2] *NSS (National Sample Survey), 73rd Round on Unincorporated Non-Agricultural Enterprises in Manufacturing, Trade and Other Services Sectors (Excluding Constructions)*
[3] *6th Economic Census (2013) available at* https://www.mospi.gov.in
[4]*Brief Note on National Manufacturing Policy* https://dipp.gov.in/policies-rules-and-acts/policies/national-manufacturing-policy

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angels not only for those who in need of the funds but also for those who are searching for opening up new avenues to grow and expand not only in India but in foreign market also. By nature MSMEs attract a huge labor force both in rural and urban sector thus directly helping in economic development of the country.

Micro, Small and Medium Enterprises (MSMEs) play a crucial role in the economic development of the country as well as in creating jobs in rural and urban sector. These budding entrepreneurs possess high enthusiasm and a visionary eye to foresee future and also have a high potential for growth. But as they are new to the game, they used to face many constraints in this process. Sometimes these constraints are for their ignorance of the whole system and sometimes it is the difficulties and negatives that is already present in the system. Among these constraints lack of adequate finance is an important and most prominent one. Despite Government's different orders on making an easy financing procedure for MSMEs, getting bank finance is cumbersome and tedious effort for the entrepreneurs. This bank financing also required lots of paper work in which the entrepreneurs are not accustomed into and relatively there is minimal help available in this case. On the other hand expecting equity financing from outside investors is not a likely option for the MSMEs as this mode of financing already involves inherent risk of the instrument itself and adding salt to cut is the uncertain future of the enterprise. Equity investors need more accurate information about the company's present and future conditions. This data and evaluation of the data available is a mammoth task. MSME in general made a critical contribution in Indian GDP. Often termed as "Engine of Growth" the MSME got a very important role in terms of employment generation and production. The MSME contributes 6.11% of the manufacturing GDP whereas 24.63% of the GDP from service activities as well as 33.4% of India's manufacturing output. The sector has consistently maintained a growth rate of over 10%. About 20% of the MSMEs are based out of rural areas, which indicates the deployment of significant rural workforce in the MSME sector and is an exhibit to the importance of these enterprises in promoting sustainable and inclusive development as well as generating large scale employment, especially in the rural areas.

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Table 1: Share of MSME in GVA and in GDP

(Figures in Rs. Crores adjusted for FISIM[3] at current prices)						
Year	MSME GVA	Growth (%)	Total GVA	Share of MSME in GVA (%)	Total GDP	Share of MSME in GDP (in %)
2011-12	2583263	-	8106946	31.86	8736329	29.57
2012-13	2977623	15.27	9202692	32.36	9944013	29.94
2013-14	3343009	12.27	10363153	32.26	11233522	29.76
2014-15	3658196	9.43	11481794	31.86	12445128	29.39
2015-16	3936788	7.62	12458642	31.60	13682035	28.77

Source: Central Statistics Office (CSO), Ministry of Statistics & Programme Implementation.

The contribution of Manufacturing MSMEs in the country's total manufacturing GVO (Gross Value of Output) at current prices has also remained consistent at about 33%, i.e. one-third during the last five years.

Table 2: Growth of MSMEs

Parameter	NSS 73rd Round 2015-16	Fourth All India Census of MSMEs. 2006 -2007	Annual Compound Growth Rate
No. of MSMEs (Total)	633.88	361.76	6.43
Manufacturing	196.65	1115.00	6.14
Services	437.23	246.76	6.56
Employment (Total)	1109.89	805.2	3.63
Manufacturing	360.42	320.03	1.33
Service	749.47	485.21	4.95

Source: MSME Annual Report 2017 – 18

1.1 Risk Capital

Also known as Venture Capital, IDBI (Industrial Development Bank of India) formally rolled the Venture Capital in 1987. A 5% tax was levied by Government on all knowhow import payments to create the Venture Capital Fund. ICICI Venture Capital formed in the same year and later floated TDICL as a separate venture capital fund. The main motive behind rolling the VC is to enable the entrepreneurs with talent and business skills and this was in their charter from the very beginning. It is a mean of equity financing and for needy firms. These Venture Capitalists include skilled professionals from various fields.

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It is more appropriate for firms with high risk, high growth and high returns. Because the venture capitalists need a higher return for their risky investments. The ability of the MSMEs to access alternative sources of funds needs to be increased considerably and this is very important for those whose main theme is innovation and new technological changes. But these types of funds are not generally available for the MSMEs as they can only access the funds of traditional nature. MSMEs face different stages of businesses. In their start up stage seed financing is necessary to study the market and opportunities, product or service development and to develop concept handling a business. This stage is very crucial as many budding talents die in this stage for not having a good financial backbone. At this stage the firms have to face a fierce competition on which their own product is tested and this is the phase when they can stay or have to quit for not being coped up with competition. Many high growth firms need incubation period to study, develop an idea or product development before they can start making profits. This phase needed the VCs to be on their side which can help them to overcome this incubation period. The Government of India in terms of the recommendation of the Prime Minister's Task Force on MSMEs, is already looking at removing the fiscal/regulatory impediments to the use of such funds by MSMEs.[5]

Venture Capital funding is ideal for newly emerging companies like Bio – Technology, Information Technology, Pharma and other knowledge based sectors in India. VCs are generally means of the main financing needed for these firms during the seeding phase of equity requirements. General venture capitalists perform on the pooled money of the investors whereas the Angel Investors generally invest their own funds. These Angels are becoming critically important as financers as alternative sources of finance are becoming more and more important. Investors such as Mumbai Angels, Nadathur Holdings and Investments, The Indian Angel Network etc. are some of the well known investors who provide funding and mentoring services to the MSMEs. In recent days bankers have curtailed their loans to the MSMEs as it is leading to more and more NPAs which is leading to lack of funding to the MSMEs. Now MSMEs mainly depend on VCs and Angels who in real life is really becoming angels to them in terms of equity financing and providing their expertise in handling businesses.

In order to provide financial support to such entrepreneurial talent and business skills, the concept of venture capital emerged. Venture capital is a means of equity financing for rapidly-growing private companies. Finance may be required for the start-up, expansion or purchase of a company. Venture capitalists comprise of professionals in various fields. They provide funds (known as Venture Capital Fund) to these firms

[5] *Report of the Prime Minister's Task Force on MSME 2010*

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after carefully scrutinizing the projects. Their main aim is to earn higher returns on their investments, but their methods are different from the traditional moneylenders. They take active part in the management of the company as well as provide the expertise and qualities of a good bankers, technologists, planners and managers.

2. Review of Literature on Venture Capital Financing

The theoretical perspective of Venture Capital has just begun. The VCs generally provides risk capital funding for the new as well as expansion oriented projects.

Bliss (1999), VCs assume active role on the management of the firms. The budding entrepreneurs may not have enough skill to carry on the business efficiently so the intervention is needed by the VCs to manage the firm well as well to secure their investment.

Balachandran (1994) defined venture capitalists as an intermediary between institutional investors and portfolio companies which actually is a narrower definition.

Kaplan et. el. (2002) stated that after the dot com boom faded out most of the VCs started seed financing.

Srinivas and Nagaraja (2013) stated that VCs play an important role in seed finance and not only that it helps in providing support to the budding entrepreneurs in terms of production, product development and market development.

Puri and Zarutskie (2010) has showed that venture capital backed companies are much keen to expansion and growth possibilities than the non venture capital backed companies.

Cumming and Johan (2010) developed a theory and proved that the duration of the venture capital investment depends on the marginal benefits arising from the investment which should be less than the cost of managing the portfolio.

3. Objectives

- To study the recent developments of Venture Capitals in India
- To study the future prospects of Venture Capitals in funding MSMEs in India
- To study the ways and means of funding MSMEs through equity options by Venture Capitals.

3.1 Venture Capitalists For MSMEs In India

Venture Capitalists are persons or firms that arrange for risk capital or equity funding and they are expected to bring the managerial as well as technical expertise to the new firms and budding entrepreneurs are lacking these skills. A Venture capital may invest in the new business by two ways – on the first hand they pool investment from other investors and then make a portfolio to invest in risky areas. On the other

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way the Angel Investors are the individuals who arrange for capital by their own and invest in the new business. The Venture Capital firms consists of people from different background like scientists, management experts, engineers etc. who are trained in their respective domains and also helps to take investment or expansion decisions for the company.

3.2 Need of Venture Capital Funding

- There are many budding and bright entrepreneurs in India with zeal to stand on their own and make things happen. But the only problem is seed finance. Venture Capitalists can satisfy their needs.
- There is generally a ownership interest for the Venture Capitalists as they take interest in management of the business like the receiver. So for their own interest they will make the business growing.
- Generally venture capitalist firms or the Angel Investors are experienced in handling risky situations. So they can share their knowledge with the entrepreneurs as well as they use it in practical life when they face situations similar to the previous and can easily solve the problem. Moreover these capitalist firms can help in growth and advancement of the business.

The MSME sector was traditionally out of the reach of the venture capitals. As this investment is too risky, so the VCs did not consider it as a means of investment. The risk capital or the equity investment has transaction cost and difficulties in issuance of these types of instruments. Now as the MSMEs are small in size and also quantifiable in number so VCs traditionally was reluctant in funding the MSMEs. But with the growth of the number of MSMEs in India and the Government policy is favoring them a lot with generation of lots of employment the scenario is rapidly changing. As the MSMEs are rapidly expanding and there are more avenues are opening up the VCs views are changing a lot. The VCs are now favoring the rapidly growing areas like Bio-technology, healthcare, pharmaceuticals, retail, media etc. than the traditionally taken Its and BPOs/KPOs. Traditionally MSMEs were lacking funds for growth and expansion but as of now the Government has changed their views a lot and the funding process has made a lot easier. Government funded schemes are now available at all the rural and urban areas. So the cost of funding has become lesser with the introduction of the VC funding. The SIDBI (Small Industries Development Bank of India) is the first state owned VC established to fund MSMEs which is operated by the wholly owned subsidiary SIDBI Venture Capital Limited (SVCL). It sometimes co-finances with private VCs in case to case basis.

Some new VCs like Erasmic Venture Fund (Accel India Venture Fund), Seed Fund, Helion Venture Partners etc. are also started financing VCs.

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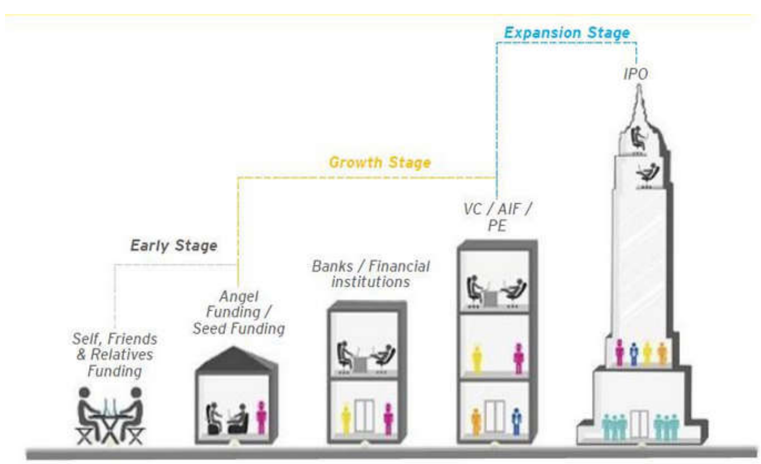
Technology is the most sought after field for investment for VCs but recently the lookups are changing from IT enabled companies to other types of businesses like ICT enabled companies and Bio-technology. Firms like Infinity Venture, IFI sponsored facilities like Swiss Tech VCF and the Government schemes like SIDBI VC and Gujarat VF. Traditional and early stage VCs look for smaller deals which typically lies between US$ 1 – 3 million range which proves that there is demand but not enough supply of the funds. Locally there are some private sources like Angel Investors, business incubator funds, and some isolated cases like micro venture schemes like Aavishkaar India Micro Venture Capital Fund etc.
Venture Capitals are the most important source of funding the risky and capital rich projects because no financial institutions are ready for financing such risks and there are also no alternatives available. In many cases like IT the value of the intellectual property is unproven thus leaving no other option than to seek for VC investments in recent fast growing fields like Bio-technology and pharmaceuticals.

3.3 Advantages of VCs in Over Other Funding Methods

- Venture Capital financing offers affordable equity capital financing for the budding entrepreneurs.
- The Venture Capitalists work as knowledge provider to the entrepreneur which also helps to grow his own business.
- VCs are experienced enough in past business operations. So they can lead the start-up to success.
- The venture capitalists can source skilled as well as unskilled workers and technology so that the expansion projects can be easily initiated. The long years of experience in providing finance as well as knowledge both in seed capital and expansion projects.

Figure 2: Investment Lifecycle for MSMEs



3.4 Stages of Venture Capital Financing

The stages of VC financing is as below –

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Seed Finance – Low level financing for improvement of new idea

Start Up – Need for financing product and market development ideas

First Round – Early sales and manufacturing funds

Second Round – Working capital financing

Third Round – Mezzanine finance or expansion finance

Fourth Round – Bridge financing for "Going Public" option

3.5 Risk in Stages –

The risk stages and locking years along with risk perception is shown below –

Financial Stage	Funds Locked in Years	Risk Perception
Seed Finance	7 – 10	Extreme
Start Up Finance	5 – 9	Very High
First Stage	3 – 7	High
Second Stage	3 – 5	Sufficiently High
Third Stage	1 – 3	Medium
Fourth Stage	1 – 3	Low

4. Venture Capital Funds in India

India has witnessed a steady growth rate in venture capital funding –

- Central Government controlled development finance Institutions –
  - ICICI Venture Funds Ltd.
  - IFCI Venture Capital Funds Ltd (IVCF)
  - SIDBI Venture Capital Ltd (SVCL)
- State Government Controlled development finance Institutions –
  - Punjab InfoTech Venture Funds
  - Gujarat Venture Finance Ltd.
  - Kerala Venture Capital Fund Private Limited.
- Public Banks floated institutions –
  - Canbank Venture Capital Funds
  - SBI Capital Market Ltd.
- Floated by Private Sector Companies
  - IL&FS Trust Company Limited
  - Infinity Venture India Fund

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4.1 Rules and Regulations of SEBI

Venture Capitals are mainly regulated by the SEBI (Venture Capital Fund Regulation, 1996 as under[6] –

- "A venture capital fund may be set up by a company or a trust, after a certificate of registration is granted by SEBI on an application made to it. On receipt of the certificate of registration, it shall be binding on the venture capital fund to abide by the provisions of the SEBI Act, 1992.
- A VCF may raise money from any investor, Indian, Non-resident Indian or foreign, provided the money accepted from any investor is not less than Rs 5 lakhs. The VCF shall not issue any document or advertisement inviting offers from the public for subscription of its security or units
- SEBI regulations permit investment by venture capital funds in equity or equity related instruments of unlisted companies and also in financially weak and sick industries whose shares are listed or unlisted
- At least 80% of the funds should be invested in venture capital companies and no other limits are prescribed.
- SEBI Regulations do not provide for any sectoral restrictions for investment except investment in companies engaged in financial services.
- A VCF is not permitted to invest in the equity shares of any company or institutions providing financial services.
- The securities or units issued by a venture capital fund shall not be listed on any recognized stock exchange till the expiry of 4 years from the date of issuance
- A Scheme of VCF set up as a trust shall be wound up when the period of the scheme if any, is over
- If the trustee are of the opinion that the winding up shall be in the interest of the investors
- 75% of the investors in the scheme pass a resolution for winding up or,
- If SEBI so directs in the interest of the investors."

5. Future of Venture Capital in India

The future prospects of the venture capital funds can be discussed in the following lines –

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[6] *As stated in SEBI (Venture Capital Fund) Regulation, 1996*

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a) The rehabilitation of sick units can be done through Venture Capital funding.
b) The small ancillary units can be revived by introducing new technologies and expanding their area of operation.
c) Service sectors like tourism, healthcare needs capital investment as well as the return from this sector is extended as it needs time to settle down.
d) Entrepreneurial spirits should be encouraged to the people who are coming out of different educational institutions, technical institutes so that MSMEs can experience a boom.

5.1 Conclusion

a. The regulatory framework should support the development of venture capital funds which can also lead to increase in seed as well as expansion financing in later years. Flexibility should be introduced to make operations easier for the VCs.
b. Raising finance, entry into the market and exit norms should be in line with the global trends.
c. As risk capital is a major issue for the growth of the MSMEs, this should be encouraged more to bridge the gap between the source and the needy.
d. If it is only restricted that MSMEs should only raise from Indian market, then it will be a problem as there is a very few no of firms that are available for financing the risk capital. So it is necessary to integrate global VC markets also so that no expansion or growth plans or seed finance are gone into waste.
e. MSMEs are lacking R&D facilities. So the Government should take initiative to promote more and more the incubators and the R&D firms and also help the VCs to promote those activities which in turn increase the ROI of the VCs and make the MSMEs real drivers of growth for the economy.

5.2 Suggestion

On the above discussion it is evident that there should be a clear cut strategic approach needed for venture capital financing. Elements like scope of financing, competitive advantage and economic performance are needed to be clearly mentioned in this approach. The strategic element of the company is needed to be analyzed beforehand to assess the type, need and importance of venture capital financing in India. It decides the success or failure of the venture capital funding for that very business. To access this there is none other than the R&D techniques to be followed very rigidly so that the investment does not go into vein. In the next step, for high technology firms, analysis of the management is also necessary. The organizational as well as business management skills sometimes define the success and failures of the firm. There should be a strategy – performance approach which can lead to efficient financing as

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well as effective management practice. The decision making part of the Venture Capital firm is most important because it deals with the selection of the portfolio as well as selection of the company on the basis of business nature and valuation models. The firm in which the VCs are going to invest to be critically scrutinized before investing. The firms are to be treated as SBUs (Strategic Business Units) where the VC firms should opt for Management by Objective (MBO) approach. The objectives should be well defined as well as future oriented and should be aimed at development of the enterprise as well as the economic development of the country.

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