A Study on Pre-Investment Actions of Indian Venture Capitalists

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The study attempts to look at one part of venture capital investment process i.e. the pre-investment actions of Indian Venture Capitalists (VCs). Specifically, the paper examines use of various deal sources, evaluation criteria and syndication practices. In addition to this, it also focuses upon various investment preferences of such investors such as stage of investments, amount of investments and instruments of financing used by them. The findings revealed that referral system was the most preferred source of deal by Indian VCs. With respect to evaluation criteria, it was found that VCs in India gave more importance to the personality, skills and experience of the entrepreneur/management followed by financial and other non-financial considerations. Further, many VCs would prefer to syndicate the deal with other VCs mostly at the later stages for various motives.

Keywords: Venture Capital, Deal Sources, Evaluation Criteria, Syndication

Introduction

World is passing through a phase of knowledge economy, where technology and knowledge based ideas are set to drive the global economy (Taneja, 2002). In this phase, knowledge-intensive, high-technology industries are expected to be the most critical and strategic industries for the survival and the growth of companies, regions, and nations (Sung *et al*, 2003). Given the inherent strength by way of its human capital, technical skills, cost-competitive workforce, research and entrepreneurship, India can unleash a revolution of wealth creation and rapid economic growth in a sustainable manner. For this to happen, there is a need for risk finance and venture capital environment which can leverage innovation, promote technology and harness knowledge based ideas (Selvakumar and Ketharaj, 2009). Thus, venture capital plays a key role in the entrepreneurial process by providing equity capital and managerial support for young, rapidly-growing, high risk and high tech private companies with the potential to develop into significant global businesses (Mason and Harrison; 1999, Mishra *et al.*; 2005). Reflecting the overall importance of venture capital to entrepreneurship, it has received considerable academic attention. In this study, an attempt has been made to look into various pre-investment activities by Indian VCs in terms of generation of deals, evaluating them and preferences towards syndication with other VCs.

Literature Review

Deal Origination

Due to prevailing stiff competition among venture funds for good investments, sources of potential deals are a matter of concern for venture capital search. However, as per the study of Zacharakis and Shepherd (2007), deal flow and due diligence are quite under researched. Studies conducted so far in this area highlight potential sources of deals (Tyebejee and Burno, 1984; Fried and Hisrich, 1994; Pandey and Jang, 1996; Klonowski, 2007). These studies revealed that deals can originate from various sources such as arising out of referral system, unsolicited calls by the entrepreneurs, active search by the VCs themselves and deals within the venture capital communities.

Tyebjee and Bruno (1984) observed that potential deals are brought to the attention of VCs from sources like unsolicited calls from entrepreneurs and referrals. Deals were referred to the VCs by venture capital community, prior investees, personal acquaintances, banks and investment brokers. Sweeting (1991) also found that most deals were referred by third parties and that VCs rarely try to discover new investment opportunities proactively. As per the study conducted by Sharma (2002) with respect to Indian VCs, these investors gave high priority to referrals or known potential investees whereas unsolicited calls by business plans were considered less important.

Screening of Potential Investment Deals

VCs commonly receive many business proposals on an average 450 per year; as reported by Tyebjee and Bruno (1984) (Manigart *et al.*, 1997) but, the rejection rate has been very high; typically, only one out of every ten to twenty projects will pass the initial screening (Koh and Koh, 2002). The process used by the venture capitalists to filter out these proposals, is known as "*Screening*".

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Fried and Hisrich (1994) described that VCs eliminate the proposals that are unable to meet the venture capital firms' investment criteria, have been previously unsuccessful in certain sectors, and seem generally unpromising. Tyebjee and Bruno (1984) stated these criteria are size of the investment, investment policy of the venture fund, technology and market share of the venture, geographical location of the venture and stage of financing. MacMillan *et al.* (1985) in their studies reported that these criteria are necessary to weed out undesirable ventures at the initial stage itself.

Evaluation Criteria

A number of researchers have studied the evaluation criteria used by the VCs across different countries for example *US* (Tyebjee and Bruno, 1984; MacMillan *et al.*, 1985; MacMillan *et al.*, 1987; Hall and Hofer, 1993; Sandberg and Hofer, 1987; Zacharakis and Meyer, 1998) *India* (Pandey, 1996; Kumar and Kaura, 2003; Mishra, 2005; Sharma, 2002), *Taiwan* (Pandey and Jang , 1996), South Korea (Rah *et al.*, 1994), *Central and Eastern Europe* (Bliss, 1999; Karsai *et al.*, 1998). These criteria generally relate to the quality of the entrepreneur/team, uniqueness of the product/service, attractiveness of the market as well as financial considerations (Tyebjee and Bruno, 1984; MacMillan *et al.*, 1985; MacMillan *et al.*, 1987; Hall and Hofer, 1993; Zhacharakis and Meyer, 1998; Sandberg and Hofer, 1987).

Besides, the identification of selection criteria has been researched using different methodologies such as Factor and Cluster analysis (Tyebjee and Bruno, 1984, MacMillan *et al.,* 1985, MacMillan *et al.*, 1987; Hall and Hofer, 1993), Construct Analysis (Fried and Hisrich, 1994), Verbal Protocol (Zhacharakis and Meyer, 1998, Sandberg and Hofer, 1987), multi methods like case analysis, published interviews, questionnaire, personal interviews, administrative records; to enhance the understanding of investment criteria and also extend it to other aspects of investment process like deal structuring and divestment (Mishra, 2005).

Thus, it may be concluded that researchers have made an extensive efforts in this area applying different methodologies from simple questionnaires and interviews to verbal protocol analysis, across developed as well as developing countries. In the present study, once again the venture capitalists' evaluation criteria have been investigated in Indian context by obtaining a larger and more representative sample.

Use of Security/ Instrument of Financing

VCs use a variety of forms of finance, including common equity, warrants, straight preferred, convertible debt, straight debt, and combinations of each form of finance. However, various studies provided empirical evidence for the use of convertible securities in venture capital contracts (Gompers, 1997; Kaplan and Strömberg, 2003; Bascha and Walz; 2001). Preference for use of convertible preferred securities centers on asymmetric information, incentive problems, and taxes (Denis, 2004).

In US, VCs typically invest in start-up companies by purchasing convertible preferred stock (Norton and Tenebaum, 1992). Sahlman (1990) and Gompers (1997) also validated this finding and reported systematic preference for convertible preferred stock in their studies. Cumming (2007) reported that the preference for convertible preferred applies to US but does not extend to Canada. Isaksson (2006) described that Swedish venture capital firms do not seem to have adopted that custom of investing through preferred stock like VCs in US.

Venture Capital Syndication

Syndication of venture capital investment is one of various strategies to deal with high risk environment developed by venture capital firms (Manigart *et al.,* 2002; Wright and Robbie, 1998). Syndication is a common practice in North America and Europe. As per the Statistics of European Venture Capital Association (EVCA), almost 30% of the amount invested by the VCs and the number of deals were syndicated in 2001. While syndication practices in U.K. and Netherlands are low both in terms of amount invested as well as number of deals (Manigart *et al.*, 2002). However, the formal academic literature on venture capital syndication is modest in scope. Despite the importance of syndication activity in the venture capital sector, little is known on the motives for syndication.

One rationale for syndication, suggested by Lerner (1994), is related to *selection hypothesis at a pre-investment stage*. The evaluation of the same venture proposal by different venture capital companies operating in a syndicate reduces therefore the potential danger of adverse selection. The finance theory views syndication as a means of risk sharing through portfolio diversification (Manigart *et al.*, 2002). The resource-based approach that holds for post-investment stage, however, sees the venture capital market as a pool of productive resources in which a venture capital organisation can access resources of another venture capitalist through syndication (Manigart *et al.*, 2002; Bygrave, 1987). Access to future deal flow may be a motivation for syndicating a deal (Sharma, 2002).

Need for the Research

The studies as described in the literature review on pre-investment stage of VC investment process have produced a number of valuable insights, but majority of these researches were carried out in the context of western countries mainly US and Europe. In Indian context, the studies addressing the pre-investment aspect of the investment process are few and far between. Three studies in relation to evaluation criteria have been brought to the notice by Pandey (1996), Kumar and Kaura (2003) and Mishra (2005). The generalized findings of these studies revealed that entrepreneurs' personality and experience were seen as being primary indicators of the venture's potential. Besides, the available literature on VC in India describes the trends in the VC industry with the help of secondary data. In view of this gap, it was felt necessary to examine the pre-investment actions of Indian VCs with the help of primary information. Hence, the study empirically examines these aspects of the decision making by VCs in India.

Research Objective

This study broadly aims at analyzing the pre-investment phase of VC decision making in Indian context. The specific objectives for this research are mentioned as below:

1. To analyse various investment policy preferences of Indian VCs in relation to amount of investment, stage of investment, instrument of financing and percentage of equity stake.
2. To study various potential sources used by VCs in India for generating deals.
3. To examine in detail the evaluation criteria used by the VCs in India as decision determinant to invest in the potential venture.
4. To study the syndication preferences of Indian VCs mainly in terms of reasons and stage preferred for syndication with other VCs.

Research Methodology

The methodology adopted for the study analyzing the pre-investment activity of Indian VCs has been presented in a tabular form (Table 1).

Table 1: Research Methodology for the study

Parameters	Survey of Members of Indian VC firms
Research Design	Descriptive
Data Sources	Primary and Secondary
Research Approach	Survey
Research Instrument	Questionnaire
Respondent	Members of Indian VC firms
Sampling Method	Non Probability based Judgmental Sampling
Sample Size	38 responses
Sample Size Determination	Dataset of VC firms in India wa s compiled using various relevant sources such as the member directory of Indian Venture Capital Association (IVCA), SEBI registered VC firms, data set compiled by Indian School of Business (ISB), Hyderabad, data of VC firms by National Entrepreneurship Network (NEN) and various newspaper articles
Contact Method	The questionnaire was circulated electronically and in few cases, the interviews were conducted on telephone for the VC firms situated outside Gujarat. For, Gujarat Venture Finance Limited (GVFL), in Ahmedabad, the researcher met the senior officials in person for survey purpose.
Data Processing	Excel and SPSS 17
Survey Period	October 2008 to June 2009
Data Analysis	Frequency distribution, descriptive statistics such as mean, median, mode, standard deviation
Inferential Statistics	Non-Parametric Test: Kruskal- Wallis Test

Data Analysis and Interpretation

Investment Preferences of Indian VCs

As per secondary literature on VC industry, Indian VC market is basically dominated by private equity (PE) (late stage financing) as opposed to VC (early stage financing). This fact was confirmed here with preference of Indian VCs surveyed regarding the stage of investment. As per the findings, early expansion (32%) and expansion financing (27%) were more preferred by the venture capital firms in India over seed (15%) or start-up financing (25%).

VCs typically invest in a small percentage of the businesses they consider for investment. The rejection rate is used to be very high. Typically, only one out of every ten to twenty projects will pass the initial screening (Koh, 2005). Survey results for VCs in India were more stringent. They received many proposals throughout the year but the actual investment was very less (Mean=1.21% and Standard Deviation=0.52%). There were multiple reasons highlighted by the VC firms for such a high rejection rate of around 99%. Main reasons included non acceptability of business plans, business not fitting into the investment preferences, very high risk, un agreeable valuation terms, very high/low level of investments required, lower returns and less promoters' contribution.

Further, the investment policy, in terms of the maximum and minimum limits of amount invested showed a heterogeneous pattern among VC firms. The lower limit of this policy is determined by taking into account the fact that a VC company cannot afford to spread its portfolio over many small deals. However, the upper limit to the investment policy is relatively flexible because VCs may consider larger deals with the intent of soliciting the participation of other VC funds. As per the survey results, VC firms in India would not like to put in less than average US$ 4 million and more than US$ 31 million approximately. Small projects were of limited interest to such firms as noted before as late stage/expansion financing was more popular among these VC firms.

Instrument of Financing and Ownership Stake

VCs mainly use equity, preferred stock, straight debt, convertible debt or a combination of each form of finance for investment in portfolio companies. Preferences of Indian VCs for use of security for investments revealed that they commonly preferred to invest in the ventures; through purchasing the equity (63%) followed by convertible debt (32%). Use of pure debt was rarely preferred (1%) while investing.

Further, the firms vary widely in terms of ownership stake that they normally take in the business of investee. The average ownership stake by the VCs may range between16% and 44% approximately.

Sources of Potential Deals

In the present study, the VC firms in India were asked to indicate their preferences for various sources of deals such as referrals, looking for deal themselves, getting the deals from VC community and prior investee and unsolicited calls by entrepreneurs themselves*;* on a scale of 1(*least preferred*) to 5(*most preferred*). The descriptive statistics are highlighted in table 2.

Table 2 Descriptive Statistics of Potential Deal Sources

Sources of Deals	Mean	Std. Deviation
Referrals	3.82	1.08
Search deal themselves	3.50	1.58
Venture capital community	3.39	1.22
By entrepreneurs	3.39	1.00
Investees	3.58	1.24

These descriptive statistics indicated that the mean values for the preferences for almost all the sources of deals as defined herein; were in the range of 3 to 4. Overall, the referrals were mostly preferred by the VCs in India followed by the deals referred through prior investee and active search for the deals by themselves.

Further, from the cross tabulation of age of the firm and sources of deals, there were significant deviations noted in the preferences of VC firms for use of deal sources. Hence, *Kruskal-Wallis test* was used to pinpoint such differences among the VC firms by age (i.e. Recently established, Already established and In-between the two); with respect to the sources of deals used.

VC firms established prior to 2000 have been defined as already established while those established after 2006 have been defined as recently established firms. And the firms set up between 2001 and 2005 are the firms in between the recent and already established firms. The following hypothesis was set for the study.

H_0 1: There is no significant difference between the age of the firm and the sources of potential deals.

H_1 1: VC firms in India of different age differ significantly in their choice of sources of deals.

The results of the test are presented below.

Table 3 Ranks of Deal Sources (As per *Kruskal- Wallis Test*)

Sources of Deals	Firms by Age	N	Mean Rank	Particulars	Test Statistics
Referrals	Recently established	10	12.20	Chi-Square	6.71
	In-between	10	16.50	Df	2
	Already established	14	22.00	Asymp. Sig.	.04
Deal themselves	Recently established	10	27.00	Chi-Square	16.68
	In-between	10	17.00	Df	2
	Already established	14	11.07	Asymp. Sig.	.00
VC Community	Recently established	10	12.55	Chi-Square	6.17
	In-between	10	16.20	Df	2
	Already established	14	21.96	Asymp. Sig.	.04
By Entrepreneurs	Recently established	10	10.15	Chi-Square	10.22
	In-between	10	18.35	Df	2
	Already established	14	22.14	Asymp. Sig.	.01
Investee	Recently established	10	8.65	Chi-Square	12.65
	In-between	10	20.55	Df	2
	Already established	14	21.64	Asymp. Sig.	.00

It may be observed from the table 3 that there were 14 firms established prior to 2000, 10 firms set up after 2000 and the rest 10 firms established from 2001 to 2005. As per the test statistics, two tailed asymptotic significance values with 2 degrees of freedom for all the sources of potential deals as defined herein were less than the significance value 0.05 i.e. $p<0.05$. Hence, H_0 is rejected. So, it may be inferred that there are significant differences among VC firms in India for the deal sources. The mean ranks suggested that recently established firms adopted proactive approach i.e. they looked for deal themselves while the already established and in between the recent and old firms, used more of reactive approach meaning thereby they prefer waiting for the deals to reach to them either through entrepreneurs, referrals, prior investee or VC community.

Evaluation Criteria

Once a proposal has passed through the initial screening, it is subject to a detailed evaluation. VCs assess the probability of success or failure by evaluating information surrounding a venture i.e. a due diligence. However, ventures can not be evaluated with sophisticated methods as majority of them lack operating history or experience. Thus, it seemed to be a useful exercise to determine whether there are any criteria at all that were consistently used by the VCs for investment decision making.

As per the results, majority of the VCs in India (67%) used a combination of the in-house experts and external specialists for conducting due diligence. As per the opinions of the Indian VCs, legal due diligence is outsourced to external experts while business and financial due diligence are conducted by the internal experts.

In order to determine the extent to which criteria identified in past studies are used by the VCs in India, this study was conducted as follow-up to the studies as highlighted above. Table 7 shows the criteria used by VCs in India for the evaluation of ventures. The respondents were asked to rate the importance of the evaluation criteria on a 4-point scale i.e. *irrelevant, desirable, important and essential*. The scale used by MacMillan *et al.* (1985), was followed in this study too. Here, each advance up scale represents a distinct and clear increase in the importance of the criterion. The evaluation criteria used in this study were the same as used in all the prior studies on the subject because the variables identified in these studies were developed over a period of time and are robust when it comes to reliability.

From the mean and standard deviation values as highlighted in table 4, it may be observed that most of the evaluation criteria listed here were considered to be significant by the VCs as they had mean values more than 2 except few like presence of co-investors, tax benefits and regulations in the industry. As far as the entrepreneur's personality/experience and venture capital firm's requirements (financial and non- financial) are concerned, except few ones, all others had mean values between 3 and 4 suggesting that VCs' own benchmarks for investment and entrepreneur's attributes were considered to be very important by these investors for evaluation.

From the ranks it may be observed that top most ranks (between 1 and 8) were secured by categories related to entrepreneurs and financial/non-financial considerations. For the product and market considerations, the criteria as listed in the table had mean values between 2 and 3 i.e. these criteria might be more desirable but not so important. The market growth which was an exception was considered to be significant for evaluation. Further, as per the survey results, VCs did not consider the environmental conditions i.e. tax benefits and regulations in the industry; significant while decision making. Tax benefits are not relevant in evaluating many deals because VCs see their mission as reaping capital gains rather than providing tax shelters for the investors in their fund.

The standard deviation values for all these criteria were between 0 and 1 indicating that there was a high consensus among the VCs for these opinions. The five relatively least important criteria were: tax benefits, regulations, presence of co-investors, promoter's own contribution and high tech product. Claim regarding the high tech product was little surprising as the major investments by VCs, as described before, was into technology based businesses (IT and ITES). It may be said that in comparison with all other criteria, this factor was not given equal importance by the VCs.

Table 4 Descriptive Statistics and Ranks of the Evaluation Criteria

Evaluation Criteria	Mean	Standard Deviation	Rank*
Entrepreneur			
Quality of management team	3.84	0.37	1
Personality and attitude of entrepreneurs	3.82	0.39	2
Past track record of the entrepreneur	3.63	0.49	6
Urge to grow	3.74	0.45	3
Referred by a reliable source	3.16	0.68	13
Entrepreneur's familiarity with the market	3.68	0.47	4
Promoter's own contribution	2.50	0.65	20
Focused development strategy	3.66	0.48	5
Market			
Market growth rate	3.47	0.60	9
Domestic/International market potential	2.92	0.75	15
Little threat of competition	2.71	0.52	17
Product/Service			
High tech product	2.61	1.08	19
Prototype should be developed	2.76	0.75	16
Proprietary protection	2.66	0.71	18
VC firm requirements (Financial and Non-Financial Consideration)			
Rate of return	3.74	0.45	3
Size of investment	3.26	0.45	11
Exit routes	3.39	0.72	10
Venture can be made liquid	2.97	0.54	14
Consistent with the investment preferences	3.50	0.73	8
Quality of business plan	3.55	0.50	7
Consistent with your expertise	3.18	0.51	12
Co-investors are present	1.55	0.60	21
Environmental Conditions			
Tax benefits	1.37	0.49	23
Regulations in the industry	1.50	0.51	22

**Evaluation criteria have been ranked on the basis of the mean, and whenever mean values have been found to be the same, ranking has been given on the basis of the standard deviation of these criteria.*

Thus, the results of this study are consistent with the findings of Pandey (1996) who had studied the evaluation criteria used by VCs in India. In general, personality and experience of entrepreneurs concerns dominate the financial criteria. And financial criteria in turn are regarded as more important than product and market criteria. Almost all studies that have investigated the evaluation criteria used by VCs, have found that management-related-criteria are the key factor that influences their decision making (MacMillan *et al.,* 1985; Hall and Hofer, 1993).

Venture Capital Syndication

VC firms have developed various strategies to deal with high risk environment. One of which is syndication (Wright and Robbie, 1998). For studying the syndication practices, the VCs have been asked whether they prefer to syndicate the deals with other VCs and if yes, at what stage they prefer to syndicate. As per the findings, 61% of the VCs have revealed their preferences for syndicated deals mostly at the later stages (65%) as compared to early stages (35%).

Further, respondents were asked to rate their motives behind syndication on variables like risk avoidance, financing of larger investments, window dressing, access to specific skills and others; on importance scale 1 (*not important*) to 5 (*extremely important*). The descriptive statistics (table 5) suggested that financing of larger investments (mean value 4.39) was rated as extremely important by Indian VCs followed by risk sharing (mean value 3.91) and need to access specific skills for better management (mean value 3.04).

Deals that are not within the purview of the investment stage, scope or geography regions were not considered as significant motives for syndication. While the VCs had neutral opinions for superior selection, access to deal flow and stronger bargaining position against investee.

Table 5 Descriptive Statistics of Reasons for Syndication

Reasons for Syndication	Mean	Standard Deviation
Larger investment	4.39	0.66
Risk sharing	3.91	1.00
Superior selection	2.78	0.95
Stronger bargaining	2.04	0.93
Reciprocal deal flow	2.65	1.11
Window dressing	1.43	0.90
Specific skills	3.04	1.07
Outside investment preference	1.48	0.99
Outside industries preference	1.39	0.99
Geography reasons	1.65	1.27

Findings and Discussion

The study evaluates various pre-investment actions of Indian VCs. The findings revealed that referral system was the most preferred source of deal for Indian VCs. Sources can be referred by financial intermediaries, parent organisations and friends. Prior investees were also considered on account of their past record. It implied that entrepreneurs approaching the VC must look for a suitable reference. VCs in India adopt rigorous approach for evaluating the business proposals. As per the results of the survey, for conducting the due diligence, VCs used a combination of in-house specialists and external experts. Generally, financial and business related matters are investigated by the internal experts while the issues related to legal and technological aspects were taken care of by the external specialists. The proposals that clear initial screening stage were evaluated in detail.

The findings of the study were similar to evaluation criteria used by the VCs in US, UK and other Asian Countries. VCs in India gave more importance to the personality, skills and experience of the entrepreneur/management followed by financial and non-financial considerations. The attributes with respect to product and market were considered to be desirable but not so essential for the purpose of investments. While the general conditions related to the environment like regulations of the government and tax benefits were not given due importance for investment purpose. One crucial preference among Indian VCs has been observed from the analysis for syndication. Many VCs (67%) would prefer to syndicate the deal with other VCs mostly at the later stages (40%) for various motives. Presence of both the perspectives for syndication i.e. finance and resource based; were revealed by them as a motive for syndication. Significant reasons for syndication were financing of larger investments followed by risk sharing and access to specific skills among others such as superior selection, access to deal flow, stronger bargaining position, and deals outside the purview of the investment stage, scope or geographic regions.

The findings of this study would be quite useful for a potential start-up looking for VC investment. As the study investigates the preferences of Indian VCs for use of deal sources, evaluation criteria, investment policy and syndication practices; entrepreneurs can accordingly approach these investors for meeting the financial requirement of their ventures.

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