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VENTURE CAPITAL FUND IN INDIA

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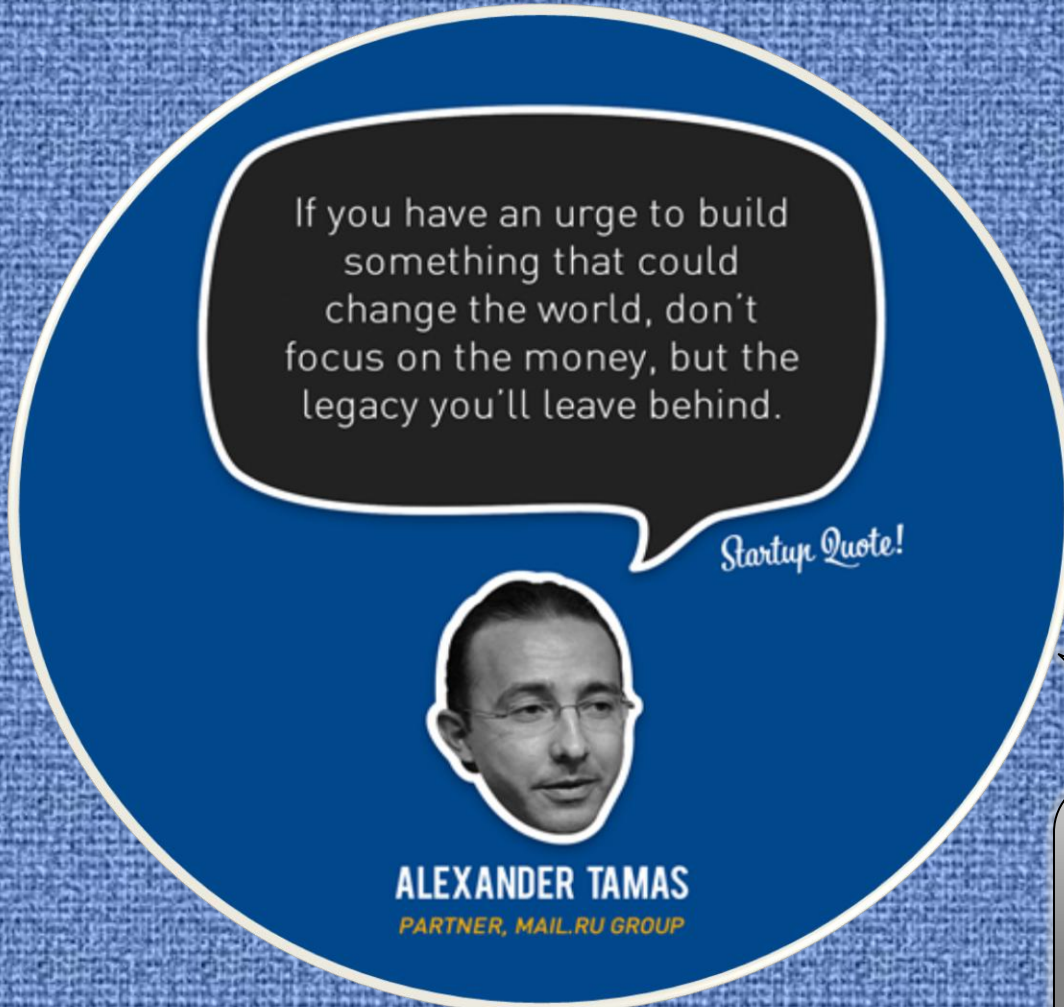


"Our belief at the beginning of a doubtful undertaking is the one thing that assures the successful outcome of any **venture**"

But how does it really work and who will make it happen?


Yee HAW!
We're SAVED!
LAST ONE IN IS A ROTTEN STARTUP!
VENTURE CAPITAL OASIS
Mike Keefe 2001

About Venture Capital

Venture Capital can mean

- **Providing Seed**
- **Start Up**
- **First Stage Financing**
- **Funding for expansion of companies not having access to public securities**

- **Venture Capital** is a form of "risk capital".- High Risk High return!
  - Capital that is invested in a business with substantial element of risk relating to the future creation of profits and cash flows.
  - Risk capital is invested as shares (equity) rather than as a loan and the investor requires a higher "rate of return" to compensate him for his risk

Contd….

- **Venture Capital** provides
  - long-term,
  - committed share capital, to help unquoted companies grow and succeed.
- If an entrepreneur is looking to start-up, expand, buy-into a business, buy-out a business in which he works, turnaround or revitalize a company, venture capital could help do this.
- Obtaining venture capital is substantially different from raising debt or a loan from a lender.
  - Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of a business.
- As a shareholder, the venture capitalist's return is dependent on the growth and profitability of the business. This return is generally earned when the venture capitalist "exits" by selling its shareholding in the business.

Origin of VCF

- In the 1920's & 30's, the wealthy families of and individuals investors provided the start up money for companies that would later become famous.
- Eastern Airlines and Xerox are the more famous ventures they financed. Among the early VC funds set up was the one by the Rockfeller Family which started a special fund called VENROCK in 1950, to finance new technology companies.

- General Doriot, a professor at Harvard Business School, in 1946 set up the American Research and Development Corporation (ARD), the first firm, as opposed to a private individuals, at MIT to finance the commercial promotion of advanced technology developed in the US Universities.
  - ARD's approach was a classic VC in the sense that it used only equity, invested for long term, and was prepared to live with losers.
  - ARD's investment in Digital Equipment Corporation (DEC) in 1957 was a watershed in the history of VC financing.
  - While in its early years VC may have been associated with high technology, over the years the concept has undergone a change and as it stands today it implies pooled investment in unlisted companies

Evolution of VCF in India

- Came in India after decades than that in USA, UK, Europe etc.
- 1973- A committee on Development of Small and Medium enterprises highlighted the need to foster VC as a source of funding new entrepreneurs and technology.
- 1988-The Government announced Controller of Capital Issues These focused on a very narrow description of Venture Capital and proved to be extremely restrictive and encumbering, requiring investment in innovative technologies started by first generation entrepreneur. This made investment in VC highly risky and unattractive.
- At about same time World Bank arranged for VC awareness seminar, giving birth to players like: TDICI, GVFL, Canbank and Pathfinder.
- Along with other reforms Govt decided to liberalise VC industry and abolish CCI
- Technology Development and Information Company of India Ltd. (TDICI), an equal joint venture of ICICI and UTI, was the first organization to begin its venture capital operations in India.
  - It was called VECAUS (Venture Capital Units Scheme)- started with an initial corpus of Rs.20 crore and was completely committed to 37 small and medium enterprises. The first project of TDICI was loan and equity to a computer software company called Kale Consultants.
- 1990- Other VCFs were established like the Gujarat Venture Finance Limited (GVFL), Andhra Pradesh's AP Industrial Development Corporation (APDIC) and the Canara Bank Venture Capital Fund

Contd…. Evolution

- **1993-** Venture capital community in India formalized with the formation of the Indian Venture Capital Association.
  - Indian Venture Capital Industry suffered several set-backs as there was no tax pass-through for investors' capital gains as was common internationally
- **1996-** The regulatory environment of the industry was defined by the SEBI (Venture Capital Fund) Regulations, 1996.
- **1997** – VC Regulations got considerable boosted by IT Revolution as the Venture Capitalist became prominent founders of IT and telecom Industry.
- **2000-** With the recommendations of the Chandrasekhar committee and SEBI (Foreign Venture Capital Investor) Regulations, 2000 VCF fostered growth in the Industry.
  - Introduction of the Finance Act, 2000 fuelled the growth of VCF by giving it a pass through status by insertion of section 10(23FB) and 115U in Income Tax Act.
- **2000-2007-** VCF industry has had an upswing. The VCF investments in India amounted to US$1 billion in 2000 and investments of US$ 7.5 billion by 2006 and the first nine months of 2007 has seen investment of US$ 7.77 billion.
- **2004-** VCF/FVCI permitted to invest in NBFC registered with RBI and engaged in equipment leasing

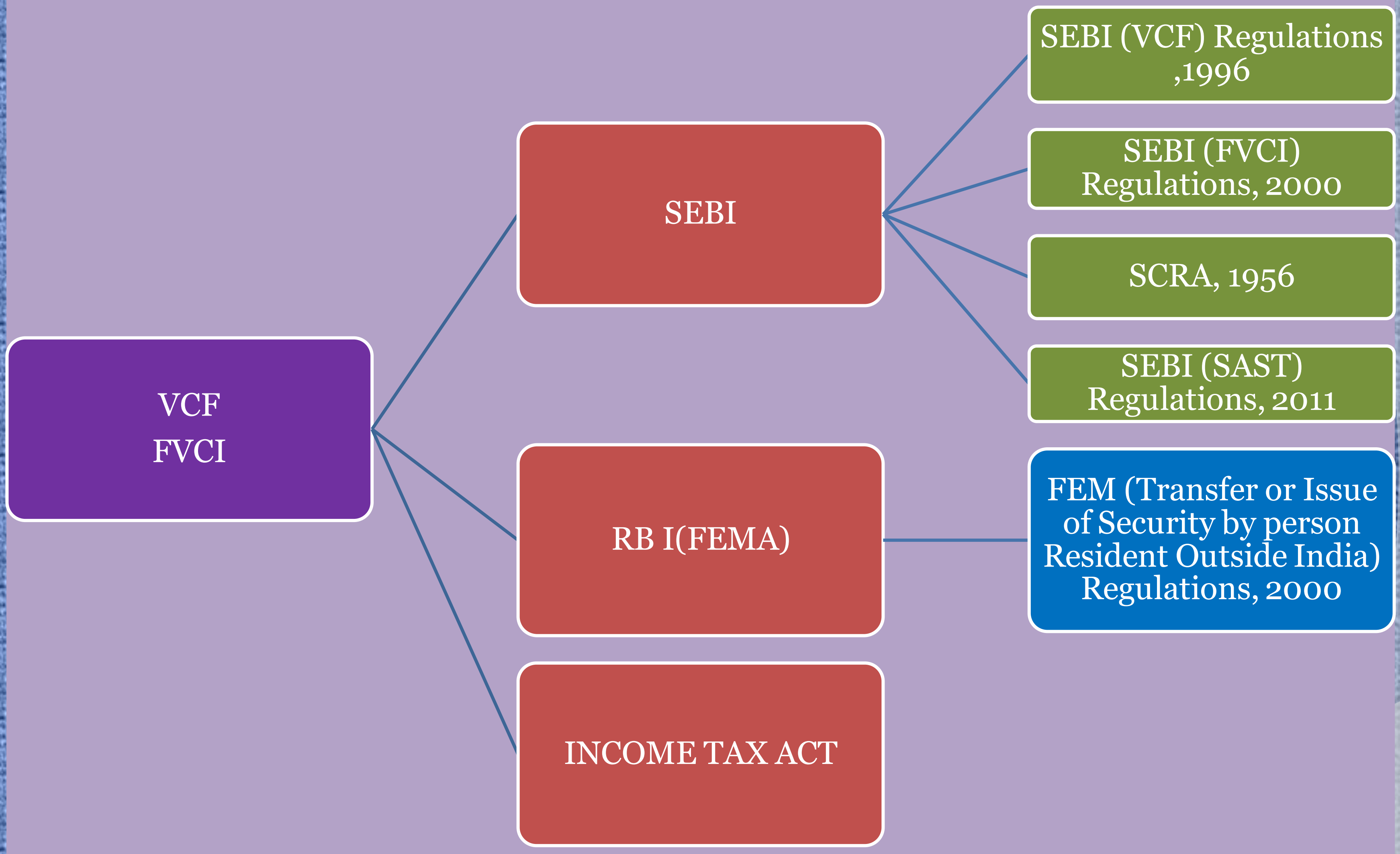
Who will invest in Venture Capital?

- Venture Capital raises money both domestically and across the world
- Kinds of Investors-
  - Angel Investors- High networth investors having appetite for high risk and higher returns
  - Institutions with diversified portfolios like pension funds, insurance companies etc
  - Fund of Funds

How does it work?

- Generally the investments are made in pre determined number and type of companies. Some investments might miserably fail, some break even while some will give highest returns
- Venture Capital do not avoid risk but manage by balancing the portfolio
- At the end of life cycle of funds the returns are distributed among investors. Returns if higher than expected minimum, it is shared between Asset Management Company (AMC) and investors in a pre determined ratio

FRAMEWORK


VCF
FVCI
SEBI
RB I(FEMA)
INCOME TAX ACT
SEBI (VCF) Regulations ,1996
SEBI (FVCI) Regulations, 2000
SCRA, 1956
SEBI (SAST) Regulations, 2011
FEM (Transfer or Issue of Security by person Resident Outside India) Regulations, 2000

STRUCTURE OF FUNDS IN INDIA

Types of Structures

- Three main types of structures
  - *One* for Domestic
  - *Two* for offshore

- Domestic Structure-

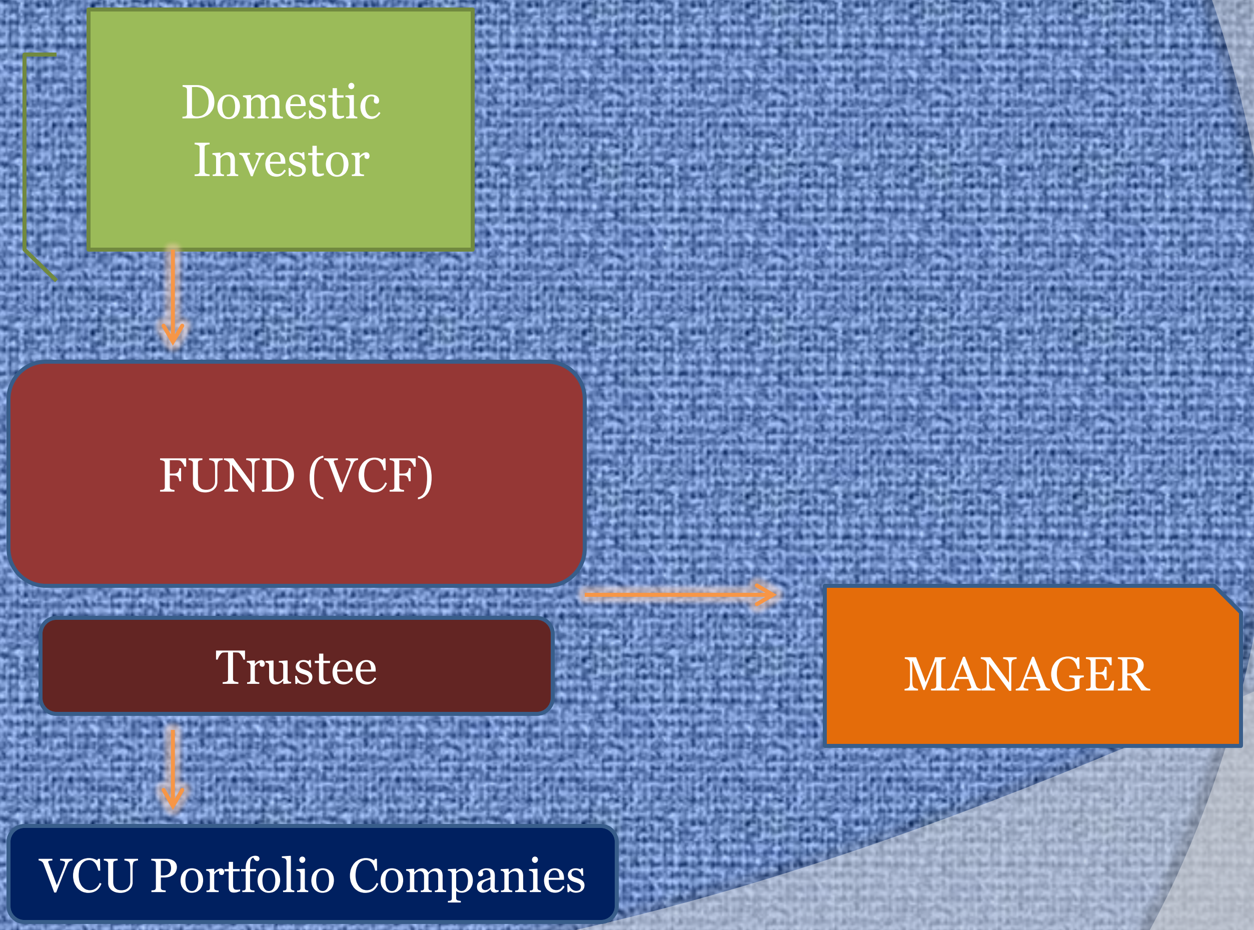
  -domestic vehicle for pooling of funds

  -separate investment advisor

  -choice for pooling vehicle falls between trust, company and/or body corporate

  -LLPs not yet recognized in India

Contd.. Structure



VCF Regulations

SEBI is the nodal agency for both registration and regulation of VCFs both domestic and overseas

- VCFs are regulated by SEBI (Venture Capital Fund) Regulations, 2000
- Definitions:
- "***Venture capital fund***" *means a fund established in the form of a trust or a company including a body corporate and registered under these regulation which—*

(i) has a dedicated pool of capital;

(ii) raised in a manner specified in the regulations; and

(iii) invests in accordance with the regulations; [Section 2 (m)]

- "***Venture capital undertaking***" *means a domestic company—*
- *(i) whose shares are not listed on a recognized stock exchange in India;*
- *(ii) which is engaged in the business for providing services, production or manufacture of article or things or does not include such activities or sectors which are specified in the negative list by the Board with the approval of the Central Government by notification in the Official Gazette in this behalf. [Section 2 (n)]*

Registration

- Any existing VC on the date of Regulations to make an application for registration within 3months from the date of Regulations
- Application to be made in Form A accompanies with non-refundable fee as prescribed in the Schedule in manner specified in Part B
  - Application fees- Rs. 100000
  - Registration fees- Rs. 10,00,000

ELIGILBILITY CRITERIAS

Company:

-Main object as business of VC in MoA

-prohibition to make invitation for public subscription

-director/principal officer/employee not to be involved in any litigation in securities market

-as the same will have a bearing on the applicant

- director/principal officer/employee not being convicted of any offence

-if it is a fit and proper person

-To check the criterias specified in Schedule II of SEBI (Intermediaries) Regulations, 2008

Contd…. Registration

- **Trust:**

-the trust deed duly registered under the Registration Act, 1908

-main object to carry on the business of VC

-the directors of trustee company or its trustee not to be involved in any litigation in securities market

-the directors of trustee company or its trustee not being convicted of any offence

-if it is a fit and proper person

-To check the criterias specified in Schedule II of SEBI (Intermediaries) Regulations, 2008

- **Body Corporate:**

-set up or established under laws of Central or State Legislature

-applicant permitted to carry on the business of VC

-Same as in case of company/trust

- Procedure/conditions/refusal for grant of certificate-[Regulations 7,8,9,10]

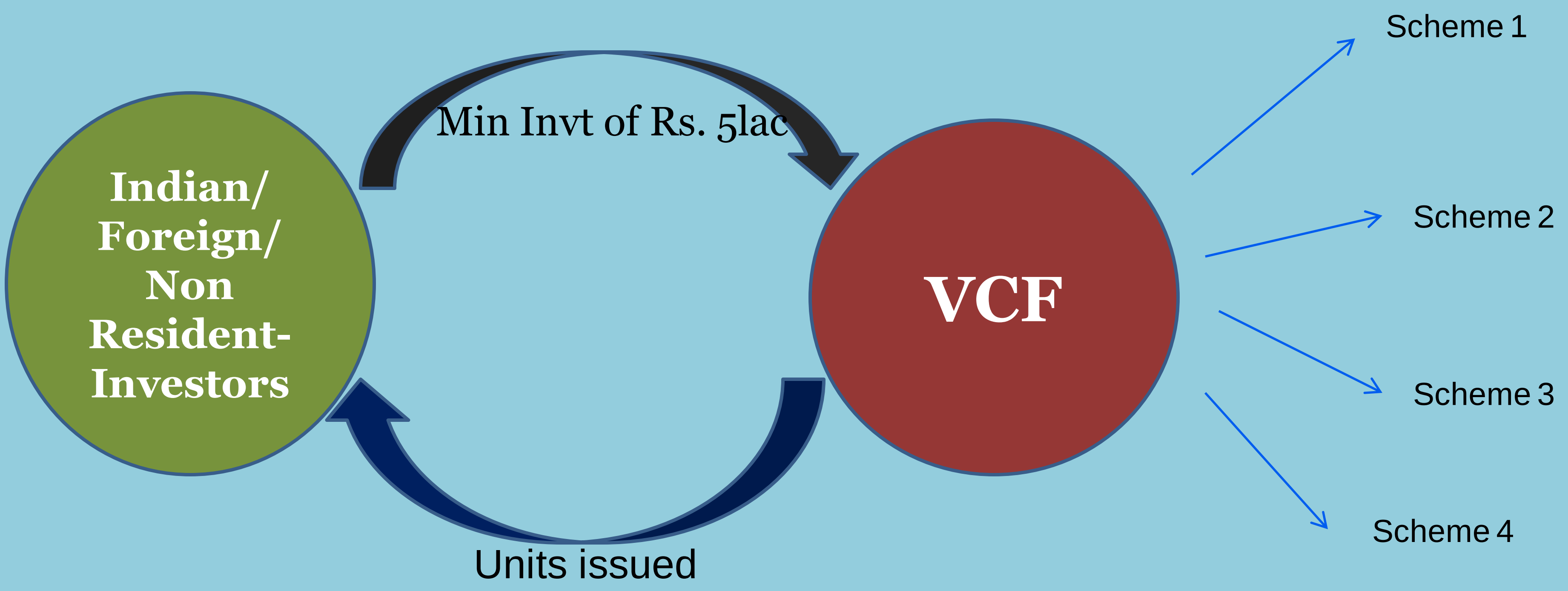
INVESTMENT CONDITIONS AND RESTRICTIONS

Minimum Investment in VCF [Reg 11]

- VCF raises money from investors
  - **Indian**
  - **Foreign**
  - **Non-Residents**
    - **In form of "units"**
      - Defined under Reg 2(l) as-***"unit"*** *means beneficial interest of the investors in the scheme or fund floated by trust or shares issued by a company including a body corporate;*
- No VCF in form of company/trust to accept any investment below Rs. 5lac
  - Proviso applicable to employees/directors/principal officer of the VCF/fund manager/asset management company
- Each fund set up by VCF to have firm commitment from the investors of atleast Rs. 5 crore before start up of operations

Analysis and Structure

- Though the VCF can be formed by way of Trust or Company or Body Corporate, but the beneficial interest lies with the investors and the legal interest lies with the managers.
- Therefore, in case of a company the funds raised cannot be used for any other purpose and the unit holders become the beneficiaries reducing the status of the company to have only fiduciary interest of the fund and therefore, no matter what form of VCF but the essence is that of a Trust
- **STRUCTURE:**



Investment Restrictions

VCF to

- ***Disclose*** investment strategy at the time of registration

VCF

- ***Not*** to invest more than 25% of the corpus of fund in one venture undertaking

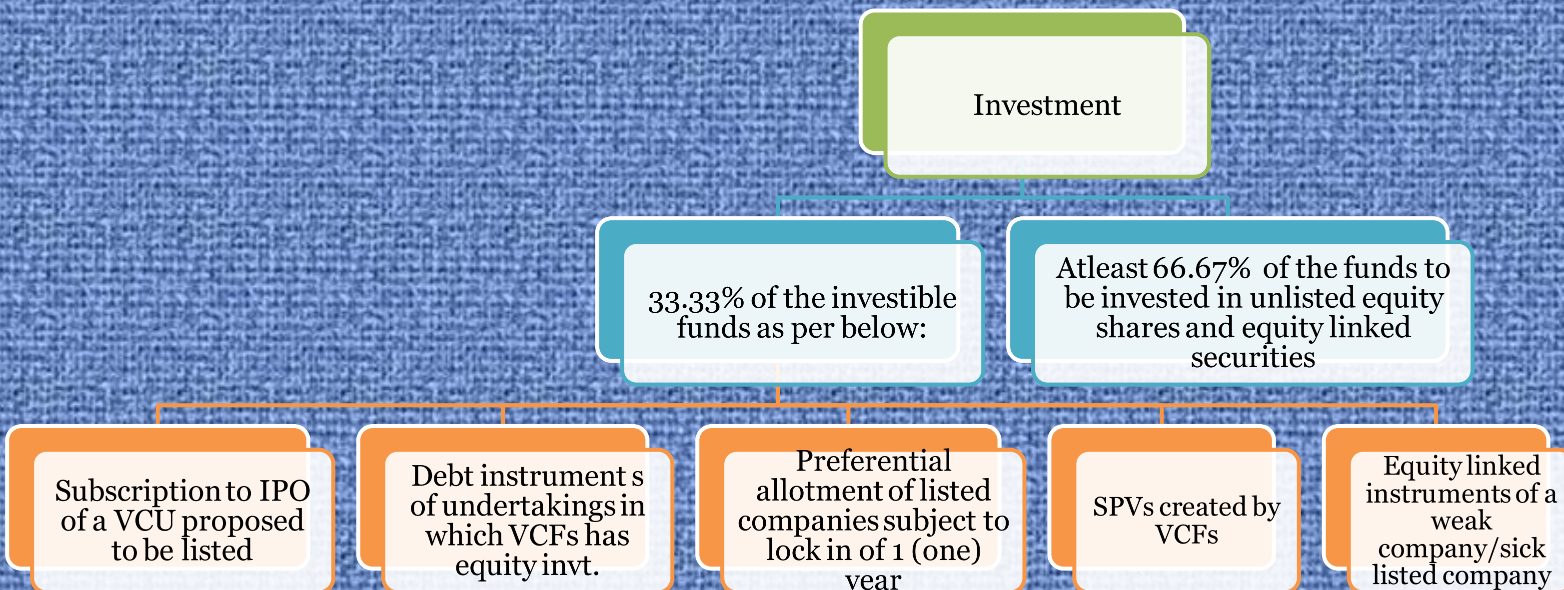
VCF can

- Invest in securities of foreign companies ***subject to*** complying with guidelines/conditions issued by RBI

VCF

- Shall ***not*** invest in Associate Companies

Investment Structure



General Obligations

- VCFs received monies in its fund only through Private Placement [Reg 15]
- VCFs to- [Reg 16]
  - Issue a placement memorandum containing terms and conditions along with details of trustees/directors/fund manager/AMCs/proposed corpus/minimum amount to be raised
  - Enter into contribution/subscription agreement with the investors/tax implications etc.
- VCFs to file such memorandum and agreement with the Board alongwith report on money actually collected from the investor
- VCFs not to issue advertisements inviting offers from the public [Reg 14]
- No VCF can get listed till the expiry of 3 years from the date of issuance of units [Reg 13]
- VCFs to maintain books of accounts for a minimum period of eight years and intimate the Board where the same is maintained [Reg 20]
- VCFs to cooperate with Investigating or Inspecting Officer in event of Investigation and Inspection if ordered under Reg 25 [Reg 27]

VCF- Trust vs Company

- Trust form is more tax advantageous
  - However, securities that a Trust form can acquire are limited to equity securities under Indian Trust Act, thus venture capital trust firm investing in pref share can lose its tax benefit status
- It is easy to form and has minimal compliances requirement;
- Liquidation of the funds in case of company structure would be a long drawn process, whereas in case of a trust it would be simpler to dilute the trust;
- Distribution of the returns on maturity or at the end of the tenure of the fund will be simpler in case of trust form than in case of company structure;
- Repatriation of the capital in the event of losses would be difficult in company form of structure as company cannot redeem equity or preference shares unless out of profits or fresh issue of shares.
- In case of trust since there are beneficiaries it is hard to say who owns a Venture Capital Trust in case of Non-Resident beneficiaries

SEBI (Foreign Venture Capital Investor) Regulations, 2000

- Introduced to regulate and facilitate foreign venture capital and private equity into India
- Definition of :

"Foreign Venture Capital Investor" means an investor incorporated and established outside India, is registered under these Regulations and proposes to make investment in accordance with these Regulations; [Reg 2 (g)]

REGISTRATION:

- Application to be made in Form A alongwith application fee [Reg 3]
- Eligibility Criterias [Reg 4]

Foreign Venture Capital Investors (FVCI) to get registered under SEBI and have Certificate of Registration [Reg 7]

INVESTMENT CRITERIA [Reg 11]:

Invest total funds committed in one VCF

Disclosure of Invt strategy to the Board

Disclose the duration of life cycle of the funds

Make investment as:

66.67% in equity linked instruments

33.33% by means in the next table:

33.33% as:

Subscription to IPO of VCU proposed to be listed

Debt instrument s of VCU in which FVCI already made invts.

Preferential allotment subject to lock in of 1year

Equity shares of a weak/sick company

SPVs

Benefits of Registration to FVCI

- SEBI (SAST) Regulations, 2011 do not get attracted in case of transfer from FVCI to promoters if there is a pre existing agreement between the promoters and FVCI
- Eligible to participate in Initial Public Offering through Book-building subject to compliance of SEBI (VCF) Regulation
- Exemption to FVCI having held shares for a period of one year prior to the date of filing of the draft prospectus with SEBI under SEBI (ICDR) Reg, 2009 in case of IPO where the entire pre-issue share capital of a company going in for an initial public offering is locked in for a period of one-year from the date of allotment in the initial public offering ("**IPO**").
  - this would essentially allow the FVCI to exit from their investments post listing;
- Tax pass through status for investment in 9 sectors
- Exemption from taking prior Government approval in case foreign investor has an existing joint venture and technology transfer/trademark agreement in the same field
- Permitted to invest their entire corpus in a VCF under automatic route;
- ✓ Exempted from taking prior governmental approval even if seeking to invest in company engaged in the "same" field of activity under the National Industrial
- ✓ Classification 1987 Code, (As per Press Note 1 (2005 Series) issued by the Ministry of Commerce and Industry, Government of India)

Explanation: any other company in which the FVCI already had an investment prior to January 12, 2005, the date on which Press Note 1 (2005 Series) was notified;

VCF under Takeover code

- For the meaning of person acting in concert, the following are included
  - a venture capital fund and its sponsor, trustees, trustee, company and asset management company; [Reg 2 (q) (2) (viii)]
- Exemptions from making open offer under sub-reg (2) of Reg 3 in case of an acquisition of shares from a *registered* VCF or a FVCI pursuant to an agreement between VCF or FVCI and the promoters [Reg 10 (4) (f)

FDI Policy for VCF in India

Offshore VCFs allowed to invest in domestic venture capital undertakings through automatic routes.

Domestic VCF set-up as a Trust

- a person resident outside India (non-resident entity/individual including an NRI) cannot invest in such domestic VCF under the automatic route of the FDI scheme and would be allowed subject to approval of the FIPB.

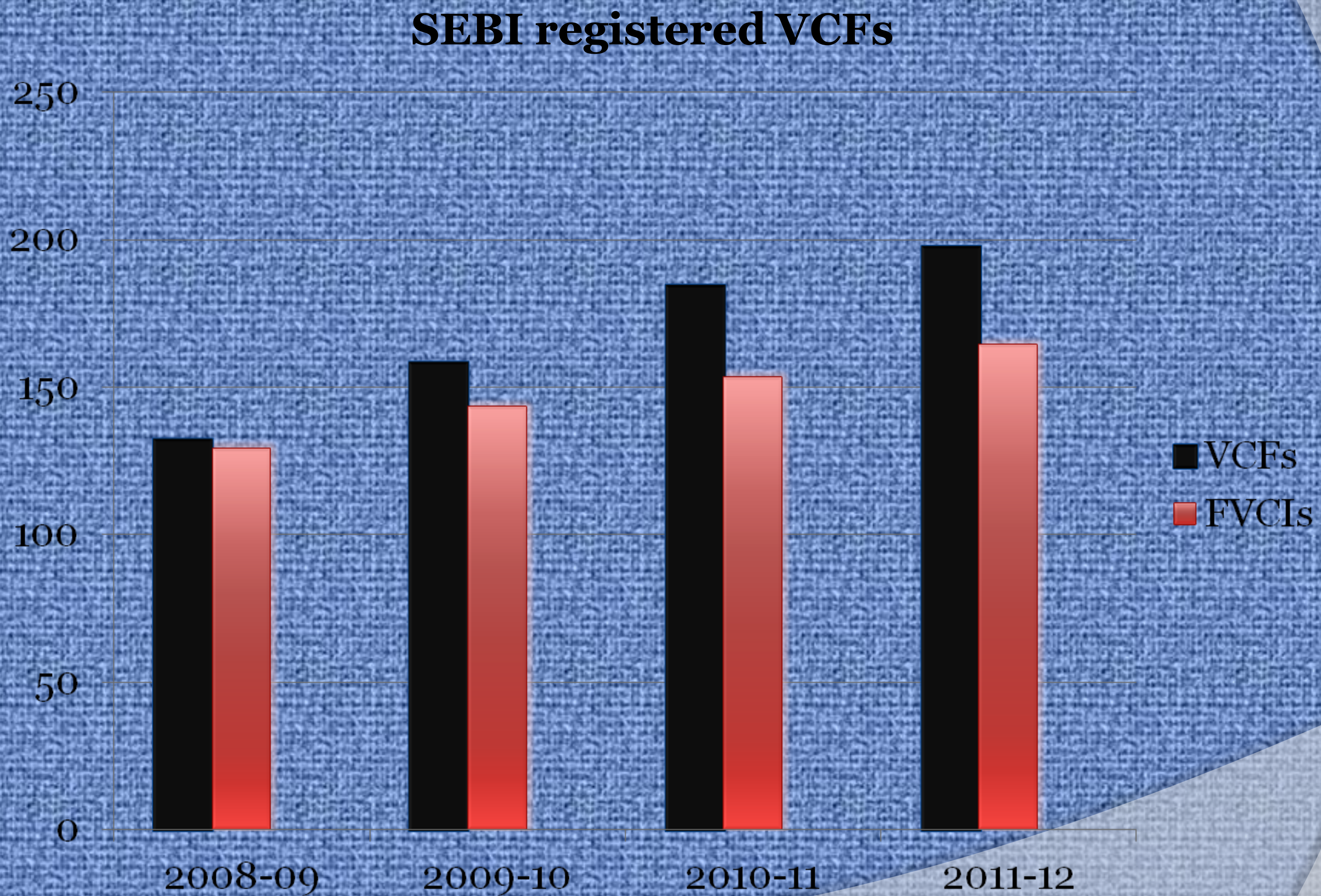
Domestic VCF set up as a Company

- a person resident outside India (non-resident entity/individual including an NRI) can invest in such domestic VCF under the automatic route of FDI Scheme, subject to
  - the pricing guidelines,
  - reporting requirements,
  - mode of payment,
  - minimum capitalization norms, etc.

A bit of Taxation

- Prior to Finance Act, 2007 registered VCFs enjoyed pass through status on income from all their investments
- Finance Act 2007 changed the definition of VCU under which benefit of pass through status is restricted to 9 sectors only
- Section 10(23 FB) of the Income Tax Act, 1961
  - Income earned by a domestic SEBI registered VCF (whether a trust or a company) from an investment in a venture capital undertaking is exempt from tax.
- Section 115U of the Income Tax Act
  - Such VCFs have been accorded a "pass through" status, i.e., the investors in the VCF are directly taxed on any income distributed by the VCFs as though the investors have made direct investments in the portfolio companies.
    - Therefore they are only allocating the funds for which they receive management fees
  - to avail this "pass through" status, the VCFs investments must be made in domestic companies whose shares are not listed on any recognized stock exchange in India

Little Statistics



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- **Assets under the custody of custodians:**

Foreign Venture Capital

Year	NO.	Amount (Rs. In crore)
2008-09	73	16579
09-10	115	17604
10-11	144	24002
11-12*	150	25590

*indicates as on last trading day of Sep 2011

Sources & Acknowledgements

- www.sec.gov
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A thanks to Vinod Sir for giving me this opportunity to expand my learning and interest through the subject of this presentation.

"So that's my presentation:
Could I have 100 million for the startup?'

THANK YOU