Venture Capital Financing in India

Dr. Shelly
Assistant Professor,
Department of Management Studies
Global Group of Institutes
Amritsar, Punjab.
shelly.aug@gmail.com

Abstract

In this era of investment when innovation and technology based business ideas thrive Venture Capital, a relatively new financial service, has emerged primarily to help first generation entrepreneurs translate their business ideas into realities. It has played key role in establishing many successful business enterprises around the globe, especially in US. Besides providing capital for idea based enterprises, who may not be able to get required assistance from traditional financial institutions, venture capitalists also reinforce their presence as value creators through their long term association with investee firms. As far as India is concerned, venture capitalists might not have been as established as their western counterparts are, but in the last ten years they have become of age and worked hard in setting up an alternate investment universe to evolve and boost the entrepreneurial startup ecosystem in the country. The present paper is an endeavor which examines theoretical framework of venture capital financing, and also analyses the Indian scenario in terms of evolution, trends, regulations and challenges faced by venture capital funds in the country. It is concluded that if thriving ecosystem for venture capital financing is created by concerted efforts undertaken by regulatory bodies, GOI and VCFs themselves, this alternate investment vehicle can become a pillar to reckon with in economic development of the country.

Introduction

In recent scenario, entrepreneurs have emerged as a backbone of economies, generating new jobs, reinforcing market competition and improving productivity (Jalaja, 2022; Sharma & Ahmad, 2022). The advent of startups created new type of ecosystem where in all types of assistance, be it financial, technical or managerial, are brought to table, so as to help first generation entrepreneurs translate their business ideas into realities, and henceforth stimulate innovation and job growth. These young companies are not in a position to attract funds via the traditional mode of financing since they take decision to enter the industry with no previous track record to fall back on plus these do not have tangible assets to offer as collateral against a loan, and have a high gestation period. This is when and where the Venture Capital Funds come into the picture and extend equity as well as competence to young firms with great potential for capital appreciation (Saminathan & Darshan, 2020). Enterprises such as Apple, Hotmail and Yahoo, to mention some companies, which were turned down by traditional financiers for funds, were subsequently financed by venture capital funds who became their knight in shining armour. Financing to these entities was ensued by smart advice, hands-on management support and varied other skills that helped the entrepreneurial dream be actualized into marketable products (SEBI, 2000).

The long and short of it is that venture capital, a type or rather a subset of private equity, targets new, highly risky but rewarding projects with an intent of participating in equity ownership and future growth prospects of an enterprise via subsequent capital appreciation, and henceforth provide a rate of return to the investors that is commensurate with the level of risk undertaken.

Literature Review

Sabitha & Shravani, (2019) stated that the government should provide more incentives to VC industry, promoting the cause of innovation and development. Moreover, venture capitalists should also be open to more diversification. Joshi et al. (2022) echoed the same sentiment in their study, whereby they contended that VCs in India do not really support truly innovative startups, primarily because it might be a risk mitigation strategy on their part, besides dealing with threats from external factors, namely, complex legal procedures, weak IP protection and asymmetry of information between the investee firms and VC funds.

Dugar&Basant (2021) empirically analysed that younger Indian VC and Private Equity firms prefer investing in younger business firms on pretext of building credibility. Even the investee firms with shorter gestation period; lower funds appetite and location at places with mature ecosystems, stand better chances of attracting early stage investments.

Venture Capital Funds, too, have their own set of challenges to deal with(Mahesh, 2019; Sabitha&Shravani, 2019). These include regulatory issues, customer loyalty, competition, lack of professional expertise among others.

Even the pandemic of Covid-19 did not dent the spirit of VC industry in India (Sharma& Ahmad, 2022). The investment picked up in the latter half of 2022, besides witnessing more number of active VC funds. The sectors like SaaS, Fintech and Consumer tech received maximum investment from VC funds.

The existing literature on venture capital financing in India is not extensive. Most of the documented literature have focused on theoretical framework, while others have stressed upon challenges faced by VC industry in India. Quite a few have empirically researched relationship of VC investment with other variables. This paper is, also, conceptual in nature and uses secondary sources of data, however, it presents more comprehensive picture about the venture capital financing in India.

Thus, the paper proceeds with the following specific objectives:

1. To analyse the theoretical framework involving working of venture capital funds.
2. To study the evolution of VC industry in India.
3. To examine the trends of VC investment in India over the last decade.
4. To study the SEBI regulations for the purpose of doing business in India, by Venture Capital Funds.
5. To identify the challenges faced by VC industry in India.

Theoretical Framework of Venture Capital

The advent of Venture Capital is primarily attributed to fill gaps in traditional financing mechanism, focusing on first generation of entrepreneurs, supporting new technologies and innovation in products or services. It fills the vacuum left by traditional sources of financing in high risk, potentially rewarding and innovative business ideas. It is distinguished from other sources of financing in several ways like: venture capitalist will be on board a ship as business partner, sharing risks as well as rewards; VC would bring domain knowledge and past experience to the table, thereby advising management on key issues; participating in strategic decisions; providing national and international contacts for building strong business connections and networks and if needed, multiple rounds of financing would be infused in investee firms. Now, this pops up a very relevant question as to how do VCs get their funds and what the sources are. Venture Capitalists get their investible funds from institutional investors, foundations and high net worth individuals. These investors have very high expectations when it comes to receiving returns on their investment.

Investment Criteria of a Venture Capital Fund

The venture capitalists do not like to play by the Queensberry rules, rather professionally manage their ratio of risk / reward via investing in business ventures which fit their investment criteria and after having displayed utmost earnestness in their assessment of proposals. Venture Capital firm's rejection of a business proposal, is not reflective, by all means, of its quality, instead it represents that proposal may not be not compatible with investment policy of that particular VC. Quintessentially, VC peruses certain relevant parameters before taking investment decision:

a) VC would primarily look out if the opportunity is worth it's while, like if it offers better quality product / service, aims to explore untapped markets.

b) Likewise, VC would be interested in commercial viability of products / services or if the product / service caters to buyer's needs?

c) VCmust be assured with respect to quality, depth and resilience in the management team to attain its aspirations.

d) The level of technology being pursued and the technical collaborations also, to a large extent, impact an investment decision.

e) VC would look for the clear exit opportunity for its investment, hopefully after having attained its target.

Business Plan

The first step for an entrepreneur is to prepare a business plan for consideration of a venture capitalist. Quintessentially, a business plan has to have an element of conviction with regard to the ability of an entrepreneur and his management team to achieve the time bound stated goals. Moreover, a business plan clearly reflects as to what extent thefounders are clear and committed to the vision of their enterprise as well as concerned sector in which they contemplate to compete (Vij&Dhawan, 2017).

The essential areas to be covered in a business plan:

Executive Summary: It is the most significant part and includes the pivotal elements while summarizing the business plan. It should apprise about the background of the company, its activities and objectives.

The Product or Service: This is very important and should articulate competitive edge or unique selling point of product or service. Several otherpoints need to be factored in too, namely, life cycle stage, product updating or adapting as per new markets, legal protection by means of patents, trademarks and value addition to the customer.

Market Analysis: An entrepreneur needs to convince venture capitalist of commercial viability of his business proposition. Certain following things need to be taken care of in this context:

a) Defining the market.

b) Explaining the concerned industry sector.

c) Size of the market.

d) Future prospects of market.

e) Is the market developing, growing, mature or declining?

f) Information about competitors, their strengths and weaknesses, market share and strategic positioning.

g) Entry barriers in the industry.

h) Who the potential customers are.

i) If market is price sensitive.

j) Information about distribution channels.

Marketing: The nextbig question which pops up, is how the investee enterpriseintends to make the most of market opportunities. For this, the business plan should outline the enterprise's sales and distribution strategy, pricing strategy and plans pertinent to advertising, public relations and promotion.

Management Team: This aspect signifies if the company has a management team with quality to translate business plan into reality.

Financial Projections: Financial aspect should consider:

a) Realistic sales, costs, cash flow and working capital.
b) Company's growth projects, say, for next few years.
c) Budget for each area of company's activities.
d) Plan feasibility and associated challenges.

Amount and Use of Finance required and Exit Opportunities: This aspect of business plan should state the following:

a) Quantum of funds required by business, sources of funds and their application.
b) Possible exit strategies for VCs.

Types of VC Funding

a) Seed Financing: It is basically R&D financing targeting at initial product development.
b) Start-Up Financing:At this stage there is no commercial sale of product, and financing is provided for developing product and initial marketing.
c) Early Stage Financing: The capital is provided to begin commercial manufacturing of product and sell it.
d) Second Round Financing: At this stage, product has already proven its worth in terms of earnings. It's just that the financial needs of Investee Company have increased despite getting external capital support.
e) Expansion Financing:As the name itself suggests, this type of financing is provided for expansion plans, be it for increasing production capacity, market / product development or infusing more working capital.
f) Turnaround Financing: It is extended if an entity becomes unprofitable post launch of commercial production.
g) Mezzanine Capital:This financing is provided to those firms which have earned profits for a few years but are yet to reach a phase of launching their IPO. It is intended as a bridge finance, and it has a short-term maturity.

Exit Mechanism of Venture Capitalists

This is one of the most sensitive and pertinent questions before any VC as to how it strategizes to exit out of investee enterprise after having attained its target. There are, of course, several routes available to make an exit:

a) Initial Public Offer: Being the most popular route, wherein the venture capitalist exits via public floatation of shares.
b) Sale of SharesMethod / Repurchase by Founder Members:Shares are sold back to the founders of an entity.
c) Sale to another Entity: The entity itself could be sold to another entity.
d) Secondary Sale: Here, the VC exits by transferring its share to another VC.
e) Liquidation: Being the least preferred method of exit, it is marked by failure of investee firm.

Indian Scenario

In this section of the paper, Indian Scenario, in terms of evolution of VC industry, SEBI regulations, trends in the last ten years, and the challenges faced by VCs in India, are perused.

Evolution of VC Industry in India

It was never a cakewalk for PE/VC industry to make its mark in India. In fact, there never existed an organized PE/VC industry in India till 1986. The evolution of VC industry in India can be phased as per the following developments (Vij&Dhawan, 2017; Shah, 2020;SIDBI, 2018&Indian Venture Capital Report, 2022):

Early Beginning

The concept of Venture Capital was embraced in India at the behest of government and its sponsored institutions, when Bhatt Committee, set up in 1972, on Development of SMEs, highlighted the problems faced by budding entrepreneurs in promoting industries. The initiative took off with the introduction of two schemes called Risk Capital Foundation Scheme in 1975, and Seed Capital Scheme in 1976, by IFCI and IDBI, respectively. In 1984, ICICI too introduced Programme for Advancement of Commercial

Technology (PACT) Scheme in 1985, providing assistance to economic activities involving high risk but withgood profit potential. Despite all these schemes, the VC industry could not gather much strength.

1987-1994

During mid 80's, the venture capital investment was, by and large, confined to three all India FIs, namely, IDBI, IFCI, ICICI who invested in technological companies. Came November 1988, when GOI took a decision of institutionalizing VC industry and also issued guidelines, to be implemented by Controller of Capital Issues (CCI). However, these guidelines had a very narrow version of VC investment, confining it to technological innovative business ventures by first generation entrepreneurs. The guidelines also confined the setting up of VCFs to either public sector banks or FIs only.In fact, the origin of venture capital financing started in India in 1988, with the formation of Technology Development and Information Company of India Ltd (now known as ICICI Venture Funds Management Company Limited), a joint venture between the ICICI Limited and Unit Trust of India.In 1990, GVFL Limited (formerly Gujarat Venture Finance Limited), was founded at the initiative of World Bank. The CCI guidelines got abolished upon the arrival of liberalization wave and so was CCI. In 1993, Indian Venture & Alternate Capital Association(IVCA), an apex body representing the interests of PE/VC industry, was set up, with a strive to take forward alternate capital industry in India.

1995-1999

Attributed to the success of Indian entrepreneurs in Silicon Valley, private venture capital funds both from abroad and India were drawn to Indian startup ecosystem.

In the year 1996, Securities and Exchange Board of India framed SEBI (Venture Capital Funds) Regulations, 1996, which saw some of domestic VCFs get themselves registered with SEBI. At present, SEBI Alternative Investment Fund Regulations, 2012 have replaced SEBI (Venture Capital Funds) Regulations of 1996. In the year 1999, 80 per cent of total VC investments in Indian Enterprises, were by foreign venture capital funds.

2000-2010

This phase, marked, by setting up of funds with an intent of extracting the maximum mileage from the startup environment, witnessed some early positive results under the impact of liberalization. Moreover, to further streamline the whole process of investment by foreign VCFs, Securities and Exchange Board of India came up with SEBI (Foreign Venture Capital investors) Regulations in the year 2000, to register them and regulate their working.

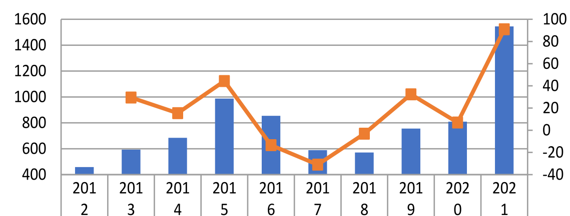
2011 Onwards

The decade of 2011-2020 witnessed VC industry become increasingly mainstream from an investment perspective. Many structural shifts including changes in type and size of deal, business domain took place. Besides, rigorous competition amongst venture capital funds, witnessed them becoming more selective and aggressive in their approach. The year 2021 saw the VC industry in India hitting the purple patch, with surge in both number of deals and funds invested.

Trends in VC Industry in India

This sub-section presents trends with respect to varied facets of venture capital financing in India. Figures 1a and 1b present the number of VC deals and the annual VC investments made in India in the last decade, respectively.

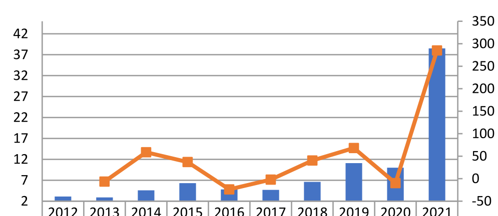
Figure 1a: Number of VC Deals in India in Last Decade



	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Number of VC Deals	458	593	684	987	854	589	571	756	809	1545
Change %		29.48	15.35	44.3	-13.5	-31	-3.06	32.4	7.01	90.98

Source: India Venture Capital Report 2022

Figure 1b: Annual VC Investments in India in last Decade



	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Annual VC investments in India ($B)	3.1	2.9	4.6	6.3	4.8	4.7	6.6	11.1	10	38.5
Change %		-6.45	58.62	36.96	-23.81	-2.08	40.43	68.18	-9.91	285

Source: India Venture Capital Report 2022

On perusal of Figures 1a and 1b, it is revealed that there was steady increase from 2012 to 2015, both in number of deals and annual VC investments, as vindicated by positive percentage change, barring one exception of annual investments made in 2013. This steady increase might be attributed to several factors like better economic conditions, new VCs competing for investment, rapidly evolving startup ecosystem, positive exit environment and changes in valuation expectations. In addition to it, GOI's initiatives such as the Startup India Programme with focus on encouraging entrepreneurship, Make in India aiming to accelerate the ease of doing business in India, tax rationalization, fast-tracked approvals contributed to this steadiness (India Private Equity Report, 2016). Post this phase, the data for 2016 and 2017 reveal that number of VC deals and the annual VC investments decreased because VCs pursued better and quality proposals and did not throw caution to the wind on account of lacking clarity on exits. However, investor's confidence renewed with Marquee exits and the advent of new sectors for investment like Financial Technology and SaaS. Despite Covid-19, momentum carried on with investments in Consumer Tech and SaaS. An amount of $ 3 Billion was raised by India-focused funds in 2020, which is 40% higher than in 2019 (Indian Venture Capital Report, 2021).Although the momentum spilled over into 2020 yet the caution was exercised because of covid-19.

The things boomeranged for Indian VC Industry in the year 2021, witnessing tremendous surge in both number of deals and the annual VC investments. In fact, the investments in 2021 grew 3.8x over the previous year of 2020. This may be attributed to a number of factors which include digital economy catalysts like UPI-led payments, ubiquity of data, aadhare-Know Your Customer (KYC); eased SEBI regulations allowing tech-first companies in India go for IPO listings and increased exit momentum, and last but not the least, tightened Chinese regulations and crackdowns redirecting the funds deployment to Indian startups(India Venture Capital Report 2022).

Table 1: Key VC Investment Themes

YEAR	INVESTMENT THEME
2017	Consumer technology, Banking, Financial Services and Insurance, Telecom and Real estate
2018	Consumer Technology
2019	Consumer Technology, Fintech, and SaaS, B2B commerce
2020	Consumer Technology, Fintech, and SaaS
2021	Consumer Technology, Fintech, and SaaS

Source: India Venture Capital Reports.

Table 1 shows the trends in investmentthemes over a time period of five years, depending upon the availability of data. It is clearly revealed that Consumer Technology has been one of the most preferred segments for making investments in all these five years. Within Consumer technology, other formats like video commerce, direct-to-consumer brand aggregator models, and short-form videos have drawn the attention of VC funding (Indian Private Equity Report, 2021)

After Consumer Technology, sectors like FinTech, SaaS, B2B Commerce have been the preferred destinations for investments by venture capitalists.

In the year 2018, Consumer Technology was a dominant investment theme again in spite of fall in value, whereas in 2017 it was accompanied by other sectors like Banking, Financial Services and Insurance, Telecom and Real estate. In 2019 Consumer Technology, Fintech, and SaaS, B2B commerce and tech received 80% of VC investments. In 2020, Consumer Technology again grabbed maximum funds, followed by SaaS at second spot. In fact, Consumer Technology, Fintech, and SaaS accounted for nearly 75% and more than 75% of all VC investments in terms of value, in the years 2020 and 2021, respectively.In 2021, a sharp rise in investments in B2B commerce and tech and Web 3.0

or crypto based start-ups was recorded over the previous year of 2020(India Venture Capital Report, 2022).

Regulatory Framework for Venture Capital Funds:

In India domestic VCFs as well as Foreign VCFs have to comply with SEBI Regulations, as amended from time to time. Presently, domestic VCFs are regulated by SEBI (AIF) Regulations, 2012 whereas foreign VCFs are regulated by SEBI (FVCI) Regulations, 2000. The salient SEBI Regulations regarding working of venture capital funds in India are examined as follows (SEBI, 2012; SEBI,2000):

SEBI (Alternative Investment Fund Regulations), 2012

1. Alternativeinvestment Fund (AIF) means fund incorporated in India in the form of trust or company or a limited liability partnership or a body corporate. It is a privately pooled investment vehicle, collecting funds from Indian or foreign investors so as to invest those funds as per pre-defined investment policy to benefit all its investors.
2. An AIF has to get a certificate of registration from SEBI for running its operations in any of the following three categories:

a. Category I AIF: It invests in startup or early stage venture/ social ventures/SMEs/ infrastructure/ any sector considered desirable by government.

b. Category II AIF: It is not covered under category I or II, and it borrows funds only for meeting out routine operational needs.

c. Category III AIF: It is known for employing complex varied trading strategies.

In India, Venture Capital is a Category I Alternative Investment Fund.

3. All AIFs shall have to furnish their investment strategy, investment purpose and methodology to the investors.
4. An AIF may raise funds via sale of units to Indian/ Foreign investors or NRIs, by way of private placement.
5. Each scheme of AIF has to have corpus of minimum Twenty Crore Rupees, and it cannot have more than one thousand investors.
6. An AIF shall not accept an investment of value less than one crore rupees from an investor, with the exception of its employees or directors.
7. Category I AIF shall be close-ended and the tenure of fund or schemes shall be at least of 3 years.
8. A close-ended AIF may get its units listed on stock exchange, with minimum tradable lot of One Crore Rupees.
9. An AIF may invest outside India but only as per RBI guidelines in this context.
10. Category I AIF can invest maximum Twenty-Five Percent of their funds in any investee company.

SEBI (Foreign Venture Capital Investor) Regulations,2000

These regulations define Foreign Venture Capital Investoras one which is incorporated and established outside India, but, is both registered and proposes to make investment as per these regulations.

1. FVCI has to apply for certificate of registration form SEBI, subject to condition of having been granted approval by RBI for making investments, amongst other conditions. It may be an investment company, investment trust, mutual fund or any other entity incorporated outside India
2. Certain conditions apply for grant of registration certificate, which include appointing domestic custodian for safe custody of securities and operating a special non-resident rupee or foreign currency account with a designated bank.

Investment Criteria prescribed for FVCIs is different from that for domestic FVCIs. At least 66.67% of investible funds shall be invested in unlisted equity shares of an investee company. On the other hand, not more than 33.33% of investible funds shall be invested, via subscribing, to initial public offering of investee company, debt or debt instruments of an investee company in whose equity shares FVCI has already invested in, and preferential allotment of equity shares of a listed company but with a lock-in period requirement of one year.

Challenges Faced by VC Industry in India

Like any other industry, VC industry, too, has its own set of challenges to deal with. The biggest challenge is mismatch between VC investors and firm owners with respect to valuation. In fact, it is one main reason for deals falling through, and also an obstruction for exits. VCs are also of this opinion that leadership issues in investee company also impact its value creation.

Another challenge is volatility in macro economic conditions. For example, inflation has an adverse impact on investments. An instance of rising inflation discourages investment in long-term business ventures. However, this may not hold true for late stage investment, as going public as an exit strategy can be thought of before inflation spirals further. Likewise, high currency risk in India impacts the performance of VC industry. However, both Limited Partners and General Partners may go for long-term investments and thus, lessen their risk (VCC, 2017).

Analysts opine that lack of tax certainty is another big challenge faced by foreign and domestic PE/VC investors in India, as in last few years, many tax notices have been issued questioning the treaty benefits, and imposing GST on carried interest income, which has brought about uncertainty amongst both domestic and foreign PE/VC funds. Moreover there is no tax parity between foreign and domestic investors with respect to long-term capital gains tax paid on sale of shares in Indian private companies (Suhail, 2022).

In recent times, VCs have been bearing the brunt for corporate governance issues in startups, which may not be an appropriate act. It is also alleged that how VCs are not kept in loop involving governance matters, which eventually snowball into national news and scandals (Sriram&Kalra, 2022).

The investment made by VCs is fraught with one big question, that is, how to exit out of investee company, with minimal losses and maximum profits, and for which favourable economic conditions and sound fundamentals of an investee company play a pivotal role. However, the year 2021, by far, has gone by as the best year in terms of number of exits and exit value generated by VCs. The total exit value reached $14 Billion, with three key exits (Bill Desk's acquisition by PayU ; initial public offerings by Paytm and Zomato) having accounted for 60% of this value(Indian Venture Capital Report, 2022).

The Road Ahead

The VC industry in India became of an age during the decade of 2011-2020, with changes registered in deal size, deal type, sector chosen for investment, immense competition amongst venture capital funds. The subdued scenario of 2020, rather due to pandemic and depressed public markets, saw the tables turning in 2021, and a surge was witnessedin number of deals, annual investments made by VCs, number of exits and total exit value generated. A growth is anticipated in future for sectors like crypto-and block chain-based technologies, healthtech and agritech (Indian Venture Capital Report, 2022). In fact, the year 2022 has seen a record number of fresh funds raised for investment by India-focused venture capital funds for investing in tech startups despite inflation. These funds have raised $14.1 Billion to be invested in first half of 2022, as per report by Silicon Valley Bank. However, lower company valuation, slowing down of unicorns creation and initial public offerings are expected(Salman, 2022). The silver lining is, India being seen as an alternative to China for investment in tech startups.

The analysts also caution on account of certain other factors like more stringent SEBI norms, looming regulatory uncertainty over sectors like fintech, online gaming, and competition in talent market will hassle the Indian ecosystem (Indian Venture Capital Report, 2022).

In nutshell, VC investment can go a long way in supporting budding entrepreneurs in a demographically dividend India, and with GOI's initiatives, it can delve even deeper and play a constructive role in economic development. The government, too, should rationally analyse the challenges facing this industry,especially the tax laws in India should be crystal clear. Attributed to the growing fascination for India as an investment destination the government, various regulatory bodies should undertake concerted efforts for creating a thriving environment for entrepreneurial investment in the country.

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