Venture Capital, Islamic Finance and SMEs

Valuation, Structuring and Monitoring Practices in India

Mansoor Durrani
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Success comes only from Allah, the Mighty, the Wise
(Qur'an, 3: 126)

To those who strive to establish a just and fair economic order.

Mansoor Durrani

To Clare, Chris and Alex for their patience and understanding.

Grahame Boocock

Preface

This book grew out of the PhD studies of Mansoor Durrani, the first doctoral research ever undertaken on the subject of VC in India. Whilst working on his thesis, Mansoor met Grahame Boocock, an academic with longstanding research interests in the areas of risk capital and the financing of small and medium-sized enterprises (SMEs). Grahame had previously spent a year at University Utara Malaysia. This book represents the fruits of their collaboration at Loughborough University, a highly rated University in the East Midlands of England.

Mansoor Durrani would like to acknowledge the assistance provided by the following individuals. Thanks are due to my PhD supervisor Professor John Presley for his invaluable comments and continued guidance throughout my doctoral studies. For Professor Khurshid Ahmad (Chairman, Markfield Institute of Higher Education, UK), I just do not have words to express my gratitude. May Allah reward him for his support, encouragement and guidance. I am also grateful for the contributions of Drs. Umer Chapra and Tariqullah Khan, both of Islamic Development Bank (Jeddah), in shaping Chapter 9.

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A final debt of thanks should be expressed to members of the Indian venture capital industry who gave generously of their time, despite operating under the pressures of modern business!

Currency Exchange Rates

As at 31/12	US$/Indian Rupee	As at 31/12	UK£/Indian Rupee
1994	31.37	1994	48.27
1995	31.58	1995	48.62
1996	35.60	1996	55.12
1997	35.75	1997	57.49
1998	43.16	1998	69.82
1999	43.42	1999	69.46
2000	45.90	2000	68.79
2001	47.12	2001	68.04
2002	48.55	2002	74.64
2003	45.87	2003	73.11
2004	46.31	2004	84.67

Source: Datastream

Glossary

ACOST	Advisory Council on Science and Technology
ADB	Asian Development Bank
AMT	Advanced Manufacturing Technology
ARD	American Research and Development
AVCJ	Asian Venture Capital Journal
BPO	Business Process Outsourcing
BVCA	British Venture Capital Association
CAGR	Cumulative annual growth rate
CBDT	Central Board of Direct Taxes
CCPPO	Cumulative convertible participating preferred ordinary share
CEO	Chief Executive Officer
CVC	Corporate venture capital
DCF	Discounted cash flow
DFI	Development finance institution
DTI	Department for Trade and Industry
EBIT	Earnings before interest and taxes
EBITDA	Earnings before interest, taxes and/or before depreciation and amortization
EQ	Emotional Quotient
ESOP	Employee Stock Options Programme
EVCA	European Venture Capital Association
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GEM	Growth Equity Market
HBS	Harvard Business School
HR	Human resources
HRM	Human resources management
ICICI	Industrial Credit and Investment Corporation of India
IDBI	Industrial Development Bank of India
IFCI	Industrial Finance Corporation of India
IP	Intellectual property
IPO	Initial Public Offering
IQ	Intelligence Quotient
IRR	Internal rate of return
IT	Information Technology

ITMT	IT, media and telecommunications
IVCA	Indian Venture Capital Association
KLSE	Kuala Lumpur Stock Exchange
LGS	(Small Firms') Loan Guarantee Scheme
LP	Limited partnership
MBA	Master of Business Administration
MIT	Massachusetts Institute of Technology
MoI	Multiple of investment
NBFC	Non-banking finance company
NEA	New Enterprise Associates
NPL	Non-performing loan
NPV	Net present value
NRI	Non-Resident Indian
NSE	National Stock Exchange (of India)
OECD	Organization for Economic Co-operation and Development
OTCEI	Over The Counter Exchange of India
P&L	Profit and loss
PBUH	Peace be Upon Him
PLS	profit and loss sharing
R&D	Research and development
RBI	Reserve Bank of India
SBA	Small Business Administration
SBRC	Small Business Research Centre (Cambridge University)
SEBI	Securities and Exchange Board of India
SIDBI	Small Industries Development Bank of India
SMEs	Small and medium-sized enterprises
SOE	State-owned enterprise
SPSS	Statistical Package for Social Sciences
SQ	Spiritual Quotient
SSIs	Small scale industries
STPI	Software Technology Parks of India
SVC	Social venture capital
TDICI	Technology Development and Information Company of India
TPIC	Technology Policy Implementation Committee
TQM	Total quality management
TTMM	Two-Tier *Mudarabah* Model
USM	Unlisted Securities Market
UTI	Unit Trust of India
VC	Venture capital
WIIG	Walden International Investment Group

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1
Introduction

The book covers two broad areas, the small and medium-sized enterprises (SMEs) sector and the operation of the venture capital (VC) industry, and a third strand examines the potential role of Islamic VC. These topics are considered in the context of India, a nation of many contrasts and enormous economic potential. The book is underpinned by a major study of the VC sector in India. The survey was conducted in the early part of the new Millennium, and the data were supplemented by ongoing dialogue with the VC community in that country. The authors also draw upon a comprehensive literature review, as well as secondary data and information from specialist research institutions and the financial media. The material should be of interest to finance practitioners, policy makers, entrepreneurs and academics.

The structure of the book is now set out briefly. Chapters 2 and 3 describe the contribution and operations of SMEs. The SME sector provides many economic and social benefits, and its contribution is ever more important in an era of rapid technological change. However, it is a misconception to see smaller firms as scaled down versions of their larger counterparts. The sector is characterized by heterogeneity. SMEs face constraints that stem from their size in relation to other market participants. Within the population of small firms, it is acknowledged that only a minority will be 'star performers'. Firms in this category have usually managed to secure external capital hence the characteristics of the financial markets available to small firms are examined. This encompasses the banking sector, as well as a more general assessment of 'equity gaps' affecting SMEs across the world.

The growth and development of many smaller enterprises is constrained by a lack or resources hence it is no surprise that governments choose to assist SMEs. However, the diversity of growth patterns for SMEs, and the variety of barriers faced by such firms, present problems in providing customized assistance for smaller enterprises within a coherent framework of support.

Chapter 4 introduces the concept of VC and traces its history. In modern times, VC was associated first with equity investments in the high-technology sphere. Nowadays, the VC industry covers a host of institutions, and venture capitalists differ in their approach to deal size and sector focus. The formal VC sector (the most high profile within the industry) has switched focus from start-up deals to larger, later-stage investments. A vibrant VC industry supports firms that contribute significantly to wealth creation; venture capitalists provide 'capital and consultancy'. There has been a massive expansion of VC activity from its US base, and the book outlines how governments across the globe have taken steps to encourage the growth of an indigenous VC industry.

Chapter 5 describes the VC investment process as a series of distinct stages then explores the theoretical foundations of VC financing. The key theme is agency theory, with most VC models examining the relationship between VC firm and entrepreneur(s) from the principal-agent perspective. The principal focus for past research studies has been the appraisal criteria adopted by venture capitalists. We concentrate on the valuation, structuring and monitoring of VC deals. These methods of risk mitigation are under-researched areas, and this book fills a gap in existing knowledge, especially for emerging economies.

Chapter 6 presents an overview of Indian economy to set the research programme in context. This fascinating nation has a population of around one billion people, and a land mass of around 3.3m kilometres (over 13 times the size of the UK). The largest cities are Mumbai (formerly Bombay), with 12.6m inhabitants, Kolkata (Calcutta), 11m, New Delhi, 8.4m, and Chennai (Madras), 5.4m. The urban population has expanded steadily since 1960 but over half of the population still lives in villages with fewer than 5,000 people in them, and they depend upon agriculture for a living. The contrasts between rich and poor, urban and rural, modern and traditional, agriculture and IT, and so on have to be borne in mind when considering the economic and financial systems of the nation.

The banking system in India has been subject to a modest programme of reform but Government ownership and control of the largest banking organizations have exacerbated longstanding market imperfections. The nation's capital markets have achieved global standards in trading infrastructure yet offer few opportunities for SMEs to raise capital. The Indian Government has long valued the contribution of SMEs, and Indians have never lacked the spirit of entrepreneurship. The presence of funding gaps has led the authorities to offer preferential financing for SMEs, and firms are directed to appropriate funding bodies through a large network of business support agencies. However, this official support system is not noted for its effectiveness and there is also a striking anomaly at the heart of the Government's assistance for small firms.

The VC industry has operated since the mid-1980s. Its development and current activity is described. The authors suggest that the VC sector in India will, over time, play an even more prominent role in the financial spectrum, especially if the nation secures its status as a global economic powerhouse. Nevertheless, the authors also highlight areas to be addressed before the VC market can fulfil its maximum potential.

Chapter 7 applies the issues identified in the VC literature to the Indian context to formulate a series of research questions in three under-researched areas. The authors investigate a number of propositions, eight in all, covering the valuation, structuring and monitoring of deals. The conclusions are based on the most comprehensive study ever carried out on the VC industry in India. The main research instrument is a questionnaire-based empirical survey.

In Chapter 8, the research findings are presented. The effort and resources required to gather this data should not be underestimated. Barry (1994) states that: 'Empirical research in venture capital is not easy. There are few tapes to spin. Because of that difficulty, comparatively little has been done, and the opportunity to develop results that are novel and important is great'. These comments are especially apposite in a developing nation like India. The high response rate enabled the authors to conduct basic statistical analysis on the data gathered and then to divide the sample on the basis of demographic factors; this approach allowed the authors to utilize more advanced statistical techniques (including cluster analysis and logistical regression) to present a more detailed picture of the operations of different elements of the VC sector.

In Chapter 9, Durrani discusses how business relationships built on a framework of trust and fairness could reduce agency problems and hence the need for corporate governance. This analysis is set in the context of the principles of the Islamic faith. Durrani demonstrates the striking similarities between contemporary venture