Funding Innovators and Start-ups

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India has seen tremendous reforms in our capital markets over the last decade. Our secondary markets are amongst the top 5 in terms of trading, regulations, liquidity and risk management. The derivatives market, too, is performing in a stellar manner. The next frontier is in creating competitive market conditions to improve access to capital for India's growing innovation and startup ecosystem since they represent the next wave of economic growth.

India currently has the 3rd largest startup ecosystem in the world, after the US and China. Today we have around 50,000 starts up, who have created $170Bn of value with approximately 39 unicorns (startups with valuations of more than $1Bn). Over 460 technology-focused funds exist in India. From 2014 till now, over $60Bn of capital has been invested in technology startups, but only 10% of this capital is Indian. Indian institutional participation in this investment wave has been minimal, forcing our startups and unicorns to domicile outside India to raise capital more efficiently. Over 20 of the 39 Unicorns are domiciled outside India, and more startups continue to shift outside.

Only around 5-6 startups have raised capital from our stock markets despite improved regulations and SEBI issuing special regulations to incentivize their listing. Our $400Bn Mutual Fund industry has hardly invested in innovation and startups. Government, of course, has tried to improve access to capital by creating a Rs. 10,000 crore Fund-of-Funds (FOF) with SIDBI, which has been successful in sanctioning around Rs. 3,500 crores to over 75 Funds. In the 2019 manifesto, the NDA promised seed capital investment of over Rs. 20,000 crore towards the technology startup ecosystem. The Ministry of IT is now working on a Rs. 5,000 CR FOF for tech startups in the software products space.

The biggest institutional failure has been the inadequate participation of our insurance sector. At the end of this year, the sector will have around Rs. 50 lakh crores in assets under management (AUM) but has hardly invested around Rs. 1,500 crores in startups. The idea that investing in startups is very risky on a risk-reward basis does not hold water. Data for an extended time period from the US demonstrates that venture investing has yielded good returns. Further, today we increasingly observe pension and sovereign wealth funds from Canada, US, Singapore and other countries make significant investments in these sectors in India, but our institutions have not matched this despite having the large pools of investable capital. India has received over $54Bn in investments in the startup sector from overseas over the last 6 years and $14Bn in the previous year alone.

A large impediment also has been the lack of technology investing skills in the insurance sector and the fear of the unknown. This can easily be mitigated by investing in Fund-of-Funds which can expose the investor to multiple technology funds over time, and they can steadily imbibe the knowledge needed to invest on their own later. A bigger obstacle for insurance companies investing in FOFs has been the IRDA regulations which seemingly disallow such investments. Further, the existing regulations preclude investing in technology funds that partially invest overseas based on a quota managed by SEBI. The Insurance Act prohibits policyholders' capital being invested overseas. This too can be mitigated by funds issuing a different class of investing units to insurance companies, which will be used to only invest in companies registered in India. Antiquated regulations are hurting the growth potential of Indian insurance companies and preventing them from fully participating in India's innovation growth story.

The other consequential issue impeding greater domestic investments is that of income tax. The current tax laws impose a tax of 28.5 % including a 37% surcharge with indexation on gains over Rs. 5 crores in unlisted companies after a holding period of 2 years for individuals. However, the long term capital gains (LTCG) tax on listed stocks is only 11.96% including the surcharge of 37% over Rs. 5 crores. Consequently, we have a perverse system which penalizes investors investing in unlisted companies with a higher risk and potentially higher rewards, as against investing in listed stocks which are lower risk because they have liquidity and higher information flows. Unlisted companies go on to list on the stock exchange later and create liquidity, but first, unlisted companies need the capital and latitude to grow and develop their business in order to get listed in the future. Indian tax laws, unfortunately, hit these unlisted companies at the cusp of growth itself; thereby penalizing young companies and their investors with higher taxes before they have had a chance to grow.

On top of all this is the infamous Angel tax, which despite best efforts still exists in another avatar and gives unilateral power to the tax officers to question valuation and add investments received to income if he is not satisfied with the information provided. The entire tax system - from angel tax to prohibitive LTCG taxes - inhibits innovation. Most countries have created favourable tax policies for the growth of innovation through tax incentives, whereas India's tax policies serve to actively disincentivize investment in innovation.

We also need to incentivize Indian investors. Income tax data shows that in AY 2018-19, a total of Rs 45 lakh crores was declared as income subject to income tax in returns, out of which only around Rs 67,000 crore was reported under long term capital gains on all assets by individual taxpayers. Abolishing LTCG tax for individuals will hardly cause significant revenue loss, but will unleash a massive wave of investments by funds and investors in startups and reduce the pain in investing.

Another major tax issue that disproportionately hurts domestic investors. Indian tax laws levy a lower tax of 10% without indexation for overseas investors in startups as against 20% for local investors after a holding period of 2 years. India's tax laws also systematically discriminate against Indian taxpayers as against overseas investors and serve to disincentivize domestic participation in India's innovation journey.

All this has led to reduced investment by Indian capital in startups and the overwhelming presence of various capital providers from overseas, including China. A palpable fear of India becoming a Digital Colony exists where our most prominent and stable startups and innovators are owned primarily by overseas investors and largely domiciled overseas. The recent ban on Chinese Apps revealed that over 60% of all apps downloaded in India were Chinese in origin. We had handed over our Digital Territory to the Chinese while defending our physical territory vigorously. The main reason was that the Chinese invest over 65b$ yearly on their startups. Lack of risk capital impeded the growth of our startups in the Apps world!

The RBI also adds to this misery by creating unnecessary paperwork for multiple filings for overseas investors in unlisted startups as against listed companies. This has resulted in our best startups domiciling in Singapore or Mauritius where such paperwork is minimal and where capital can flow in and out quickly, albeit in a tightly regulated environment. India does have healthy policies for capital flows for overseas investors in listed stocks but excessive filings for unlisted stocks. If an Indian company were to be acquired by an overseas company, then too a valuation report and other documents are unnecessarily called for by RBI. This impedes the free sale of such companies forcing them to domicile overseas where they can quickly be sold. If a listed company were to be divested to an overseas investor the process, barring any open offer, is much simpler to execute.

This dichotomy in RBI regulations between listed and unlisted companies creates unnecessary friction to the ease of doing business and drives many potential investors away from investing in Indian startups. This challenge can be solved by asking such startups to be registered with and their shares held electronically, by Approved Depositories, just like overseas investors do in listed companies in India. Otherwise, if our high-growth companies are driven away to list overseas because of such overbearing regulations, then the scope of investment for Indian investors to invest in them gets further reduced.

Antiquated regulations, discriminatory tax policies and excessive filing requirement create barriers for innovation in India. Despite all this, the fact that India is the 3rd largest start ecosystem is a tribute to the amount of pain our entrepreneurs are willing to endure to grow their companies here and their vision to Make-in-India. Imagine the unprecedented growth our ecosystem would embark on if only these regulations and policies were more conducive!

All these restrictive regimes have led to the majority of our unicorns domiciling overseas with almost no Indian capital invested in them. Of course, even if such startups have the majority of their business and market growth here, but are domiciled abroad and are invested in by overseas investors, they will, in turn, look to list overseas. The lack of such large companies having domicile in India, with majority Indian capital is also creating another unfortunate myth that our stock markets are not liquid enough, will not allow significant capital raises, or support good valuations. All of which is patently untrue.

Indian markets reward growth and stable governance. The high PE for FMCG companies despite their low growth rates demonstrates that these fears are exaggerated. The high PE enjoyed by tech companies like Infosys, Wipro and TCS during their growth years confirms that our markets reward growth. It is true that many startups, because of very high growth, could make losses for a period, but this will not deter local investors so long as the growth is evident. The significant capital raised by many first-time listings amply demonstrates the liquidity available here. This is further confirmed by the actions of overseas investors to invest in such listings in Indian local markets.

Another view held by some venture capital (VC) firms against listing in India is about the 'promoter lock-in' conditions for listing. Here again, SEBI has stated in its discussion papers that they have an open view on this matter and are willing to have norms similar to that of Nasdaq for companies listing here.

The Indian startup ecosystem has a target of 100,000 startups by 2025, with 100 unicorns creating in total over $500Bn of value. This will require between $100-150Bn of capital investment between now and 2025. It is an exceptional opportunity for India to become an Innovation SuperHub and create a wave of high-growth jobs and wealth creation for millions. India must capitalize on this remarkable, once-in-a-lifetime opportunity, by reforming tax laws, reducing the regulatory barriers for large institutional investors to invest, and reducing the RBI's excessive documentation requirements by creating conditions akin to listed companies.