Chapter 1
Introduction

Motivation and Background of Study

For any country or economy to grow, the existence of a robust financial ecosystem is essential which is capable of creating new companies. Today, world has great demand for innovation and it has become imperative to create an ecosystem to promote and transform the entrepreneurial ideas into revenue generating companies. For many people, venture capital is the money for start-ups and great ideas. Generally, private investor or ‘angels’ are known as principal source of funds for start-ups and great ideas. Many times, the venture capital companies also define venture capital as money for expansion of existing businesses too. It is also defined as money invested in small and medium enterprises which are giving minority shareholding in the business and irrevocable right to acquire it. Over a period of time the concept of venture capital has been shifted from technology oriented manufacturing organizations to being very close of ‘private equity class’ for unlisted new companies. The young and new companies face challenges of equity gap (Wetzel, 1983; Barth, 1999). The complexities in the new business increase with the development of new idea in to a growing business (Klofsten, 1992; Greiner 1972). The venture capital firms provide both funding and competence to such young firms with great potential of capital growth.

The dictionary meaning of ‘venture’ is a ‘course of action’ especially in business, of which the result is uncertain and there is a risk of loss or failure as well as a chance of gain or success. It is actually to risk going somewhere or doing something daring (Longman dictionary of contemporary English, 1993). ‘Capital’ means wealth, especially money which is used to produce more wealth or for starting a business. On combining the
two, venture capital means money needed to start a risk or daring business. This is the reason it is known as risky capital. Venture capital by definition is also known as a “patient and brave money” (Timmons & Bygrave, 1986), “money of invention” (Gompers and Lerner, 1999) or defined as a very specific case of PE who provides equity funds to start up, private firms in distress and firms seeking finance for buyouts. The importance of venture capital is well recognized by world class companies like Microsoft, Apple and Intel etc. too (Jörgensen and Levin, 1984).

In simple words, venture capital is the capital which is risky and collected through various sources to invest in conjunction with management in fast growing business segments. It is an important source of funds/equity for start-up companies which are private in nature. In general, the venture capital firms are closely held in nature which is funded by different public and private wealthy individuals, corporations, foundations, pension funds, foreign investors venture capitalists and entrepreneurs are engaged in creating long term value for themselves, shareholder and communities.

A venture capitalist carefully screens the technical and business perspective of a proposed company before taking an investments decision in that venture (100/10/1 rule). The venture capitalists invest in a very small percentage of total number of business proposals received by them and these final proposals are the companies having long-term perspective. Once short listing of the business proposals is done having long-term potential, the venture capitalist actively work with the management of this infant company for strategy formulation.

The venture capital process is quite extensive and it includes all activities beginning from raising money for investment funds, managing the investment process and then producing the desired results in the form capital growth of the new firm (Fried and
Hisrich, 1994; Gompers and Lerner, 2002). The venture capitalists take this higher risk in an expectation of high returns. As the idea behind venture financing is to provide funds to very new and innovative businesses therefore the risk is very high in funding such enterprises. Many of the enterprises financed by venture capitalists (VCs) do not survive in long run and others may also result in moderate returns. At the core of the process they manage the inherent risk involved in these investments with intent to get potential returns on investment. Information asymmetry is the major reason for the risk involved in funding by venture capital firm. Generally the risks associated with venture capital firm are categorized into risk of adverse selection and risk of moral hazards (Amit et. al, 1998).)

The entrepreneur can be at informational advantage than the venture capital firm which may result in an adverse selection of venture by a venture capitalist ((Eisenhardt, 1998; Amit et al., 1998; and Cumming, 2006). These studies have also documented that the risk of moral hazards may come when the venture capitalist behave opportunistically. But the studies prior to that focused more accessibility of a target market for successful and profitable existence of venture capitalists (Tyebjee & Bruno, 1984; MacMillan et al., 1985; Black and Gilson 1998) in a seminal paper revealed that the venture capitalist has to exit to free up resources for reinvestment in new investee companies. This helps them to facilitate fresh new capital and establish reputation. The realization or return on investment is known only upon exits. MacMillan et al. (1985) identified five types of risks considered by venture capitalists and the strategy of entrepreneur is specifically analyzed by a venture capitalist while investing in it.

Other research on VCs focused on the fact that the financing by a VC is done in various phases or rounds and each time there funding criteria may not be same. Hence for an entrepreneur, getting funds in different rounds may be having different challenges (Steier and Greenwood, 1995). The research done in early 2000s focused more on the
screening criteria of VCs (Bachher, 2000; Kaplan & Stromberg, 2003; Kumar Kaura, 2003; and Silva, 2004). During past decade, there have been studies on VC exits related venture capital firms in United states, Canada and Europe, where the VC institution has been established for a longer time period than in other parts of the world, and there exist recognized track record of very successful VC exits (Cumming 2008; Gompers and Lerner, 2002; Cumming et al., 2003; Bayar and Chemmanur, 2006; Espenlaub, S. 2009). The research and literature shows mixed evidence of exit behavior for US and European venture capital firms. However there are very few studies which talks about Asia Pacific subcontinent and in particular to emerging, high growth markets such as India (Espenlaub et al., 2009).

The past studies conducted on Indian venture capital firms are more of general and descriptive in nature (Dossani and Kenney, 2002; Annamalai and Deshmukh, 2011; Pandey, 1998; Verma, 1997). In one of the initial research done by Pandey (1998), an attempt was made to identify the investment criteria by Indian VCs. Mitra (2000) studied the investment criteria by private and government Venture Capital Funds in India. The study indicated that the private and government funds were more concerned for investment in large sized organizations in order to reduce the cost of monitoring. In another research by Pandey (1998), a comprehensive case study on Technology Development and Information Company of India (TDICI) was done to understand the process of investment by Indian venture capital firm. The entrepreneurs look for continuous assistance from venture capital firms to ensure their target capital structure while VCs were not found to meet the expectations of entrepreneurs (Kumar, 2005).

The existing literature on venture capital has studied the historical growth of Indian venture capital firms and made a comparison of Indian VCs with VCs in other countries. The issues related to venture capital and corporate governance have also been highlighted.
in past studies. The role of venture capitalists is identified as an important factor in promotion of new ventures (Subhash, 2006 and 2009; Chary, 2005). Panda (2012) examined that venture capital firms in India and made an attempt to identify the financial indicators considered by VCs before funding an entrepreneur. The challenges of Venture Capital industry are unique therefore it must be properly supported by government of India.

Succinctly, it can be said that the past research on venture capital was more focused on the investment process and screening process of VCs. The research afterwards includes various challenges faced by VCs in India and abroad. The more recent studies are focused on alternatives of exit, timings of exit, impact of human capital on the performance and exit decision of startups. The detail discussion regarding extant literature on the related issues has been made in chapter two of the study. The scope of research in Venture Capital industry is existent in all facets as it is not a fully developed industry in many countries and even at nascent stage in other countries. But the exit is the last and most important step of venture financing. The current study has shown the interesting findings related to exit strategy of the venture capital firms.

**Theoretical Background**

The research on venture capitalists has become vigorous beyond doubt. Before discussing in detail the theory behind exit strategies and various routes of exits in Venture Capital Industry, it is essential to understand the relevance or significance of venture capital exits from their backed companies. Gompers and Lerner (2002) acknowledged exit as most important aspect of Venture business. The funding provided by venture capitalist happens to be in various stages and is for a specific time period only. The venture capital firms raise funds from various sources. It includes individuals, banks, insurance
companies, pension funds and other financial institutions etc. All these stakeholders are interested in knowing the exit strategy of venture capital firm and its success rate. The exit in venture capital as a last phase of investment process by venture capital firms (Timmons and Bygrave, 1986). The exit opportunity is important to determine the quantitative performance of a venture capital firm and it is an essential part of venture capital cycle. The success and sustainability of a venture capitalist depends upon its successful exit from its backed companies (Giot and Schwienbacher, 2005). The researchers have also examined entrepreneur-centric approach of exits by venture capital firm (Wennberg et al , 2010; DeTienne and Cardon, 2012). But these studies lacked to consider the point of view of investors of VC firms. The returns realization through these exits is primarily source of profit for venture capitalist since they don’t get dividend on investments (Cumming, 2008). As a result, VC returns are linked to the exit from investment (Espenlaub et al., 2009).

Figure 1: *Simplified version of Venture capital Process*
Moreover, in case of exit strategies, numerous supplementary issues are also imperative. For example, what options of exits are available to VCs and what are determinants considered by the VCs to take an exit decision. Schwienbacher (2007) debated the influence of exit preferences on startup innovation strategies. Nowadays there has been numerous ways in which VC can exit. The choice of any of these available exit routes depend upon various strategic factors considered by VCs at the time of screening as well as at various phases of financing too. The highly profitable companies go for IPOs as exit channel (Schwienbacher, 2002). Gregoriou and Kraeussl (2006) identified that the VCs do not prefer to sell their stake to the entrepreneur and prefer to sell it to another investor. Elisabete et al, (2009) also indicated that the new listing of entrepreneurs funded by VCs has increased during the research period and VCs tend to sell their stake in a phased manner. Cao (2011) talked about the buyout as an exit option by using LBO funds. While Cumming (2008); Gompers (1999) discussed the importance of convertible securities as an exit option. Ibrahim (2012) thrashed out the importance of secondary market sale as an exit route. Hence there exist various options for exit routes and empirical studies have highlighted the bearing of diverse exit route options on the success of VCs. The following table has mentioned the most popular exit routes adopted by VCs are mentioned below
### Alternatives of Exit Routes to Venture Capital Firms

<table>
<thead>
<tr>
<th>Sr.No</th>
<th>Type</th>
<th>Description</th>
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<tbody>
<tr>
<td>1</td>
<td>Initial Public Offer</td>
<td>When a company gets listed on a stock exchange and offers general public to invest in its equity then this first issue to general public is called as Initial Public Offer. An old company as well as a young or new company can get itself listed on stock exchange. The company can sell its existing shareholding to the general public or can also issue new share capital for general public or both.</td>
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<td>2</td>
<td>Acquisition or trade sale</td>
<td>The trade sale is also a popular mode of exit by the venture capital firms. When the shares of the company are sold to another company in the same industry then it is called acquisition or trade sale. It is also preferred because the venture capital firms can get the value of their shareholding in terms of cash. Many times it brings higher valuation to VC firms too in comparison to IPOs.</td>
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<td>3</td>
<td>Secondary sale /Refinancing</td>
<td>Secondary sale or refinancing is another option available to venture capital firms in case they do not prefer trade sale as an exit route. Under this, the shareholding of venture capital firm is purchased by another private equity investor or investment institution.</td>
</tr>
<tr>
<td>4</td>
<td>Buyouts /LBO</td>
<td>Under this route of exit, the company which acquires the venture uses the cash flow of company for funding the debt it is planning to raise for acquisition.</td>
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<tr>
<td>5</td>
<td>Reverse Leverage buy outs (RLBO’s)</td>
<td>When a company was made private through leverage buyout want to repackage it by offering its shares to general public ten it is called reverse leverage buyout.</td>
</tr>
<tr>
<td>6</td>
<td>Convertible securities</td>
<td>The convertible securities are also good options. Under this, the type of debt funded by venture capital firm can be converted into equity of the company at a pre-determined price and within the</td>
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The existing literature on theoretical framework behind the exit strategy of venture capital firms has focused on various characteristics. But the nitty-gritty of all major theories reclined towards two stages, one, the type of exit route and, two, the timings of exit by VCs. One of the earliest studies on exit behavior of VCs, conducted by Gompers (1996) was based on Grandstanding theory. Schwienbacher (2002) considered principle agent framework or agency theory to provide an explanation on effect of stage financing and monitoring on exit possibilities.

According to Grandstanding theory, VCs prefer IPOs as first choice for reputation building. The Grandstanding theory is further studied by Hibara (2004) for Japan, and Espenlaub et al (2009) for Europe. Cumming et al (2005) discussed a theoretical model based on financing duration by VCs based on liquidity of market. Schwienbacher (2007) concluded that quality of product and competition in product market are the determinants of exit decision by a VC.
Bayar and Chemmanur (2011) used a basic model which states at any point (t = 0) shares are held by three types of agent – Entrepreneur, VC and other private equity investor. At point when t=1, any one of the agent can sell their stake to meet liquidity demand either by going public or secondary sale. Between time 0 and 1 product market competition takes place, they use this to describe choice between IPO and acquisition,
exit choices between venture backed and non-ventured back and on the resolution of IPO valuation premium puzzle.

VC and/or entrepreneur chooses between going public or selling the firm to an acquirer. The general theory of exit states three basic stages – investment stage, value addition stage and actual exit stage, VC looks for possible exits in investment stage, provide management services in value stage. The general theory of VC exit says that a VC takes an exit route when expected marginal cost of investing becomes more than expected marginal benefit from investing. Felix et al (2014) through his optimal duration model illustrating impact of increase in degree of asymmetric information on the optimal duration of the investment; they argue that with time asymmetric information decreases, venture capitalist should keep their investment for long in such scenarios.

![Diagram of Venture Capital Investment Duration](image)

Figure 4: Venture Capital Investment Duration (Adopted from Cumming and Johan, 2010)
Increase in capital available for investment, increase in investment opportunities, and/or improvement in market conditions reduces investment duration.

In addition to above theoretical models, the researchers have used other conceptual frameworks to study the exit strategies of VCs. Cumming and Macintosh (2001) focused more on hazard model to analyze the determinants of VCs exits. Bock and Schmidt (2015) to study the relevance of venture firm characteristic and it behavior on the exit.

**Ecosystem for Venture Capital in India**

In initial days, the funding available to new business was predominately through the banks and government owned financial institutions. These institutions provide debt in form of loans or collateral based money to less riskier based projects. In 1972, a committee on small and medium enterprises alleged that the existing ways of financing is inadequate for the fast-growing technology as a result incremental steps were taken to foster the venture capital as a new avenue and source of capital to those promising small and medium enterprises.

National financial institutions like IFCI provides medium and long term capital finance to new business. Private Banks like ICICI through its subsidiaries and joint venture with unit trust of India emerged as a venture capital supplier to medium and large enterprises. Budget of 1986-87 provide major transformation and momentum to venture capital in India through the cess on imports to build corpus, followed by the VCF guidelines thereafter in a year (1988) through policy initiative. In year 1990 small industries development bank of India was formed to support financing in the small scale industries.

In year 1989 to promote tourism industry new initiative was launched as - Tourism finance corporation of India Ltd to promote and provide assistance through underwriting securities equipment leasing to hotels, amusement parks and entertainment complex. Some of other means of venture financing available in India thereafter includes the following.
Among Asia Pacific sub-continent countries, India is an attractive location for VC investments and recognized as one of the most influential emerging economy and second largest country in the world in terms of population. The mixed economy in which industry has been given strategic importance after liberalization reforms in 1991. The Government of India has opened various sectors for 100 percent foreign equity ownership to improve infrastructure and industrial growth. Startup India, Standup India initiative by government of India, envisioned to build strong ecosystem for innovation and startups. These programs act as catalyst and vehicles for investment in Indian startup industry.
Venture capital firms made 197 investments worth $623 million in Indian companies in first six months of 2016. Pertinent from the activity in the region, the list of VC investors who were active in India are quite diverse as well which includes new entrants and old India hands. It includes subsidiaries of American, European, and Japanese VC firms as well as local co-operate and government institutions. As per ThomsonOne database, IPOs Trade Sale, Secondary Sale, Buyback and Write off are the most commonly adopted exit routes by venture capital firms. During 2002-2012, the IPOs were the prominent exit route with 55% followed by trade sale (36%) and secondary sale (7%) respectively.

India’s venture capital industry is still at evolutionary and infancy stage but heading towards maturing phase with investment of $10B in last 4-5 years. There is strong growth in exits in last 3 years and there is expectation that it will grow further in future – by 2024. Indian positive macroeconomic outlook and stable government attracted global LP’s with more positive outlook then the past. Huge corporate VC’s have started looking
India as potential future market for direct investments, with consumer technology and IT/ITeS as preferred choice for investments.

Some of the drivers for high growth and momentum in startup ecosystem in India are young talent, macroeconomic growth, co-worker space, supporting regulatory framework including many government initiatives like Atal innovation mission, SIDBI funds of funds and Make in India.

Although, developed countries have always remained as first choice of any startup due to their infrastructure readiness, India today is recording fast growth due to large small and medium incubators, global partnership and growing young population. To grow further it needs favorable economic conditions, sufficient liquidity, sound monetary and fiscal policies. In this respect, positive macroeconomic & financial environment, regulatory framework, tax policies, well-regulated capital & IPO markets are few essential ingredients, catalyst and enablers for future investments.

**Significance of the Study**

The exit is a process; it needs strong execution, strategy and planning which revolves around state of these determinants at a particular time. There is underlying specific cultural, economic and geographical factors which change when an event is triggered and these determinants may differ under different situations. Therefore, an understanding of various aspects related to exit decisions by the venture capital firms in India will put forward more insights on this less explored area. Multiple impending exits are pending in next 5 years across different countries and geographies including India, which is considered one of the top preferred destination for startup investments by venture capitalist and private equity. Also, the venture capital firms and other investors providing funding to startups need more evidences and research output discussing the exit strategies.
The academicians also need to deliberate this issue while enriching their students in classroom. So, considering all these aspects, the current study is designed. The further justification regarding significance or need of current study, it is imperative to critically examine the past research and identifying the existing gap in the past research. It will justify the purpose of this study. In lieu of this, chapter two has discussed various studies contributing to the extant literature on several issues related to exit strategies by venture capital firms.