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ROLE OF INCUBATORS AND VENTURE CAPITAL IN ENTREPRENEURIAL DEVELOPMENT

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Abstract

Entrepreneur plays a vital role in the economic development. An entrepreneur is a person who innovates and takes risk for his existence. Market economy can be developed only through facilitating innovations and nurturing entrepreneurship. Innovations and entrepreneurship are inseparable. Business Incubators are useful as a vehicle to carry forward the business idea. Business Incubator is a consulting firm on one side and a non-financial collaborator with the entrepreneur to develop and launch a new product in the market on the other side. It also provides coaching in management, administration, marketing and intellectual property rights and other legal matters. Venture capitalists are the individuals, families and partnership firm and even public limited companies that should invest and should have space to participate in the management, not to control the firm but to lend a helping hand till it matures.

Role of Incubators and Venture Capital in Entrepreneurial Development

Entrepreneur plays a vital role in the economic development. An entrepreneur is a person who innovates and takes risk for his existence. Market economy can be developed only through facilitating innovations and nurturing entrepreneurship. Economic growth is dependent on the stocks of natural and human resources, capital stock and technological development. Technological development and capital formation are interdependent and they are largely dependent on the quality of entrepreneurship in the economy. Public policies can only marginally influence the availability of natural and human resources, whereas the public policies are essential to promote innovations and cultivate entrepreneurship. Schumpeter describes "Innovations as creative destruction as every innovation makes the existing capital and products obsolete". This aspect of innovation thrills the entrepreneurs to take risk in introducing innovations and it is the only way for him to stay in business. Innovations and entrepreneurship are inseparable and economic growth depends upon them.

Research and Development is essential for the entrepreneurial growth and technological development. Developed countries like the US and Germany spend nearly 3 % of their national income on Research and Development and more than 6 % on education. The corresponding figures for India are 0.75 % and less than 4 % respectively.

Financial Support System for Innovations

The process of transformation from 'Mind to Market' is classified into three stages

Mind to Market
- Birth Phase
- Survival Phase
- Growth Phase

Business incubators are useful as vehicles to carry forward the business idea. Heavy financial support is essential at the second and third stages when the idea in the minds of a scientist is validated and released as a commercial product in the market. It requires the entrepreneurial talents in a scientist or an engineer to identify the commercial aspect of a scientific idea. This technopreneur is in short supply. Though he is ready to take risk, he has no capital to invest. He may also need support to develop a full management team and to create the marketing team for successful launch of the product in the market. Therefore, the transformation from the stage of 'idea' to that of a 'successful enterprise', he needs not only financial supports but other support systems for developing the enterprise. In the Indian scenario given below, there are a multitude of agencies that finance the survival and growth phases, and the most important among them are the Venture Capital Firms. We have a large number of financial institutions like commercial banks and development institutions to finance commercial enterprises and these institutions are comfortable in financing based on tangible assets of the enterprise. Knowledge based industrial entrepreneur can not depend upon traditional institutions as it involves financing a new idea and not production of a commercially viable product or service.

Business Incubators

Business Incubator (BI) is a consulting firm on one side, and a non -financial collaborator with the entrepreneur to develop and launch a new product in the market. Business Incubators provide space for scientists or inventors to develop a new product. It also provides coaching in management, administration, marketing and intellectual property rights and other legal matters. Business Incubators help the entrepreneur to establish contacts with the network of service providers, vendors and customers. Though BI generally does not make investment in a particular product, it helps the entrepreneur to source the required finances from venture capital funds and other financiers. BI helps to establish a business firm and accelerate its growth.

BIs are generally promoted by a consortium of Government agencies, universities / research institutions and business organizations. There are a few private firms that function as BIs. Generally a BI specialises in a particular field or technology, eg IT. BIs located in universities/ research institutions sensitize the scientists about business opportunities. The European Union along with Department of Science and Technology, Government of India, set up a BI along with Regional Engineering College, Trichy and Science and Technology Park, Trichy. This organization will have tie-up with 1200 BIs in European Union and promote high-tech start-ups in India. Similarly, International Crops Research Institute for the Semi-Arid Tropics (ICRISAT), Hyderabad, has set up an Agri-Business Incubator with funding from National Science and Technology Entrepreneurial Development Board, Ministry of Science and Technology, Government of India. Society for Innovation and Entrepreneurship (SIME) is located in IIT, Mumbai, which is a BI that serves as a platform for promotion entrepreneurship among professors and students. Inbizine and Indiaco are private BIs promoting IT companies. Infodev - a consortium of development agencies, with secretariat at the World Bank, provides the networking of BIs across the globe, through conduct of conferences and symposia.

What is Venture Capital?

A venture capitalist (VC) provides funds for a start up firm or a small business unit with exceptional growth potential, which is attributable to the innovation it has made, and the VC also provides managerial and technical expertise to the firm.

Generally the VCs are governed by the following considerations:

- The firm should have a new technology or new marketing concept or new product application possibilities, which are protected by patents and staff of outstanding competence and integrity.
- The VC should have the space to participate in the management not with a view to controlling the firm but to lend a helping hand till it matures.

- The firm should also show promises to mature within a few years to the point of an initial public offering.

A VC is always a high risk-taker and naturally expects a higher rate of returns on the capital invested. VCs are the individuals, families and partnership firms and even public limited companies and the venture-backed companies are those in which venture capitalists have invested their funds. A venture capital firm usually has a team consisting of veterans in business, technology and academic research. They fund a few projects and work very closely with them till they reach the stage to go public. The VCs are patient investors because they wait to reap the benefits only after the enterprise matures to go public. In other words, they are long-term investors. The VCs participate in the management because they can provide advice and counsel designs to improve the chances of the investment's ultimate success. The VCs invest and participate in the business and share the risks of the entrepreneur. In short, the VCs finance high-risk business projects, expecting high returns and the investments do not yield till the firm matures to go public.

Stages of Investments

When an entrepreneur has an idea of a new process or product, there is a need for funds to expand on Research and Development. At this stage, the entrepreneur tries to get his funds from his family, friends or from business angels. Business angels are very rich persons who provide funds for a firm or individual who has a new idea with a potential to turn it into an innovation. But unlike the VCs, the business angels do not involve themselves in management.

Once the product is developed, it has to be launched in the market. This requires some investment in plant and machinery, raw materials, labour and other inputs. As the product or the process is new, there is no track record for its success in the market and hence the failure rate is high. This is called the start-up stage when the VCs intervene with their investment and business expertise. The test run for the product in the market is also very costly as the markets are big and competition is stiff. Once again the profitability of the business proposition is not assured. This is called the First Round or Series A. The next stage is called Expansion or Series B and C, when the firm has to expand production and marketing facilities after a successful test run. Though the success rate is higher at this stage, the firm may not have collateral to furnish for obtaining funds from the commercial banks. Subsequently, the firm enters the pre-IPO stage or mezzanine, when the firm needs additional funding to do window dressing, to clean up the balance sheet and finally to prepare for going public with Initial Public Offer (IPO). Once the IPO is successfully completed, the venture capitalist gets back his investment, mostly several times higher than the initial investment. The VCs shall enter the firm as investors at any one of the stages from startup to expansion and mezzanine, depending upon their risk taking abilities.

Process of Investment

When an entrepreneur approaches a VC for funding, initially the VC should get satisfied with the technological capability of the entrepreneur and whether his innovation is patented or to be patented, his managerial skills and the network with other professional bodies. Then the VC screens the proposal of the entrepreneur in terms of investment size, the industry and the stage of investment. Usually the VCs specialize in funding projects from a particular industry like IT or leather. Secondly, given their financial position and risk taking abilities, they decide on the quantum of investment for the proposal and the stage at which such investments are to be made. Some VCs may invest at later stages in large amounts in a few firms and some other VCs may invest in early stages in smaller amounts in a large number of firms. The VCs also apply due diligence to find out the viability of the business plan, capacity of the management team, the propriety of the technology, and accounting integrity of the firm. After this, they go through the negotiation process of finalizing the deal and complete the legal procedures for investment and for monitoring the utilization of the fund. They also sit in the board meeting for monitoring the progress of the company and to add value through effective participation in the management. Once the firm matures, then the VCs get back their investment through IPO or sale to the third party or buyback by the promoter.

It is essential that the financial objectives of an entrepreneur coincide with the investment priorities of the VCs. The entrepreneur should also look for the track record of the VCs with regard to their management of funds, industry experience and the liquidity procedures.

Venture Capital in India

The venture capital is supposed to have developed in an organized way in the post second World War period in the US. Thereafter it spread to other parts of the world. In 1973, a Committee on Development of Small and Medium Enterprises, constituted by the Union Government, recommended the need to foster venture capital as a source of funding new technopreneurs. Consequently, some public sector financial institutions set up investment funds to finance high-tech business ventures and they extended only financial help and not the managerial and other inputs that are usually expected from a VC. In 1988, the Government of India announced guidelines for setting up venture capital funds and accordingly only banks and financial institutions were allowed to set up venture capital funds. In 1995, a fresh set of guidelines was issued by the government allowing participation of foreign entities in venture capital. The Central Board of Direct Taxes announced tax exemptions for venture funding. In 1996, SEBI framed regulations for venture capital funds. Thereafter venture capital funding was brisk till 2000, mainly due to India's success in solving Y2K related issues and boom in IT sector. The slump in the IT and related sectors in 2001 – 03 affected the venture capital market adversely. The boom in the Indian Economy since 2002 and diversification of venture capital in new areas like biotechnology, medical and health care, media and entertainment, aided the venture capital market to expand.

On an average, the VCs in India are risk averse and hence invest mostly in expansion and mezzanine stages. The government backed venture funds make their investments in smaller amounts in a large number of new ventures at early stages and are fairly spread across different sectors. The private venture funds park their investments in a few sectors at the expansion or mezzanine stages and their investments are in larger amounts in a few ventures. This distortion in venture funding should be corrected. Unless venture funds spread their investments in a large array of categories, both innovation and entrepreneurship can never be developed. Of late, we have been witnessing the encouraging trend of proportion of venture funding in IT and ITES declining and other sectors like financial services, manufacturing, medical and health care attracting more venture funds. Of late, some venture capital firms work with the objective of helping entrepreneurs in rural and semi-urban areas, the notable among them is Aavishkaar, which has some success stories to its credit.

Mitra(2000) observes, 'The private and government VCFs differ regarding the scale of their investments. Private funds tend to have fewer but larger investments in later-stage ventures, which require less monitoring. (A typical investment could be for Rupees 100 million . In contrast, government funds invest smaller amounts over a larger number of start-up and later-stage ventures (a typical investment is between Rs.20 and Rs.30 million)

Conclusion

The surest way to develop a market economy is to promote innovations and entrepreneurship. The Government should increase expenditure on education and both public and private sectors should collectively increase expenditure on R & D. As expenditure in R & D will only create an idea, BIs and VCs have the crucial role of taking the idea to the market as products and services. Technological development in all areas along with the BIs, VC is sure to hasten the economic growth process.

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Table-I

Total Number and Value of Private Equity and Venture Capital Investments

Year	Number of Deals	Value of Deals (in US$ million)
2000	280	1160
2001	110	937
2002	78	591
2003	56	470
2004	71	1650
2005	146	2200
2006	311	6300