

of the success demonstrated by India in assisting with Y2K related issues as well as the overall boom in the Information Technology (IT), Telecom and the Internet sectors, which allowed global business interactions to become much easier. In fact, the total value of such deals done in India in 2000 was \$1.16 billion and the average deal size was approximately US \$4.14 million. See Figure 1.

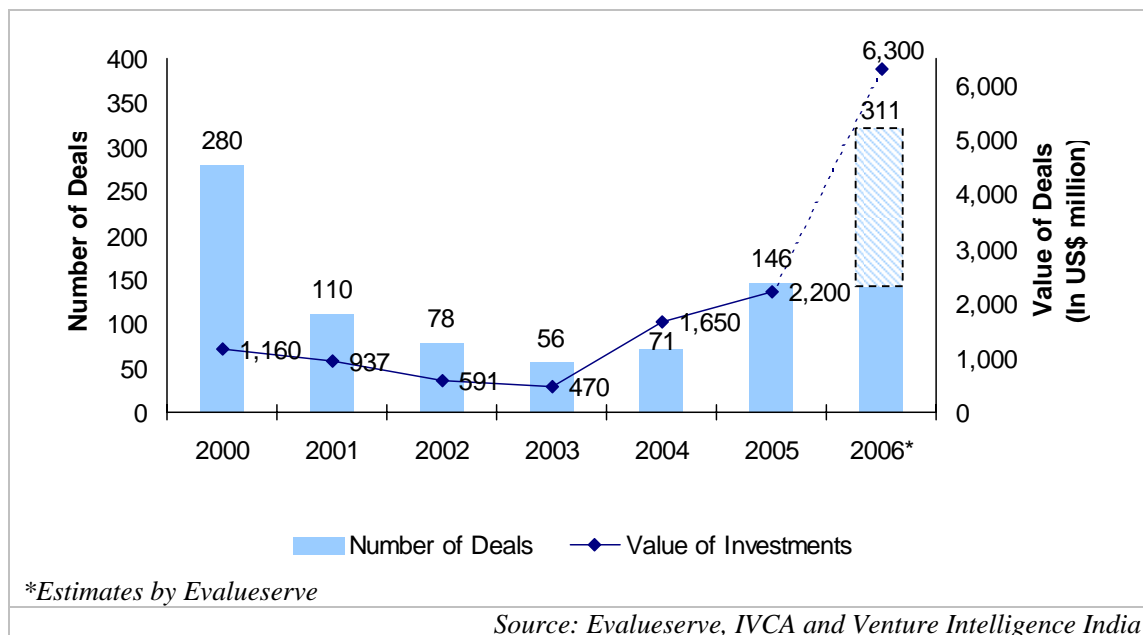
2001-2003 - VC/PE becomes risk averse and activity declines: Not surprisingly, the investing in India came “crashing down” when NASDAQ lost 60% of its value during the second quarter of 2000 and other public markets (including those in India) also declined substantially. Consequently, during 2001-2003, the VCs and PEs started investing less money and in more mature companies in an effort to minimize the risks. For example:

- (a) The average deal size more than doubled from \$4.14 million in 2000 to \$8.52 million in 2001
- (b) The number of early-stage deals fell sharply from 142 in 2000 to 36 in 2001
- (c) Late-stage deals and Private Investments in Public Equity (PIPEs) declined from 138 in 2000 to 74 in 2001, and
- (d) Investments in Internet-related companies fell from \$576 million in 2000 to \$49 million in 2001.

This decline broadly continued until 2003.

2004 onwards - Renewed investor interest and activity: Since India’s economy has been growing at 7%-8% a year, and since some sectors, including the services sector and the high-end manufacturing sector, have been growing at 12%-14% a year, investors renewed their interest and started investing again in 2004. As Figure 1 shows, the number of deals and the total dollars invested in India has been increasing substantially. For example, US \$1.65 billion in investments were made in 2004 surpassing the \$1.16 billion in 2000 by almost 42%. These investments reached US \$2.2 billion in 2005, and during the first half of 2006, VCs and PE firms have already invested \$3.48 billion (excluding debt financing). We forecast that the total investment in 2006 is likely to be \$6.3 billion, a number that is more than five times the amount invested in 2000.

Figure 1: Total Number and Value of PE and VC Investments



PE investment expands beyond IT and ITES: A very important feature of the resurgence in the PE activity in India since 2004 has been that the PEs are no longer focussing only on the IT and the ITES (IT Enabled Services, commonly known as “Business Process Outsourcing” or BPO) sectors. This is

partly because the growth in the Indian economy is no longer limited to the IT sector but is now spreading more evenly to sectors such as bio-technology and pharmaceuticals; healthcare and medical tourism; auto-components; travel and tourism; retail; textiles; real estate and infrastructure; entertainment and media; and gems and jewellery. Figure 2 shows the division across various sectors with respect to the number of deals in India in 2000, 2003 and the first half of 2006.

Figure 2: Percentage of the number of deals by PEs in various sectors

Sectors	2000	2003	2006 (Q1&Q2)
IT & ITES	65.5	49.1	23.18
Financial Services	3.13	12.3	9.7
Manufacturing	3.0	1.8	19.3
Medical & Healthcare	2.0	7.0	8.3
Others	25.2	29.8	37.9
Total	100.0	100.0	100.0

Source: Evalueserve, IVCA and Venture Intelligence India

2. Early Stage VC Investments during 2000-2006:

Since the Purchase Power Parity (PPP) in India is approximately a factor of 5 (as in, a factor of 5 is used to normalize the GDPs of US & India on a PPP basis), our analysis shows that early stage VC investments in India should include those that are \$8 million or less. In fact, we can classify early-stage investments further into Seed, Series A and Series B investments depending upon their value. Figure 3 below highlights an approximate comparison of the typical range of Seed, Series A, and Series B funding in India versus that in the US (actual dollar amounts; not adjusted in terms of PPP).

Figure 3: Investment Range of Early-stage VC Deals in India and the US (in US \$)

Year	India	US
Seed	Up to \$900,000	Up to \$2.5 million
Series A	\$1 million to \$3 million	\$3 million to \$10 million
Series B	\$3.5 million to \$9 million	\$11 million to \$30 million

Source: Evalueserve

Figure 4 given below provides a break-up of the total value of investments into early-stage investments (primarily by VCs) and late-stage investments and PIPEs (primarily by PEs). Even within early-stage investments, seed investments declined the most during 2000-2003 and have essentially remained negligible during 2004-2006.

Figure 4: Value of Deals (in \$ millions) Based on the Type of the Investment

Year	2000	2001	2002	2003	2004	2005	2006 (Q1&Q2)
Early and Mid Stage VC	342	78	81	48	150	103	86
Late Stage and PIPEs	819	859	510	422	1,500	2,097	3,394

Source: Evalueserve, IVCA and Venture Intelligence India

Figure 5 shows the break-up of early-stage investments by Seed and Series A and B investments. In a nuance, perhaps unique to India, after interviewing several entrepreneurs and experts in India, we believe that since the Indian upper middle class has become quite affluent during the last 7-10 years, the entrepreneurs are relying more and more on family and friends for seed funding, and since emerging entrepreneurs come from this upper middle class, the need for seed funding from VCs could remain low for many years to come!

Figure 5: Number of Early-stage VC Deals

Year	2000	2001	2002	2003	2004	2005
Seed	74	14	7	5	6	5
Series A and B	68	22	9	8	23	14

Source: Evalueserve, IVCA and Venture Intelligence India

The remaining portion of this article is limited to early-stage VC investments only, i.e., investments in a start-up or a small company when the total amount of external money invested is up to \$9 million during its entire period of existence.

3. VCs that are likely to invest in Early Stage Companies in India

Barring occasional forays by VC firms into India in the early to mid-1990s, the first major rush of VCs to India in recent times was witnessed during the dotcom boom in 1999-2000. However, several ended up closing shop during 2001-2003 because of the bust that followed. The period 2004-2006 has seen a resurgence of VC activity. The various VC players operating in India can be broadly classified as follows:

3.1. Government Funds: Some Indian state government funds are actively investing in India. These include SIDBI Venture Capital Limited, Gujarat Venture Fund Limited, RVCF, APIDC, Canbank Venture Capital Fund Limited, IFCI Venture Capital Funds Limited, Rajasthan Asset Management Co. Private Ltd., KITVEN and Kerala Venture Capital Fund Private Limited. Investments from these institutions have the advantage of lower ‘cost’ of capital and hence can be more attractive to entrepreneurs; however, the maximum amount of capital available is typically \$500,000.

3.2. Non US-based Funds: These international funds largely invest in early stage and mid stage companies and include Barings, 2iCapital Private Limited, Aavishkaar India, 3i, (private equity firm headquartered in Europe), Chryscapital Management Companies, HSBC Private Equity Management (Mauritius) Limited, IL&FS Investments Managers Limited, Information Technology Venture Enterprises Limited, Indian Direct Equity Advisors Private Limited, Kotak Mahindra Finance Ltd, Merlion India Fund (Standard Chartered Private Equity), Punjab Venture Capital Limited and SICOM Capital Management Limited.

3.3. Large Company Funds: For the last 3 to 5 years, many large companies have also been making early stage and mid-stage VC investments. Such companies are mostly investing in their own industries and leveraging their expertise with a longer-term view of potential acquisitions. Large company funds operating in India include those set up by high-tech firms such as Intel, BlueRun Ventures (owned by Nokia), Motorola, SAP Ventures, Siemens, Acer Technology Ventures, and Cisco. In addition, several financial companies and a few Indian conglomerates including the following have small VC funds: Kotak, IDFC, Reliance Capital, JM Financial, Religare (owned by Ranbaxy), State Bank of India, Banc of America Equity Partners Asia, Unitech (a very large real-estate developer and manager in India) and Piramal (a well known pharmaceutical company).

3.4. VC Entrants from the US: Evaluateserve’s research indicates that several US-based VC funds have also been investing in the Indian market for the last six years. So far, these funds have been investing in early and mid-stage technology companies dealing primarily with consumer Internet, mobile devices, wireless and wire-line, IT services, BPO services, software and hardware products, electronics and semiconductors. Most of these VC firms are listed in Figure 6.

Figure 6: US-based VC funds investing in India

	Venture Capital Firm	Key Principals	US-India Cross Border & India-based Companies in their Portfolios
1	Westbridge (now a part of Sequoia Capital India)	Sumir Chadha KP Balaraj Surendra K Jain Sandeep Singhal	AppLabs, Astra, Brainvisa, Celetron, ICICI OneSource, Indecomm, Induslogic, MarketRx, ReaMatrix Tarang, Zavata, Dr. Lal PathLabs Royal Orchid Hotels, Bharti TeleSoft Mauj, Nazara, Shaadi, Times Internet

			Travelguru, Emagia, July Systems, Strand Life Sciences, Zenasis
2	Oak Investment Partners	Ranjan Chak	Talisma, Sutherland
3	Matrix Partners	Shirish Sathaye Avnish Bajaj Rishi Navani	Not Available
4	Sherpalo Ventures (now, a part of Kleiner Perkins, Caufield and Byers, KPCB)	Ram Sriram Sandeep Murthy	Cleartrip, Paymate, Naukri.com, 247 Customer
5	The View Group	Mintoo Bhandari Gopal Jain Mehool Parekh Manish Sabharwal	Integreon, Ingenero, TWS, Tracmail, Peerless India
6	Bessemer Venture Partners	Rob Chandra	Shriram EPC, Sarovar Hotels & Resorts Rico Auto Industries, Motilal Oswal Financial Services Ltd
8	Trident Capital	Venetia Kontogouris	Cognizant, Microland, Outsourced Partners International
9	Walden International	In process of hiring more Principals after Dinesh Vaswani left	Headstrong, e4e, InfoTech, Mindtree Venture InfoTek
10	New Enterprise Associates (NEA)	Vinod Dham Vani Kola	IndusLogic, Sasken
11	Canaan Partners	Alok Mittal	e4e
12	Softbank Asia International	Ravi Adusumalli	SIFY, Slashsupport, Intelligroup
13	International Finance Corporation	Paul Asel	Indecomm Global Services
14	Artiman Ventures	Amit Shah Yatin Mundkur M.J. Aravind Saurabh Srivastava	BioImagine, Net Devices, Opsource
15	Columbia Capital	Hemant Kanakia Arun Gupta	Net Devices, Approva
16	Gabriel Venture Partners	Navin Chaddha	Allsec, IL&FS Investsmart, MakeMyTrip, Persistent Systems, Tejas
17	Norwest Venture Partners	Pramod Haque Vab Goel	Persistent Systems, Yatra
18	Austin Ventures	Venu Shamapant Krishna Srinivasan	Siperia
19	Sigma Partners	Mark Pine	Emagia Solutions, Kirusa, Zenasis Technologies, Virtusa
20	Charles River Ventures	Izhar Armony	July Systems, Virtusa, Net Customer
21	Financial Technology Ventures	Eric Byunn	Exlservice
22	Telesoft Partners	Arjun Gupta Santhil Durairal	Bombay Cellular
23	Draper, Fisher, Jurvetson	Raj Atluru	Personiva (f.k.a, Pictureal) Seventymm

Source: Evalueserve

3.5. New Groups Raising Money for Investing in India: In addition to the US-based VC groups that have already invested in cross-border start-ups and in “pure” India-based companies, and excluding US-based PE firms (e.g., Francisco Partners, General Atlantic Partners, Warburg Pincus, Kohlberg

Kravis Roberts & Co.) that are likely to make late-stage investments or PIPEs, our research shows that more than 21 other groups are raising – or have raised - money to establish funds in India. These groups are primarily US-based VCs, usually with Non-Resident Indians who are based in the US, who have by and large not made any investments in India. Of these 21 groups, some have requested anonymity and confidentiality because they are still in the process of raising money but others are mentioned below:

- (1) Helion VCs (with its Principals Ashish Gupta, Rahul Chandra and Kanwaljit Singh, who very recently, made their first investment in JiGrahak Mobility Solutions)
- (2) Nexus India (with its Principals Naren Gupta, Suvir Sujan and Sandeep Singhal)
- (3) Quattro BPO Solutions (with its Principal Raman Roy, who very recently, made his first investment in Annik Technology Solutions)
- (4) Inventus Capital Partners (with its Principals Kanwal Rekhi and John Dougery)
- (5) Inc3 (with its Principal Dimant Bhayani)
- (6) IDG Ventures India (with its Principal Manik Arora)
- (7) Silicon Valley Bank (with its Principals Ash Lilani and Suresh Shanmugham)
- (8) Draper Fisher Jurvetson (with its Principal Mohan Lakhamraju)
- (9) Venrock Associates (with its Principal Dev Khare)
- (10) Lightspeed Venture Partners (with its Principal Ajit Deora)
- (11) Diamondhead Ventures (with its Principal Raman Khanna)
- (12) Sierra Ventures (with its Principal Vispi Daver)
- (13) Globespan Capital (with its Principal Venky Ganesan)
- (14) Storm Ventures (with its Principal Sanjay Subhedar)
- (15) Shasta Ventures (with its Principal Ravi Mohan)
- (16) Outlook Ventures (with its Principals Carl Nichols and Sandeep Aneja).

3.6. Future of Early Stage Investments in India: In summary, our research shows that there are more than 44 VC groups that have either already raised -- or are in the process of raising -- between \$40 and \$400 million for early-stage investments in Indian companies. If all these groups were successful in raising money, then jointly they would raise \$4.4 billion (i.e., an average size of \$100 million per fund) that would need to be invested during the next 4-5 years. Considering the Purchase Power Parity (PPP) in India is approximately 5, this is equivalent to investing around \$22 billion in the US, which is really large no matter the geography! Since about \$1.75 billion (or approximately 40% of \$4.4 billion) has already been raised, if we assume just half of this money (i.e., \$2.2 billion) is eventually raised, it would clearly result in a glut of VC money for early-stage and mid-stage investments in India, especially true if the VCs continue to invest only in currently favourite sectors such as IT, BPO, software and hardware products, telecom, and consumer Internet.

Given that a typical start-up in India would require \$9 million during the first three years (i.e., \$3 million per year), and assuming that the start-up in fact survives for three years, investing \$2.2 billion during 2007-2010 would imply investing in 150 to 180 start-ups every year during this period, which would simply not be possible if the VCs continue to focus on their current favourite sectors. This, of course, would be a marked contrast to the current situation in India (wherein such funding is rather scarce) and it will also make the market for the 'right deals' extremely competitive for these VCs.

Keeping this in view, in the next section, we analyze some of the on-the-ground realities and best practices for VCs to invest effectively in India.

4. On-the-Ground Realities and Some “Best Practices” for Investing in India

In many respects, the sophistication and maturity of VC investments in India today are probably at the same level as in the early 1970s in the US. This section advocates some “best practices” and highlights some of the key differences between investing in early-stage and mid-stage companies in the US versus investing in similar companies in India.

4.1. Maniacal focus on early profitability might be counter-productive for a product company:

Unlike most start-ups in the US, which are usually product-based and are usually expecting 2-3 stages of investment, entrepreneurs in India are usually focussed on making their companies profitable as soon as possible. This mindset might be because Indian entrepreneurs have, to some extent, traditionally founded services and trading companies. From an Indian entrepreneur’s perspective, the reasons for making their company profitable quickly include: (a) the scarcity of available venture capital in India so far, (b) reluctance in giving up too much equity, and (c) since most Indian start-ups have been in the service sector so far, they require a significantly smaller amount of venture capital. Of course, the disadvantages of such a maniacal focus on profitability include (a) the possibility that an Indian start-up may not be able to grow very quickly or realize its full potential and (b) the possibility of an Indian start-up being upstaged by some other firm somewhere else in the world. Hence, the VCs must play a crucial role in educating Indian entrepreneurs to think differently in the context of product-based companies compared to how they have traditionally run their companies.

4.2. Need for continued funding but in small amounts:

Since the Purchase Power Parity in India is 5, and since many – if not most – Indian start-ups still continue to be created in the services business, and since the entrepreneurs for even those product-based start-ups wish to achieve profitability quickly, we believe the VCs should not look at funding Indian companies in distinct stages (i.e., seed funding, Stage A funding, Stage B funding, mezzanine funding etc). Rather they should provide small portions of “continuous” funding based on continued attainment of predefined metrics such as revenues, profits, development expenses, etc. Of course, this would imply that the VC has to be more involved operationally with the Indian start-up and simply attending a board meeting every two or three months might not be sufficient. It would also imply that the VC would essentially act as a “bank” that provides money in exchange for equity, as and when needed.

4.3. Indian entrepreneurs lack marketing, sales and business development expertise:

During our interviews and research, we found Indian entrepreneurs to be quite adept technically and definitely at par with similar entrepreneurs in developed countries. However, we also found the entrepreneurs in India generally lacked expertise in marketing, sales and business development areas, especially when compared to their counterparts in the US. Furthermore, since India had socialistic economic policies during 1947-1992, there is a lack of good talent in marketing and sales professionals who can thrive in an extremely competitive environment. Hence, finding the appropriate marketing, sales and business development people is one area where Indian start-ups need help. This problem is further exacerbated because the Indian economy has been growing at 8% and most start-ups have to compete for talent not only with other companies who are exporting similar or dissimilar products and services but also with many Indian domestic companies. In fact, finding and retaining the ‘right talent’ has become an issue not only in marketing, sales and business development but also in research, technical and advanced development areas. Finally, if the eventual market were a developed country, then such expertise can be potentially found in that country. However, if the market for the corresponding product or service is India, China or some other developing nation, then finding such people can be a Herculean task!

4.4. Indian entrepreneurs are hesitant to give up control:

Indian entrepreneurs are usually hesitant about giving up control. In fact, most of the entrepreneurs in India currently receive their initial funding from family and friends, and even if they do not do so, the Indian social system is such that relatives and friends still end up being a major influence. Also, since the Bombay Stock Exchange (BSE) has been growing quite rapidly (in spite of the recent 20% drop) and a company with \$20

million in annual revenue can be easily listed on it, many Indian entrepreneurs would rather list their companies on BSE than give up a substantial share to the VCs. Consequently, the VCs will have to provide a very clear value proposition to the start-ups and cannot simply state that they bring value to the table just because they are well connected, etc. In fact, we believe that in some cases the VCs may even have to go to the extreme of closing contracts and bringing in the revenue on behalf of a start-up rather than simply “opening doors” by providing the contacts in their “Rolodex.”

4.5. Lack of financial transparency and other processes: Again, partly because the Indian economy was a “socialistic and closed” economy and partly because Indian entrepreneurs are not as proficient at business development as their counterparts in the US, Indian start-ups lack financial transparency and often have limited experience in implementing effective financial processes. This usually makes the task of the VC much more difficult not only during the due-diligence phase, but also in helping the start-up grow rapidly. Consequently, we believe that immediately after making its investment, the VC may have to “roll up the sleeves” and help the entrepreneurs in “process-izing” the company. We also believe that simply directing the Indian entrepreneurs to implement processes during monthly or quarterly board meetings may prove to be futile because many entrepreneurs might not know how to execute on these instructions.

4.6. Investment thesis and the current model is un-sustainable: One of the most worrisome aspects of the VCs’ new-found zeal to invest in India is that most VCs want to continue to invest in Indian start-ups in areas they are most familiar with, i.e., in IT, telecom and Internet products and services. So, it is not surprising that eight consumer-travel Internet websites have already been funded in India, and given that this sector only accounted for approximately \$152 million worth of booking transactions in 2005, and given that this number is likely to grow to only to \$1.2 billion by 2010, the actual revenue and profits earned by this sector even in 2010 are likely to be \$75 million and \$9 million respectively, which is miniscule by any standards! Similarly, if we study the cross-border and “pure” India-based companies listed in Section 2.4, more than 90% are in the IT, ITES and BPO, Telecom, and Consumer Internet.

So, going forward, the VCs may want to investigate the following rapidly emerging sectors for potential investment: auto-components, travel and tourism, domestic healthcare and medical tourism, retail, textiles, biotechnology, pharmaceuticals, real estate and infrastructure, entertainment and media, gems and jewellery, and of course, the traditional sectors that include telecom, IT, and Business Process Outsourcing services. An overview of these sectors has been provided in a separate research paper from Evalueserve.

Finally, it is interesting to note that in this regard, several VC firms (e.g., ChrysCapital, Westbridge – now a part of Sequoia Capital, India) are beginning to follow a well-rounded and diversified strategy, but so far most of it is limited to late stage investments and PIPEs. For example, during the last 2-3 years, Bessemer has invested in the following companies:

- (a) Shriram EPC, a specialized engineering services company addressing the Indian infrastructure sector
- (b) Sarovar Hotels & Resorts, a company that manages a diverse portfolio that includes hotels, resorts, restaurants, and corporate hospitality
- (c) Rico Auto Industries, which designs and manufactures auto components for such firms such as Ford, GM, and Cummins, and
- (d) Motilal Oswal Financial Services Ltd, a financial services and brokerage company serving the needs of both institutional and retail investors in India.

4.7. Lack of VCs who have cross-border experience: The other really worrisome aspect is that many US-based VCs believe they can help the growth of Indian start-ups, and provide good returns to their own shareholders by:

- Making decisions by periodically visiting India: This usually requires conducting frequent conference calls and either the VCs flying to India or the executive management of the start-up flying to the US every two or three months (for a face-to-face meeting). Since the Indian start-ups require a lot of handholding in the areas mentioned above, this approach is unlikely to be very effective.
- Sending one of the senior partners in the VC firm to India to set up a subsidiary that can help its portfolio companies: Although this approach may work, it is likely to fail in instances where the partner has not lived and managed any organization in India for at least two to three years. This is because even Indians living in the US are usually not familiar with the typical business practices in India unless they have had 2-3 years of recent experience on the ground in India.
- Hiring a junior partner in India: This approach has three major disadvantages: First, the challenges required by Indian start-ups vary from hiring good talent inside and outside the country to setting up effective and efficient processes. Second, if the partner is fairly junior then this person may not have sufficient experience to advise this start-up effectively, and third, such a junior partner would have a ‘low standing’ within the VC firm and hence, both the junior partner and its portfolio companies in India would feel they are being dictated to by senior partners in the US (who may not understand the environment in India adequately).

4.8. Well-known US VCs may not have the same brand recognition in India yet: Since venture capital investing in India is a relatively recent phenomenon, VCs who may be well known in the US may not yet be able to take their brand recognition in India for granted. In fact, we believe that successful Indian entrepreneurs and VCs who have lived in the US and have at least ten years of experience in running their own companies, or have been *actively* involved in helping others and can get down in the “trenches” with the Indian entrepreneurs are more likely to succeed and build a brand-name for themselves and their groups. Of course, on the other hand, since most – if not all – of these groups are raising the money in the US, brand name VCs in the US will definitely be able to raise this money much more efficiently and effectively than those groups that are not known in the US. Again, the implication for the VC firm is that it will have to articulate a very clear value proposition.

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