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A study of Financing Sources for Start-up Companies in India

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Abstract

This paper presents the burgeoning growth of start-up companies, and their potential sources of financing with special emphasis on financing ventures in India. The various stages of development for start-ups, as well as their financing sources at each stage have been explored. The goal of the research was to investigate whether India has made sufficient arrangements to fund the entrepreneurial ideas that have potentials of success and growth in times to come. This paper intends to provide an insight into the prolific funding being made available to Startup Companies in India, thereby backing any research in this regard. Also, at the international level, there is more and more research associated with the importance and ways of financing new businesses and businesses that are in their early phases of development, especially in the period of intense globalization. Therefore, the progress made by India so far and the incentives and regulations framed by the Government of India have been discussed hereunder.

INTRODUCTION

Start-up companies are newly founded companies or entrepreneurial ventures that are in the initial phase of development. They are most commonly associated with high-tech projects, development and production, distribution of new products, processes or services. The Ministry of Commerce and Industry released a notification on April 1, 2015 to define a startup. According to it, “an entity will be identified as a startup.

1. Till up to five years from the date of incorporation.
2. If its turnover does not exceed 25 crores in the last five financial years.

3. It is working towards innovation, development, deployment, and commercialization of new products, processes, or services driven by technology or intellectual property."

HISTORY OF STARTUPS IN INDIA

Before the recent hysteria of Startups, India was mostly popular as an IT outsourcing destination that provided cheap and easy labor to the global companies for carrying on various back-end jobs. Technology startups in India date back almost three decades. On compilation of the Industry's major landmark, Microsoft Accelerator in India came up with four distinct phases of growth and maturity that have traversed so far: software services and global delivery model, the dotcom era, the rise of product startups and growth of startup ecosystem. Some of the milestones include US-based Texas Instruments' decision to start an R&D center in Bengaluru in 1985 which further served to be an incubator for many of the current entrepreneurs, and the launch of the infamous accounting software Tally in 1986.

Aiming to foster entrepreneurship and promoting innovation by providing an ecosystem that is conducive for growth of Start-ups, with an object to facilitate India become a nation of job creators instead of being a nation of job seekers, the Indian Prime Minister launched the initiative formally on January 16, 2016 from Vigyan Bhawan, New Delhi.

STAGES OF STARTUP AND AVAILABLE MODES OF FINANCE AT EACH STAGE:

From an investors point of view there are 6 phases of investment; Self Funding or Bootstrapping, Friends and Family, Seed, Growth (also known as the 'Early Stage') and Expansion.

1. <u>Self-funding/Bootstrapping</u>

Self-funding being the first phase of the entire investment process is the stage in which a founder invests his or her money to begin the startup journey. A founder introduces the initial startup investment from his own funds/savings before going to the next stage of investment. However, a high net worth individual can be expected to put in much more money. It also demonstrates additional commitment on the part of the entrepreneur to other outside investors (including Angel Investors) from whom the money can be raised at a later stage. Sometimes entrepreneurs also choose to provide funds via loans to their company. This is a common practice, although most venture investors usually require that such debts are converted into equity during the entire investment process.

2. <u>Friends and Family</u>

In the friends and family phase of investing, the founder reaches to people from friends and family and asks them to put a portion if not all of their life savings in the business idea. The founder needs to be very honest with them about the risks of losing all of their investments in case the startup business stagnates, thereby failing, so that their expectations are set clearly upfront. A major risk is that because these investors are often not aware of the technicalities of running a newly setup business, they might have unrealistic expectations and may be too much demanding on how much ownership stake they should be given.

3. Seed

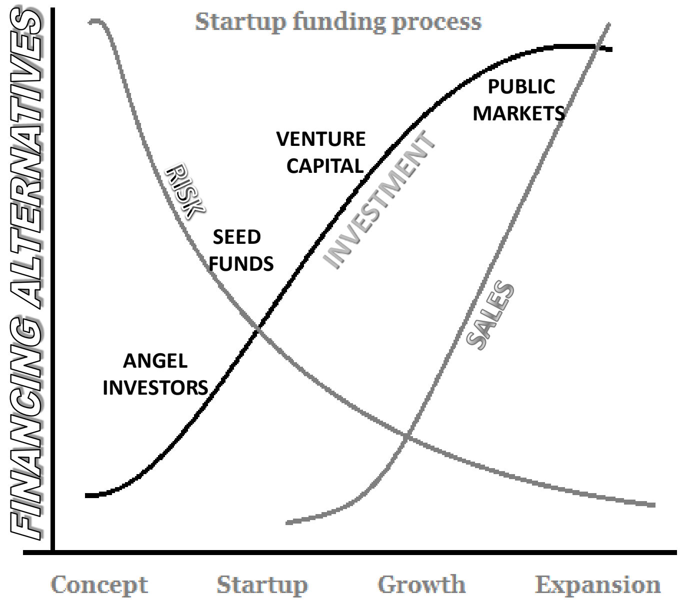
The seed stage of investing is the first level of raising capital outside of the most common reach of the Entrepreneur such as self funding. Usually, this round is sourced from professional, experts or seed capital investors such as Angel Investors can either individually, or in an angel group comprising small individual angel investors. Since Angel Investors in most cases having their own businesses have experience, being a founder they can provide more than just capital. It is their knowledge, experience and expertise of the startup ecosystem prevailing in an economy that might provide useful insights to the Entrepreneur. Usually, the three most common traits of an Angel Investor include Wisdom, Wealth, and willingness to Work. These Angel Investors in India invest solely into an entrepreneur with an idea and they usually do not encumber the entrepreneur with any corporate governance responsibilities.

4. Growth/Early Stage

Early Stage Investing is the first round into venture capital. It is often used to scale the company's business model & often comes from larger institutional funds. Many of the famous venture funds are the commonly known early-stage investors in India. The major advantage of having a conventional venture fund as an investor is that they typically have sufficient funds for investment and therefore can provide growth capital in the future, leading to "Series A" financing rounds and also actively participating in "Series B" financing and sometimes beyond that. Moreover, VCs invest money according to their fund size. An entrepreneur looking to raise INR 5 – 10 Crores could approach early stage Venture Capitalists also known as Micro VCs. The benefit of choosing a Venture Capitalist that can participate in follow-on investment rounds is that it is not required of the entrepreneur to start looking for an investor once the initial money invested is over. Depending upon the size of investment and the stage at which they enter in a startup, Venture Capitalist expect returns as low as 2 times upto a maximum 10 times cash on cash basis.

5. Expansion

The expansion stage is where the startup business is growing month over month at a good pace. Business valuation varies wildly in this phase and has a great scope for heavy negotiations. One common thing is that the founder will own a microscopic amount of the company started by him in comparison to the stake owned by him at the Self Funding stage. In most cases, his share would be 10% or less but a very high valuation. If the founder believes and hopes to have a real chance of the company becoming a unicorn (a company valued over $1B) in the future with an excellent chance of going public, then it is a common practise to sell the business at this point or very soon after that, in order to be in a win-win situation for all.



TACKLING RISKS AND CHALLENGES

Risks are an indispensable part of startup success. However, an alert and insightful mind is necessary while making decisions relating startup activities to reduce any risk of failure. Although challenges are a part of every startup, the determination to overcome these challenges even in times of distress and doom is what makes a successful startup. Startups that succeed are the ones that are always in search of business opportunities, they are diligent in grabbing and exploiting them besides finding innovative ways to tackle the challenges that are faced by all Startups & learn from their own mistakes and stay focused on their vision. With the current startup ecosystem in India on a move, there is no major reason why a great idea shouldn't succeed with the right ingredients of running Startup businesses.

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