Emerging Challenges for Venture Capital

Saurabh Srivastava
Chairman
Indian Venture Capital Association

The promise of venture capital in India looked like a clear winner in the mid-nineties. A broad global consensus had emerged that the private sector had to be the primary catalyst for growth and development, rather than the state, and many emerging economies were demonstrating encouraging progress.

Although venture capital was not expected to be a panacea, there were high expectations by both international investors and developing country entrepreneurs that the factors of supply and demand were in perfect harmony for this new asset class to succeed.

But to everyone's disappointment the promise of venture capital in India has failed to meet expectations. After an initial proliferation of new funds in the mid nineties, growth has slowed to a trickle, and there is a discouraging pessimism among most practitioners that this trend will soon be reversed.

The most sweeping lesson learned from this disappointing experience is that the venture capital model that worked so successfully first in the U.S. and then in Europe does not travel well to India. Virtually everyone involved in the early years assumed that a little tinkering around the edges would suffice to replicate the success achieved by venture capital investors in a few industrialized nations. The development finance institutions (DFIs), as strong promoters of private sector development, encouraged investors to support identical fund structures and investment approaches even though the regulatory and legal frameworks did not provide adequate investor protection. Fund managers adopted similar processes for identifying, analysing and valuing the target companies and structuring the deals despite the dramatic differences in accounting standards, corporate governance practices, and exit possibilities. And investors willingly jumped aboard the bandwagon. Faced with disappointing early results, however, all stakeholders are being forced to rethink their approach.

Some of the most legendary high growth companies in the U.S. were initially financed with venture capital, such as Federal Express, Oracle, Apple Computer and Intel. As these success stories multiplied and became widely known, large institutional investors such as pension funds and insurance companies were drawn to the asset class, fuelling the industry's explosive growth in the 1980s and 1990s. Venture capital under management in the U.S. skyrocketed from about $4 billion in 1980 to close to $300 billion in the late nineties, spawning the rapid growth of many new and innovative firms, especially in the US technology sector. If the model worked so well in the U.S. and some European countries, according to the reasoning of many investors, why not India?

By the early nineties India seemed like fertile ground for this tested and successful paradigm. With so many factors pointing in the right direction, emerging market funds proliferated in the mid-nineties in US and Europe.

This venture capital expansion was strongly supported by both bilateral development institutions, such as the Overseas Private Investment Corporation (OPIC), the U.S. Agency for International Development (AID), and the multilateral DFIs that focus on private sector development, such as the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD). By the end of 1998 these institutions had committed more than $15 billion to some 220 venture capital funds, a seemingly strong endorsement of this new investment vehicle designed to further private sector development.

The DFI role was critical in these early years when private investors were hesitant to commit capital to countries with unfamiliar local conditions and highly uncertain risk-return tradeoffs.

Unlike some industries, measuring venture capital performance leaves little room for ambiguity: cash returned to investors relative to the amount invested, and the timing of these disbursements. This simple metric can be captured in a single number, the internal rate of return, which has the added advantage of being easy to compare with other investments in a portfolio, and other funds in the same asset class. On this basis, by the late nineties, the emerging market venture capital funds were seriously under performing.

IFC officials, managers of the largest portfolio of emerging market venture capital funds, have acknowledged that cumulative returns on its investments in venture capital funds are in single digits, or lower.

As these results became known, investors responded by turning away from India venture capital. The "Latin American Venture capital Analyst" reported that venture capital funds raised in 2001 were at the lowest level since 1995, when the industry first began to take off. As one institutional investor explained, "Basically, we don't want to increase our exposure in the region, and only when money starts coming back will we re-

invest." Once the rumours about poor performance and declining investor interest gather momentum, the well-known herd mentality takes over. "After three or four years of lousy returns in Asia, Latin America and Russia," one fund manager lamented, "it's going to be very difficult to find new money. Investors do not have any high profile role models of consistently successful funds to demonstrate that this type of investing works well. The publicity is bad, and getting worse." As long as this sentiment prevails, venture capital investing in India will stagnate.

Arguably, these early judgments are premature and misleading. Many of these first generation funds have been in business for only three or four years, far too short a time frame to begin measuring results. Even in the U.S., most funds have a ten year life and do not begin generating positive returns until about five years into the cycle. Until mid-2000, these funds also bore the unenviable burden of comparison to their industrialized country counterparts at a time when returns in the U.S. and Europe were at historically unprecedented levels. The National Venture Capital Association reported that the average return for all venture funds in the U.S. was a staggering 146% in 1999, and the five year average was 46%. With the technology bubble punctured and stock market indexes descending from their unprecedented heights, at least the comparators for India funds will be more realistic.

Defenders also point out that they have been victimized by the dollar's sharp appreciation against most currencies in Asia and Latin America since the mid nineties. Even when portfolio companies perform at an exceptionally high level in local currency terms, if the currency has depreciated significantly against the dollar, real returns to foreign investors evaporate. This is precisely what has occurred in some of the countries that have received the highest volume of venture capital investments, such as Southeast Asia, Brazil, and Argentina.

These defensive explanations, however, cannot obscure the inescapable conclusion that the industry has performed poorly in absolute and relative terms, as measured by exit results . Although too early for final judgments, there is no question that performance will only improve if the major stakeholders take stock and significantly change their approach. The model that worked so well in developed countries needs more than fine-tuning when exported to India.

The venture capital industry evolved gradually in the United States over a thirty or forty year period in response to a set of conditions that were increasingly conducive to this type of financing, such as strong demand from cooperative entrepreneurs, a sympathetic public policy environment, a reliable legal system, political and economic stability, and well developed financial markets. These success factors, however, are demonstrably absent in India.

Given the paucity of financing alternatives for most firms, fund managers expected deal flow to be the least of their concerns. What escaped their attention, however, was the quality of the business practices of many companies. The first gaping difference that altered the entire venture capital equation were the standards of corporate governance-the accuracy, timeliness and transparency of financial and operating information provided to investors, and the willingness of managers to subject themselves to some degree of accountability by outsiders. Even in the best of circumstances, relationships between investors and the managers of their portfolio companies are complex and often contentious, but the absence of sound corporate governance practices has sharply accentuated the tension.

Opaque book keeping and disclosure habits also may impede access to other potentially damaging information that might alter investor perceptions of company value, such as environmental liabilities or unresolved legal disputes. As one investor noted, "One big problem in [India] is skeletons in the closet. Many of these great companies have hidden subsidiaries, offshore sales and other tax avoidance schemes."

Weak corporate governance is compounded when legal systems do not offer a reliable outlet for resolving disputes. Carefully constructed and enforceable legal contracts serve as the bedrock for conducting all financial transactions, regardless of the country. Indeed, whether banks or equity providers, financiers normally have little direct control over the firms in which they invest and depend heavily on the legal system to protect their rights.

These fundamental shortcomings magnify the reality of a venture capital environment that is starkly different and more difficult than what practitioners were accustomed to closer to home. The basic assumptions underlying the U.S. venture capital approach are largely missing in India, with a predictably adverse effect on performance. Results will only improve, therefore, if the stakeholders change their approach. The fund managers must align their business model more closely with India realities.

The post-investment role of the venture capital investor in India is even more important than in developed countries, given the extraordinary challenges of creating a viable exit opportunity. Fund managers must re-think the professional skillset required for these tasks, recognizing that the analytical and negotiating skills required to make an investment are not same as those required to enhance corporate value during the post-investment phase.

Regardless of the country or culture, successful entrepreneurs share numerous traits, particularly during the critical start-up phase of launching a new business. They tend to have an uncompromising, single-minded persistence, a fierce determination to overcome adversity, and unbridled optimism, regardless of the odds. Venture capital investing in India is akin to a start-up company, and successful practitioners must

be endowed with a similar arsenal of personal characteristics not unlike the U.S. venture capital pioneers in the sixties. They too were hard pressed to convince skeptical investors to commit capital in high-risk companies with no track records; they also complained about ill-prepared and secretive entrepreneurs; and, long before the NASDAQ emerged as an IPO outlet for small companies, they had difficulty planning profitable exit opportunities. Then as now, during the inevitable period of trial and error in the formation of a new industry, failures out-numbered successes and naysayers appeared more credible than the innovators and risk takers. But the successful U.S. venture capitalists rapidly ascended the learning curve, demonstrating an uncommon capacity to make creative adjustments along the way in response to their early, often difficult experience. This pioneering generation of emerging market venture capital managers must follow a similar trajectory, and not permit early failures and disappointments to obscure a number of favorable factors that bode well for the future.

As long as there is an international consensus on the private sector's preeminent role in the development process, alternative financing techniques such as venture capital must remain on center stage. Globalization, with its emphasis on open markets, lower barriers to trade and investment, and cross border competition, will reinforce this trend by fostering intense competition among countries as well as firms. There can be no greater incentive for local political leaders to adopt reforms that strengthen the enabling environment than awareness that they are in a fierce global contest for scarce financial resources. Some governments already are responding by passing legislation to better protect the rights of minority shareholders and by liberalizing onerous tax regulations that discouraged foreign investors. This new environment also favors so called new economy companies, with managers who are less resistant to third party investors and more accepting of international standards of corporate governance.

Thus, despite the early setbacks and disappointments, there are encouraging signs that a venture capital rebound in India is not only desirable, but plausible. For this to occur, however, the key stakeholders must make creative adjustments that reflect their understanding that the realities surrounding this type of investing requires a different approach. Then the promise of venture capital will begin to be realized.