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Venture Capital: World-Wide Scenario

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Abstract

Venture capital (popularly known as VC) investment has become one of the most swiftly growing investment approaches world-wide, especially in developing countries. The contributing features to this growth are the latest economic as well as legally permissible changes. Various governments have provided purposeful operational and well-designed autonomy to institutions while at the same time closely observing them by framing numerous rules and regulations that lay down various ways for the investment. In other words, it can be said that the laws-by laws are still investment-friendly and offers various benefits in the shape of tax reforms for both domestic as well as foreign investors.

Keywords: *Seed Stage, Global Deal, Healthcare, Deceleration, Hedge Funds etc.*

1. INTRODUCTION

The term *VC* (i.e. *V*enture *C*apital) is used for capital that is invested by an outsider in a small or belligerent business venture. It is an established fact that risk and return have strong bonding and the more return one expects from any venture the more it gets closer to high altitude of risk. In a typical venture capital investment, a venture capitalist would invest in a business over a period of three to five years and exit once it has earned its return. But the growth and smooth functioning of the venture capital market depends on the total growth and smooth functioning of the country's legal system and economy. Therefore, to understand the venture capital market development in India, or any country for that matter, it is necessary to take a look at the legal system and the economy first.

In India, an investor may incorporate a company or form a trust, in order to invest in venture capital. A foreign company can establish a place of business in India as a foreign company under Section 591 of the Companies Act 1956 or as a domestic Indian company incorporated in India under Section 3 of that Act. Otherwise, a venture capital fund can be created as a trust under the provisions of the Indian Trusts Act 1882 (the "Trusts Act"). According to Section 7 of the Trusts Act, a trust can be created by any person competent to contract. The only condition is that the trust should be created for a lawful purpose. Though the application process and eligibility criteria for granting a registration certificate are almost same for both types of venture capital funds, that is, domestic and foreign; there are slender differences in the conditions for the grant of the certificate. While a domestic fund is not allowed to carry on any activity other than the venture capital fund, a foreign investor must appoint a domestic guardian and should have a foreign currency account in one of the designated banks. Also, domestic fund is not allowed to invest more than 25 percent of the funds in one venture undertaking.

2. REVIEW OF LITERATURE

Venture capital investment is generally recognized as a three-stage process: fundraising, investing, and exiting (Gompers and Lerner, 2006; Silveira and Wright, 2010). During investment, venture capitalists select and allocate equity into new "untried firms pursuing complex, innovative technologies or novel business strategies" (Gompers and Lerner, 2001, p. 87). Unlike traditional financial intermediaries, venture capitalists provide organizational, managerial, and industry advice, assisting entrepreneurs to mitigate complications such as uncertainty, knowledge gaps, inexperience, and volatile market conditions (Arthurs and Busenitz, 2006; Bottazzi et al., 2008; MacMillan et al., 1989; Metrick and Yasuda, 2010). Venture capitalists are able to better manage inherently risky investments because they usually possess specialized industry knowledge and networks of experts who can evaluate people, markets, and technology (Gompers and Lerner, 2001). Although the role of venture capitalists is clear, an underlying ambiguity exists as to whether government policies address industry or market development. The notion of a market is widely used, but not well defined, in venture capital market development studies (Brooks, 1995). "Industry" and "market" are commonly interchanged throughout the literature; but separately they imply different phenomena (Brooks, 1995). Many studies have implicitly viewed venture capital markets as freestanding entities and have attempted to develop them accordingly, leading some to suggest this as one reason for some governments' failed policies (Avnimelech and Teubal, 2008; Lerner, 2009). From a more mainstream economics perspective, a market requires both a buyer and seller, or supplier and consumer, to perform transactions of exchange (Samuelson and Nordhaus, 1985). Other scholars classify market as a form of institution at a higher level than the organization (Porter, 1981). In contrast, industries are mainly concerned with the supply-side focussing on firms producing similar goods or services (Brooks, 1995). These definitions suggest that the development of a venture capital industry would create a strong supply of venture capital, but not necessarily demand from players with whom to transact. It is from this market-based definition that we review the main approaches to venture capital market from a market-based perspective where we define venture capital market development as the development of buyers and sellers in the activities of fundraising, investing in, and exiting from high-risk ventures. Scholars describe a variety of solutions for venture capital market development. Despite a proliferation of works, a consensus on how to grow venture capital markets is yet to emerge (Lerner, 2002). This review provides a general stock take of existing knowledge about venture capital market development to identify existing gaps and problems, and outline some future research directions that might assist scholars toward better explanations of venture capital market development. Recently Lerner and Tåg (2013) categorized various institutions as direct and indirect policies in the context of comparing venture capital markets across countries. In their study direct policies took the form of governments having direct involvement in venture capital markets, where as indirect policies referred to creating the institutional environment through, say, taxation and IP policies. The purpose of their study was to compare how institutional differences affected the venture capital market performance, so the role of governments was not central to their discussion. About the same time Avnimelech and his colleagues described the notion of time approaches to venture capital in the context of conceptualizing evolutionary explanations of venture capital markets. These authors' categorizations of direct, indirect, and timed approaches provide the basis for us to organize and review existing literature that is pertinent to our aim reviewing existing explanations of governments' role in venture capital market development.

3. GLOBAL SCENARIO

Year 2015 was a record-setting year for venture capital, with over $128 billion of total investment made worldwide, topping 2014's total by 44 percent. From healthcare to Fin Tech, and retail to education, companies sparked changes that could affect every sector and every business moving forward. Investors saw this potential and made significant investments; in fact, 71 VC-backed companies achieved Unicorn status ($1 billion valuation) during the year, compared to 53 in 2014. The World Economic Forum calls this dawning era of transformation and innovation the Fourth Industrial Revolution. However, after 2 incredibly strong QTR.s, investors are becoming more cautious with their funding. We've seen VC investment drop from $38.7 billion in Q3 to $27.2 billion in Q4, while the number of deals hit a low not seen since Q1'13. The drop-off was most noticeable in Asia, where China and India received significantly less funding than in all previous QTR.s of 2015. Comparatively, Europe experienced the least decrease in VC activity, although both the number of deals and the total deal value in Europe remain small compared to other regions of the world. The drop in VC investment signifies a shift in thinking as global investors seem to be taking a less bullish view of the market. An uncertain global economy, a projected slowdown in China, and expected interest rate increases following the recent increase in the US seem to be driving some investors to hold back their investment dollars.

These trends, along with a number of fourth QTR. of 2015 IPOs falling short of recent private valuations appear to be making investors more vigilant. Some investors have even moved to write down a number of their major VC investments in order to reflect fair market value. Investor vigilance will likely continue to impact VC activity heading into the second QTR. of 2016.

Asian VC activity declines amidst slowdown concerns Asia was also hit hard overall by the decline in VC activity during fourth QTR. of 2015, with both China and India receiving substantially less VC investment than in each of the previous three quarters. In fact, total deal value in Asia dropped from $14.2 billion in third QTR. to just $9.7 billion in fourth QTR.. Concerns regarding a slowdown in China's economy and a weakening retail sector appear to be fuelling caution across VC investors.

4. F & D (FUNDS 'n' DEALS)

Funding to VC-backed companies in 2015 reached a multi-year high, topping 2014's total by 44%. Mega-rounds proved to dominate the start up world in 2015 as, despite the highs in funding, deals actually fell 3% versus 2014.

Table 1

Annual Global Financial Trends to VC Backed Companies					
Particulars	**2011**	**2012**	**2013**	**2014**	**2015**
	1	**2**	**3**	**4**	**5**
INVESTMENTS (*In Billion Dollars*)	49.1	44.8	50.2	89.4	128.5
NUMBER OF DEALS	5534	6442	7259	8089	7872

Source : Ventue Pulse, KPMG International and CB Insights.

Table 2
Trend Values of Investments

S.no.	**Year ended**	**Investments (in billion dollars)**	**Trend values** $Yc=a + bx$
		(Y)	$Yc=72.40 + 20.34x$
1	2011	49.1	31.72
2	2012	44.8	52.06
3	2013	50.2	72.40
4	2014	89.4	92.74
5	2015	128.5	113.08
11	2016	------	133.42
12	2017	------	153.76
13	2018	------	174.10
14	2019	------	194.44
15	2020	------	214.78

An annual growth of 20.34 billion dollars in investments is expected to take aggregate investments to 214.78 billion dollars by 2020 which means a significant growth of 677.11 % during second decade of 21st century, which in itself is a good sign of economic health.

5. SEED-STAGE DEAL SHARE

Deal share to seed-stage investments dropped below 30% in Q4'15, reaching just 29%. Series A deals reached a 5 QTR. high at 26% deal share. Mid-stage (Series B - Series C) deals accounted for 23% of all deals in Q4'15, matching the previous 5 QTR. high from Q3'15.

Table 3 : Qtr.Ly Global Deal Share (Stage-Wise) (In Percentage)

PARTICULARS	SEED/ ANGEL	SERIES					
		A	B	C	D	E+	OTHER
	1	2	3	4	5	6	7
QTR. 4 (2014)	34	25	13	7	4	3	16
QTR. 1 (2015)	34	22	13	7	5	3	16
QTR. 2 (2015)	32	24	14	9	4	4	14
QTR. 3 (2015)	32	23	15	8	4	4	15
QTR. 4 (2015)	29	26	16	7	3	3	16

6. MEDIAN EARLY-STAGE & LATE-STAGE DEAL SIZE

Median early-stage (Seed - Series A) deal size among all VC-backed companies was $2.5M in Q4'15, up 14% versus the previous QTR.. The climate remains competitive for micro-VCs, multi-stage funds and strategic investors looking at early-stage deals.

Table 4

Particulars	Median early-stage deal size (in million dollars)	Median late-stage deal size (in million dollars)
QTR. 4 (2014)	2.2	18.3
QTR. 1 (2015)	2.0	22.0
QTR. 2 (2015)	2.3	30.0
QTR. 3 (2015)	2.2	35.0
QTR. 4 (2015)	2.5	31.3
AVERAGE	2.24	27.32

The staggering drop in mega-rounds led to global median late-stage deal sizes falling off Q3'15's highs. However, despite just 38 mega-rounds, the median late-stage deal size stayed at or above $30M for the third straight QTR.

7. ROLE OF SIGNIFICANT SECTORS IN VC-BACKED DEALS

Internet and mobile continue to represent the bulk of deals to VC-backed companies, as the two major sectors accounted for 66% of all deals in Q4'15. All other sectors remained fairly range-bound with healthcare accounting for 13%, software 6%, and consumer products & services 4%.

Table 5 : Quarterly Global Deal Share (Sector-Wise) (In Percentage)

Particulars	Internet	Mobile & Tele communications	Healthcare	Software- (non-internet / mobile)	Consumer products & services	Other
	1	2	3	4	5	6
QTR. 4 (2014)	46	20	12	6	3	13
QTR. 1 (2015)	47	19	13	5	3	13
QTR. 2 (2015)	49	18	11	5	4	14
QTR. 3 (2015)	49	18	11	6	3	13
QTR. 4 (2015)	50	16	13	6	4	12

8. ASIA : THE LARGEST MEDIAN FOR LATE-STAGE DEALS

Median late-stage deals in Asia have been greater than both US and European medians for the last 5 QTR.s. After Q4'14 saw median late-stage deal size in Asia spike to $230M behind big rounds including Xiaomi's $1.1B financing, Asia deals once again increased to $150M+ in Q4'15 behind $1B+

financings to China Internet Plus Holdings (the merged entity of Dianping and Meituan) and Ele.me

9. TECH ON THE TOP

Tech companies have taken 76%+ of all deal activity to VC-backed firms in each of the past 5 QTR.s. Healthcare failed to garner more than 13% in any QTR. over the same period.

Table 6

TECH *vs* HEALTHCARE (*In Percentage*)

PARTICULARS	TECH	HEALTH CARE	OTHER
	1	2	3
QTR. 4 (2014)	78	12	10
QTR. 1 (2015)	76	13	11
QTR. 2 (2015)	78	10	12
QTR. 3 (2015)	78	11	11
QTR. 4 (2015)	78	13	9

10. VC IN ASIA – THREAT OF DECELERATION

On the whole, year 2015 was a record-setting year for venture capital investment in Asia. Over the course of the year, over $39.7 billion total was invested - more than in the previous 4 years combined. However, despite a banner year, VC activity in Asia declined during Q4'15. In other words, total deal value dropped from $14.2 billion during Q3'15 to $9.7 billion in Q4. The lack of mega-rounds played a factor in the decrease from quarter to quarter. While Q3 included five mega-rounds over $500 million (e.g., Didi Kuaidi, LY.com, Olacabs, Ele.me, Snapdeal), the largest funding rounds during Q4 were significantly smaller, including the likes of Pharmaron ($280 million), Olacabs ($275 million) and Weiying Technology ($235 million).

A number of factors may be affecting the decrease in Asia VC activity, including concerns about a slowdown in China's economy and a weakening retail sector. Traditional companies in particular are going through a phase of evolution, struggling to find ways to compete with newer, internet-based businesses. This thirst for innovation has increased corporate interest in new companies and driven the value of startups higher over the course of 2015 - a factor that may be causing some VC investors to hold back, expecting valuations to get reined in over the next few quarters.

While VC investment in startups has slowed, consolidation has been happening everywhere – especially in China. On the deals front, there has been significant M&A activity this quarter. For example, high-profile mergers have taken place between travel websites, dating websites and restaurant booking and reviewing apps.

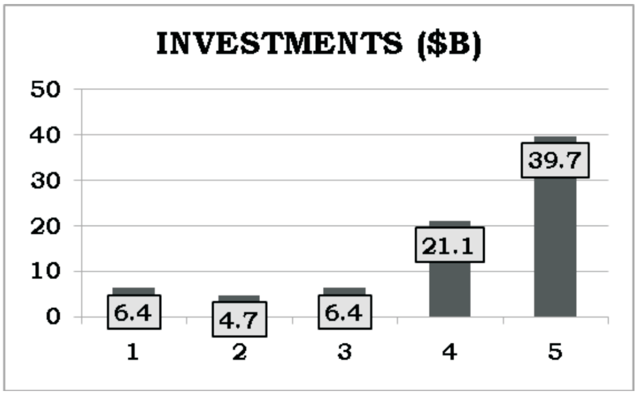
Asian investors, becoming more selective VC investors across Asia, are also becoming more selective about where to focus their investments. Investors seem to be shifting their focus to companies with proven track records and performance. Many VC investors are also shifting their focus to international investment to balance out their portfolios given the volatility in the Asian market. A number of Asian VC investors have been making investments in the US, Europe and Australia - where many believe the investment environment is more stable.

New business models coming under analysis in China. Companies using innovative business models seem to be coming under more regulatory scrutiny, especially in the Fin Tech space. Recently, the Chinese government has been focused on getting micro-finance companies to clean up their business practices. This focus may be drawing attention and concern from investors.

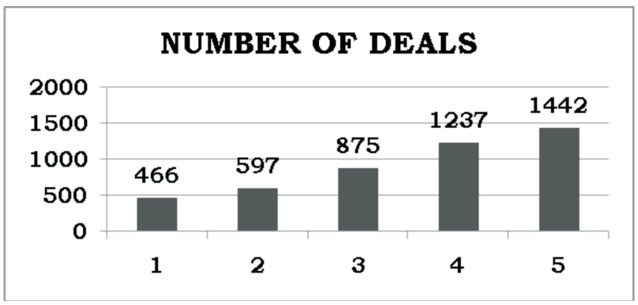
11. FUNDING STATUS IN ASIA

A mix of traditional venture capital money and hedge funds, private equity investors, and corporates drove a colossal amount of funding to Asian VC-backed companies in 2015. Specifically, in 2015 there were over 85 equity financings of $100M+ as funding reached $39.7B in 2015, more than in the previous 4 years combined. Deals also increased 17% year over year to 1442.

Graph 1 : Asian Financing Trends (Annual) to VC Backed Companies



Graph 2



Mega-rounds to companies like Didi Kuaidi, which raised $3B in Q3’15, were sorely missed in Q4’15 as funding to Asian VC-backed companies fell 32% to $9.7B on 346 deals. Despite the pullback, Q4’15’s funding and deal totals were up 4% and 5% respectively versus the same quarter a year prior.

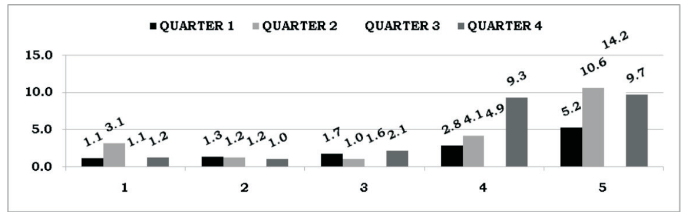
Table 7
Asian Quarterly Financing Trends to VC Backed Companies
(i) In Billion Dollars

PARTICULARS	2011	2012	2013	2014	2015
	1	2	3	4	5
QUARTER 1	1.1	1.3	1.7	2.8	5.2
QUARTER 2	3.1	1.2	1.0	4.1	10.6
QUARTER 3	1.1	1.2	1.6	4.9	14.2
QUARTER 4	1.2	1.0	2.1	9.3	9.7

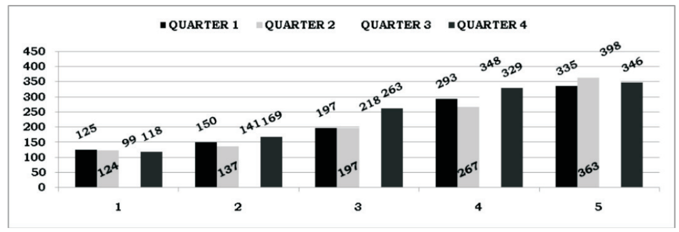
Table 8 : (ii) DEALS

PARTICULARS	2011	2012	2013	2014	2015
	1	2	3	4	5
QUARTER 1	125	150	197	293	335
QUARTER 2	124	137	197	267	363
QUARTER 3	99	141	218	348	398
QUARTER 4	118	169	263	329	346

Graph 3



Graph 4



With an overall pullback in late-stage mega-rounds, mid-stage (Series B – Series C) deal share reached a 5 quarter high of 29%. Early-stage (Seed - Series A) deal share rebounded from a 5 quarter low in Q3’15, accounting for 55% of all deals to VC-backed companies in Asia.

Table 9

Particulars	Seed / Angel	Series					
		A	B	C	D	E+	Other
	1	2	3	4	5	6	7
QUARTER 4 (2014)	32	29	15	7	3	2	12
QUARTER 1 (2015)	32	31	17	7	3	2	10
QUARTER 2 (2015)	32	27	17	10	3	3	9
QUARTER 3 (2015)	29	24	19	8	3	3	13
QUARTER 4 (2015)	30	25	21	8	3	1	11

The median early-stage deal size in Asia fell for the second straight quarter to $2M in Q4’15 amid a decrease in early-stage deals on an absolute numbers basis. Overall, early-stage deals have been at or above $2M for the past 5 quarters.

Graph 5

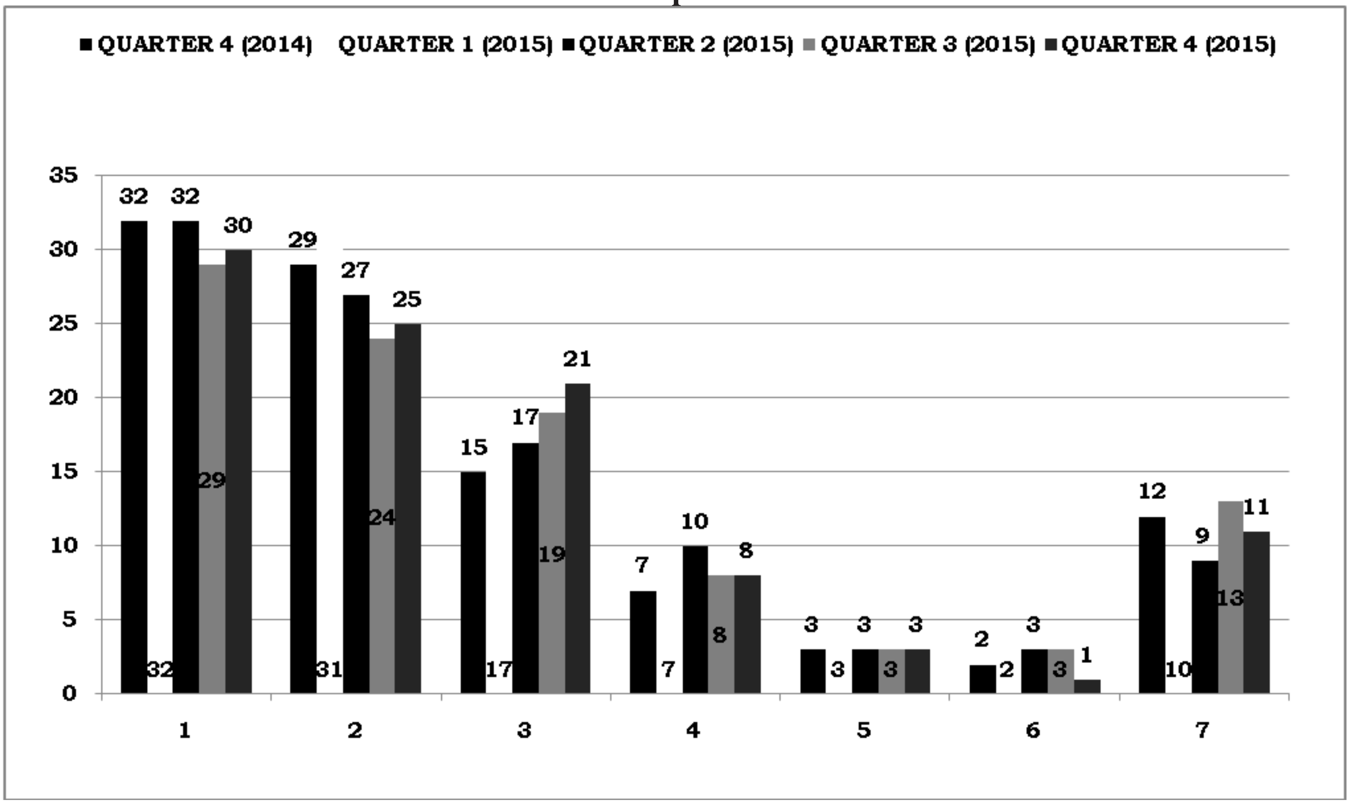
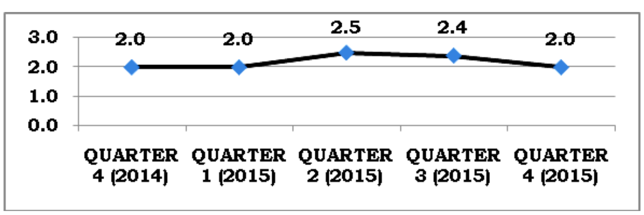


Table 10

Particulars	Median Early-Stage Deal Size (In Million Dollars)
QUARTER 4 (2014)	2.0
QUARTER 1 (2015)	2.0
QUARTER 2 (2015)	2.5
QUARTER 3 (2015)	2.4
QUARTER 4 (2015)	2.0



The median late-stage deal size in Q4'15 reached $154M as fewer than 30 late-stage deals weren't enough to outweigh the decrease in mega-rounds. This was the third time in the past 5 quarters that late-stage deal sizes have reached $100M, the others being Q4'14 and Q3'15.

Table 11

Particulars	Median Late-Stage Deal Size (In Million Dollars)
QUARTER 4 (2014)	230.0
QUARTER 1 (2015)	96.0
QUARTER 2 (2015)	85.0
QUARTER 3 (2015)	100.0
QUARTER 4 (2015)	154.0

12. DEAL STATUS & FUNDING...ACROSS THE CONTINENT

Both North America and Asia saw significant drop-offs in total funding to VC-backed companies in Q4'15. North America saw just $14.1B of investment in Q4'15, the lowest QTR.ly total since Q3'14, while Asia funding fell to $9.7B. Despite the similarity in deal activity in Asia and Europe, Asia captured over 3x the funding in Q4'15.

13. SUGGESTIONS & CONCLUSION

From the experience of venture capital

activities in various countries across the globe, especially the developed countries, following suggestions are worthy of consideration -

1. Lack of social awareness of the existence of venture capital industry has been observed. Apposite knowledge of venture capital activity is vital for its growth. Barely a small number of people know about the principal objectives and functions of the existing venture capital funds and thus backing of the media is required to bridge the bay between the society and the existing venture capital funds. Further, there is meagre awareness about the availability of venture capital finance from private and public sector institutions. There is no direct advertisement or publicity which should be corrected. Thus, one instantaneous measure could be the formation of an informed website which could have sufficient and useful data on venture capital activity.
2. The government and other institutions should strive to create a conductive business environment to ensure simplified start up processes, improve delivery time reduce corruption, pool informational needs and start up, improve corporate governance norms, create an environment that will reduce risk and encourage more seed funds and corporate players to provide start up funding.
3. There is a need for a larger amount of fiscal incentives for investment in the high-risk and perceived high technology sectors. This will encourage industries as well as venture capital agencies to search for innovative investment opportunities in high-tech area for translating ideas into ventures.
4. At present, in most of the economies, there is no distinction between the tax liability on the income from risky investment and risk-free investment. Apparently this is unfair. Therefore, suitable provisions may be incorporated in the taxation laws, to make risky investments attractive.
5. There is always an interim development period between making the venture capital investment and the investee company coming of age. Therefore, during this period, the venture capitalist may be compensated in some form of tax incentives/relaxations/breaks.
6. P3 i.e to Promote Private Participation in the venture capital activity, tax incentives/ relaxations/breaks shall also be provided not only to banks, institutions, but also to high net-worth individuals in order to encourage investment in venture funds.
7. Well-organized and competent system must be evolved to smooth the progress of liquidation of investments of venture capital funds.
8. Alongwith these measures, the corporate sector should also be encouraged to participate in the venture capital by providing suitable tax incentives. Allowing the venture capital firms to list their shares/units will also encourage the corporate sector to invest their surplus funds in venture capital funds.

In this era of globalization, where change plays a dominant role in influencing the fate of the industry, the success of any country or organization depends on its strength in creativity and innovation. Venture capitalists can create the right enabling environment for such innovation and nurture it with care so that it powers change and dramatic growth in industry.

❍

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