Entrepreneurship

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Lecture 31

Raising Finances and Developing Financial Strategy Part 1

Hi friends, welcome to course on Entrepreneurship. We have considered several aspects of entrepreneurship in the past including the role of technology in structuring entrepreneurial initiatives. In this session we will focus on one of the very important topics of entrepreneurship that is successful entrepreneurship. This topic pertains to raising finances for start-up and entrepreneurial firms. Why is this topic different from what happens normally?

The difference between entrepreneurship of the previous periods and the new age entrepreneurship or start-up is boiling down to one factor. In the previous generation of entrepreneurship to ensure that the finance are more or less tied up before one embarks on the entrepreneurial journey. So, if one were to setup an ancillary unit for an industrial undertaking, there would be a market research done, there would be contacts with the original equipment manufacturer.

There will be discussions with the bank. There will be a kind of debt equity profile developed and then every other issue like development of the product or ordering of equipment for the facility or taking up the land for the facility, understanding where to locate, which industrial zone is the most appropriate one; where do the government policies are helpful. These are factored in a kind of multitasked way before entrepreneur starts his or her venture. That was the regime in the past.

But when we today look at the new age entrepreneurship or the start-up domain, it is the germination of the idea that is the trigger for entrepreneurship. One does not really wait till the finances are tied up; or the whole location and other issues are tied up before the entrepreneur starts moving on the venture. So, that means there is a lot more risk taken mainly because the ideas are very novel, they could be very disruptive and one needs to get on with the development of those products or services based on those ideas.

So, which means the challenge for raising finances in a new start-up domain or in a new entrepreneurial domain or significantly much more different and much more challenging than they are in the conventional entrepreneurship. So, we will discuss some of these aspects in this session.

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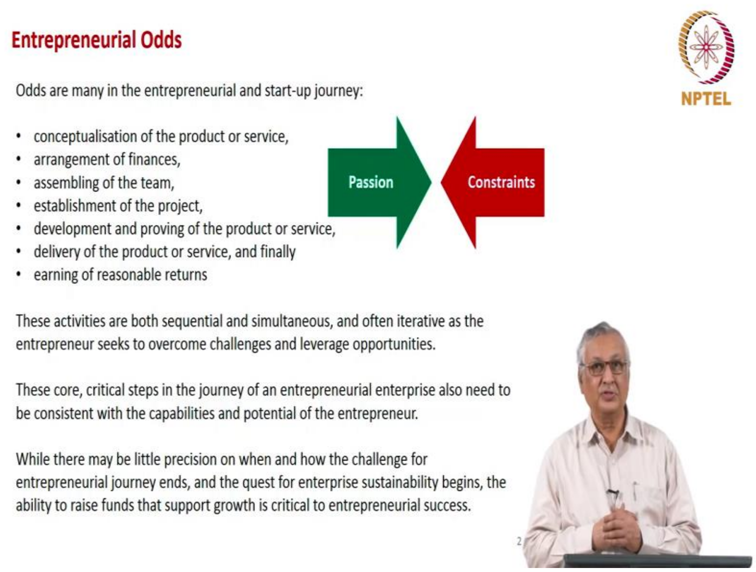

So, if you look at the entrepreneurship, there are several odds when we start on an entrepreneurial journey. One is the conceptualisation of the product or service. Second of course the core topic here, the arrangement of finances and that requires assembling of the team, establishment of the project developed at least. And thereafter we will have development and proving of the product or service, delivery of the product or service and finally earning of reasonable returns.

So, this is a virtuous cycle by which any company has to operate in the industrial or business domain but in the case of entrepreneurship we have discussed and we have again considered that the entrepreneur typically would like to move on the moment the product or services conceptualised and rest of the journey is powered by passion and whatever we have discussed as the other points or the constraints or the challenges which the entrepreneur faces.

Therefore, while these activities, about seven of them, are sequential as well as simultaneous, the need for raising finance comes as an overarching challenge in the entrepreneurial journey. So, how do we really handle this? Because there is no precision as to when does the scalability from an idea to a product begin. When does the need for sustainability in terms of generating your own resources begins? But all through is very clear that one requires funding that is very critical to entrepreneurial success.

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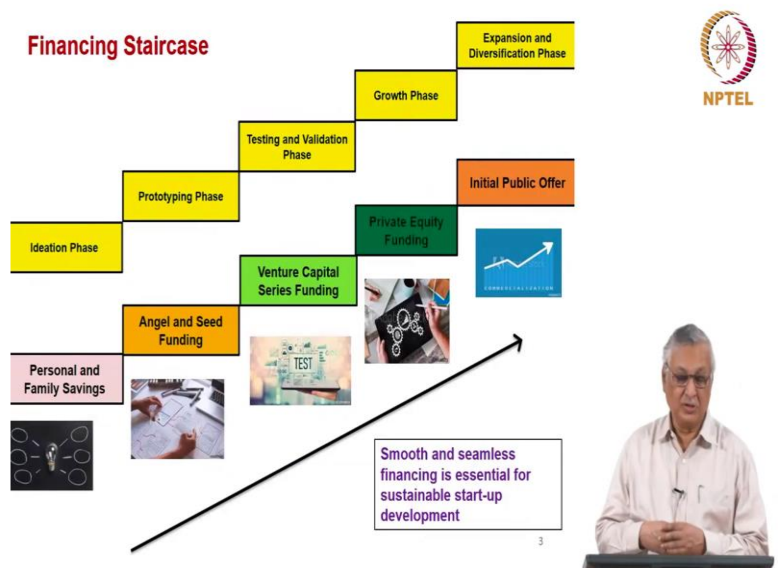

So, we have seen the product staircase in the past. We have said that there is an ideation phase, there is a prototyping phase, there is a testing and validation phase, there is a growth phase and there is an expectation of expansion and diversification. These are the 5 phases in which we can look at the entrepreneurial journey.

Now, the great thing about entrepreneurship is that much as the financing of the entrepreneurial journey is very challenging, it is also very evident in today's situation that there are multiple avenues of finance that are available for start-up compared to the availability for the earlier generation entrepreneurs. So, typically they start from one's own personal and family savings, then one moves on to angel and seed funding, then one moves on to the venture capital several series funding.

Finally, when you are in the growth phase to private equity funding and when you go to the expansion and diversification phase a combination of private equity funding as well as initial public offer. And there is nothing very sacrosanct or very right and rigid about how these fund-raising initiatives occur. For example, there is a very clear link between ideation phase and having personal and family savings to start the first sketching of the idea even first prototype.

Typically, angel and seed funding helps us do the prototype and by the time the prototype is built, we are able to attract venture capital investors to come into the entrepreneurial firm and then help us go with the testing and validation phase and private equity takes over when the company is into growth phase. But there is also a possibility that this venture capital investment can extrapolate itself in the growth phase as well.

Similarly, private equity funding can keep the company privately held for quite long period of time. So, there is no hard and fast rule. But there is generally this kind of linkage that happens. Several phases of the entrepreneurial journey are also linked to the appropriate phases of funding.

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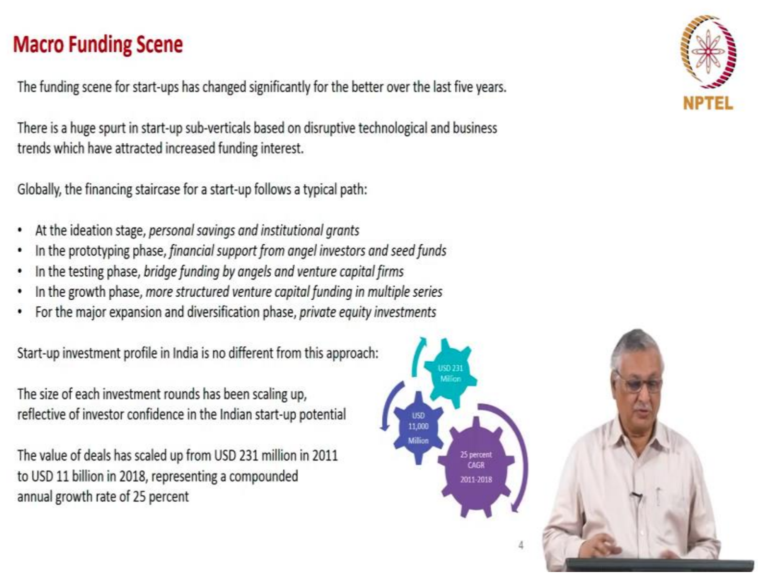

So, when you look at the macro funding scene, if you see at the statistics available, I will quote two types of statistics, one type of statistics is between 2015 and 2017 and another class of statistics is related to what we have about 2018 deals. The value of deals in the start-up space have moved up from 231 million in 2011 to 11 billion dollars in 2018. This represents and year over year growth of 25 percent, which is not at all a small sum by any measure.

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And when we look at the start-up funding, funding is available as low, from a level which is as low as US dollar 50,000 to a level which is as high as US dollars 2.5 billion. And over the last few years the number of deals have been varying between 50 and 100 typically each month. However, there have been ups and downs as to how the deals happen and nature of participation in this start-up journey is usually multilateral.

When I say multilateral, what I mean is that typically the investor stay on and newer investors come in and that is linked to what we have seen in the earlier phase that some in class of investors are better suited or their funds are more tuned to investing in certain stages of an entrepreneur’s journey. So, therefore you find different classes of investors getting into the company and helping the company grow.

Another important feature of our funding in the Indian scenario is that there is a significant flow of funds into the traditional brick and mortar space as also in the consumer internet and e-commerce platform. When we talk about the traditional brick and mortar space, what we are talking about is digitization of the brick and mortar space. Most of the activities or in terms of let us say digitization of the processes which are already existing.

We have considered in the previous presentation, for example, that logistics which is by and large highly physical activity with goods and trucks being the core of this logistics value chain apart from warehouses, we find the digitization of these processes have led to a number of logistics start-ups and has attracted lot of funding into those kinds of ventures.

But at the same time, we are also seeing that the newer area like healthcare, fintech, big data, cloud SaaS products and artificial intelligence they are attracting lot of start-up funding. Here, what you have is a start-up split by regions and you can see that Delhi NCR is one area and of course traditionally Bangalore has been leading the start-up revolution in India. We have start-ups spread over in Pune, Mumbai, Hyderabad and to some extent in Chennai as well.

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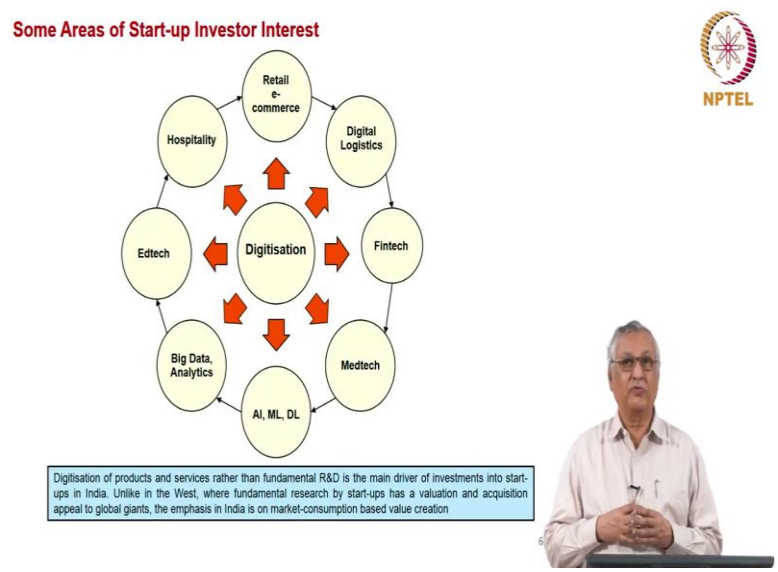

From an analysis of the deals which we have, we have found that there are at least 8 areas where there is significant amount of investor interest. First, as we have all seen retail e–commerce, conversion of physical commerce into e-commerce. That is one of the most sort after investment destinations. Second is digital logistics and third is fintech, fourth is application of digital technology into medical and health care matters.

And in the recent past there has been a significant interest in big data and analytics which is going into artificial intelligence, machine learning and deep learning as well. Hospitality has been a great instrument for attracting investments, OYO is a classic example. Edtech is also another example, and when we talk about hospitality, we also talk about ticketing sites, digital parameters for making travel and stay more comfortable.

But the question which faces us in India is that when you look at these kinds of areas which are attracting lot of interest. Digitization of products and services rather than fundamental R and D seems to be the trigger for attracting investments. Why is it so? Probably, because India is a huge market of 1.3 billion population and the biggest driver is consumption.

So, any start-up which gains a place in this huge consumption canvas is likely to provide significant returns when the start-up is scaled up. So, that is the reason why there is significant interest in claiming the consumption space and channelling lot of investments into this space.

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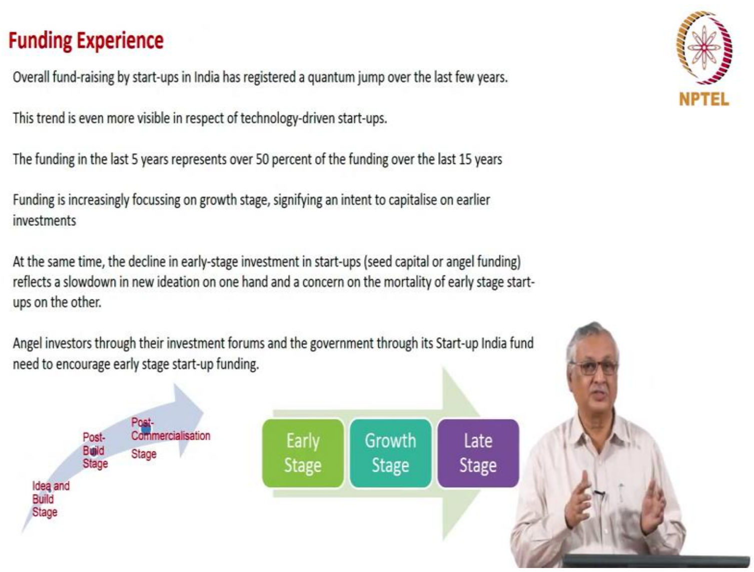

As I said that there are 3 phases if you kind of compress those 5-6 phases, we considered earlier one is an early stage, second is a growth stage, third is a late stage. By the time the company completes the early stage one can say that the company would have translated its idea into build of a product. When the company goes through the growth stage and completes, it would have validated and is in a pre-commercialisation phase and when the company gets into the late stage it is a post commercialisation phase.

But the point as per the statistics is that there is a kind of plateauing down of the early stage investments while there is a growth in the growth stage and late stage investments. Why is it like that? Probably two factors could be driving this kind of change: One there is a worry about the early mortality of the deals in the early stage that is many of the ideas which are coming in the early stage or as I mentioned focuses on the digitization of existing process where the entry barriers are low and returns are thin and there could be higher level of mortality.

So, investors are becoming more circumspect on getting the real differentiated venture rather then also a me-too kind of venture. And the reason why growth stage and late stage funding is going is the interest to consolidate whatever investments that have been made and ensure that this scaling up is done appropriately. Again, this kind of movement a kind of sinusoidal movement that happens in the investment space is a natural corollary of how the industry develops, the overall start up industry develops.

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So, when we look at the overall global map there are 3 regions which you can see here; one is the green, the other is the light green and the other is the brown. Now, if you see the deep green is one where there is lot of interest in the start-up investments and China and US qualify in that region. India ranks second along with certain Asian countries in getting this next round of or next stage of investments. But when we look at Russia, and lot of Europe and also the Latin American countries you will find that probably the interest is ranking number 3.

Now, India is definitely a start-up funding destination and the Prime Minister Shri Narendra Modi has gone on record in his recent Saudi Arabia address that India is the third largest start-up system in the world and probably India would provide the best returns for any investor who is willing to invest in start-ups. So, clearly there is lot of interest and when we as start-up advocates look at funding scenarios, we got to keep these macro-developments in our mind.

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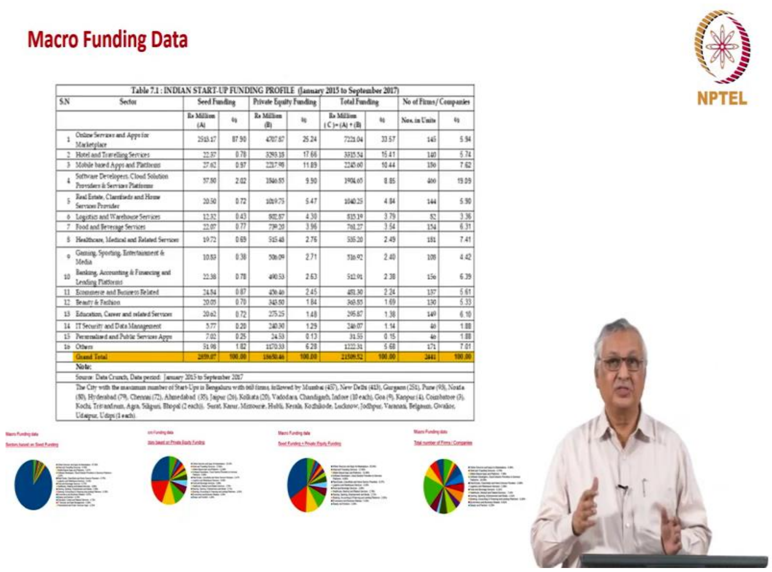

So, this table which is a busy slide talks about 16 different verticals although shown in the horizontal lines, they represent 16 different verticals we have, one is online services and apps for the market place. Second is the hotel and travelling services, third is the mobile based apps and platforms, then we have software developers, real estate, logistics, healthcare, gaming, banking, accounting, e-commerce, beauty and fashion, education, career related, IT security, personalized and public service apps and various others.

And the funding is classified into 2 stages, one is seed funding and second is private equity funding which also includes the venture capital funding and the total funding as also the number of firms. So, if you see in terms of the sectors based on seed funding, you will find that few sectors have received the preponderant spike of the investment, whereas as you move from that to the number of firms you will find that there is more secular distribution. And this is also explained by the fact that some of the e-commerce companies have reached such stage that they are able to attract a significantly higher investment related to the other start-ups.

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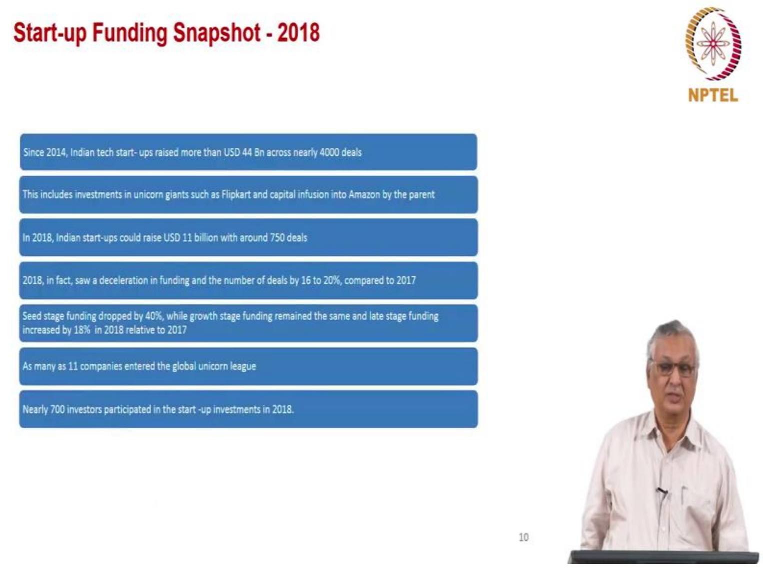

So, from 2014, Indian tech start-ups have raised USD 44 billion across nearly 4000 deals and this includes of course the investments in unicorn giants such as the Flipkart and Snapdeal and also capital infusion into Amazon by its parent corporation. In 2018, therefore, including those kinds of activities, the Indian start-ups could raise USD 11 billion dollars with around 750 deals. As I said earlier in 2018, we had seen a deceleration in funding of both the deals as also the early stage deals.

And seed stage funding has dropped by almost a 40 percent while the growth stage funding has remained the same. Late stage funding has increased by 18 percent and the driver of the late stage funding have been the companies which are into big bloom like Flipkart and other start-ups in the e-commerce space. And interestingly as many as 11 Indian companies have entered the global unicorn stage, the topic which we have discussed in one of the earlier presentations and nearly 700 investors have participated in India’s total start-up investments in 2018.

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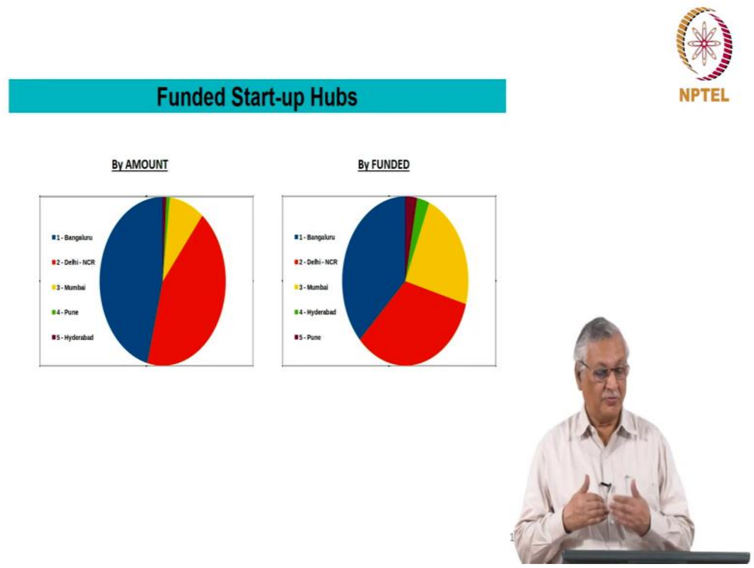

Now, when we look at the start-up hubs you will find that Bengaluru is leading the start-up, almost 50 percent of the overall, then Gurugram or Delhi NCR region that follows with the second largest area. Mumbai is the third one and Pune and Hyderabad somewhat shared the balance spoils of investment. And the same situation is thereby the number of companies which are funded, Bangalore leads followed by Delhi NCR followed by Mumbai, Hyderabad and Pune.

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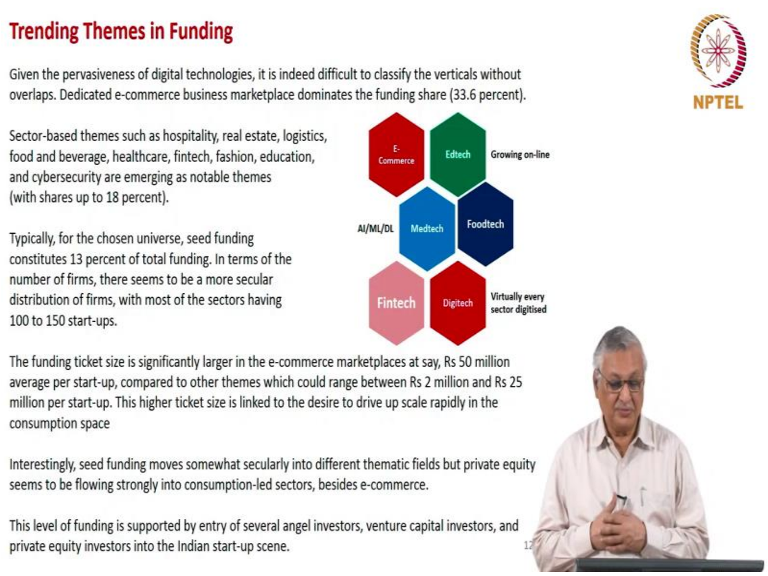

Now, the trending themes in funding as we said are e-commerce, Edtech, Medtech, Foodtech, Fintech and Digitech. All of these things are marked by 3 fundamental trends at this point of time. One there is a growing online business, second every element is virtually digitized and thirdly from digitization people are moving into predictive and prescriptive studies, which is artificial intelligence, machine learning and deep learning.

The funding ticket is obviously large as the start-up moves on this stage. But we have seen also funding in the ranges of 2 million to 25 million occurring in the venture capital series. Interestingly seed funding goes into different streams. There is really no sector which these seed funding investors avoid. As long as the idea is interesting people would like to put money, but when it comes to more of growth stage funding, more of venture capital funding, more of private equity funding, the funding moves to areas where consumption space is directly catered to by the start-ups.

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So, when we look at the sectors from the 2018 data which is available, we have analysed that Fintech, Enterprise Tech, e-commerce, consumer services and health care. By the number of deals these are the ones which are leading, whereas in terms of the value of the funding e-commerce is leading followed by consumer services followed by Fintech, travel tech and enterprise tech. So, this is the kind of mix which we are having.

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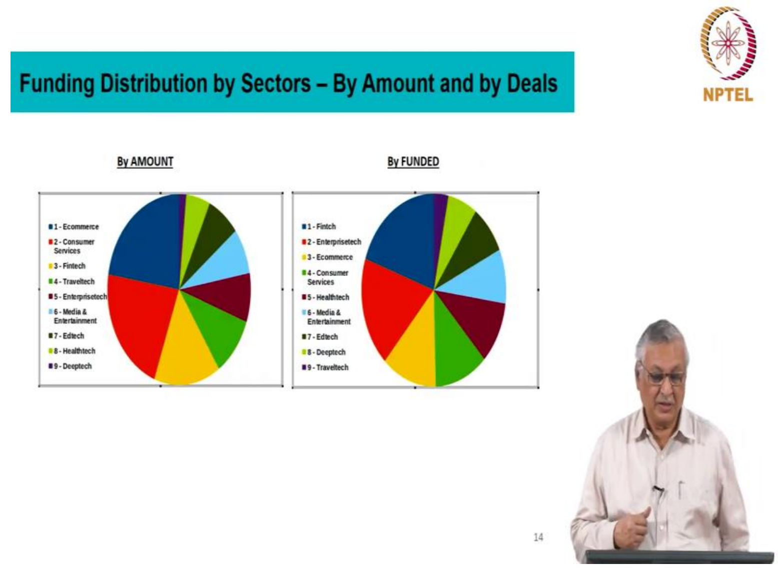

And when we look at the sectors again, you find that e-commerce, consumer services and Fintech these are having about 60 percent of the total amount that is funded, whereas by the number of companies, the distribution is much more varied.

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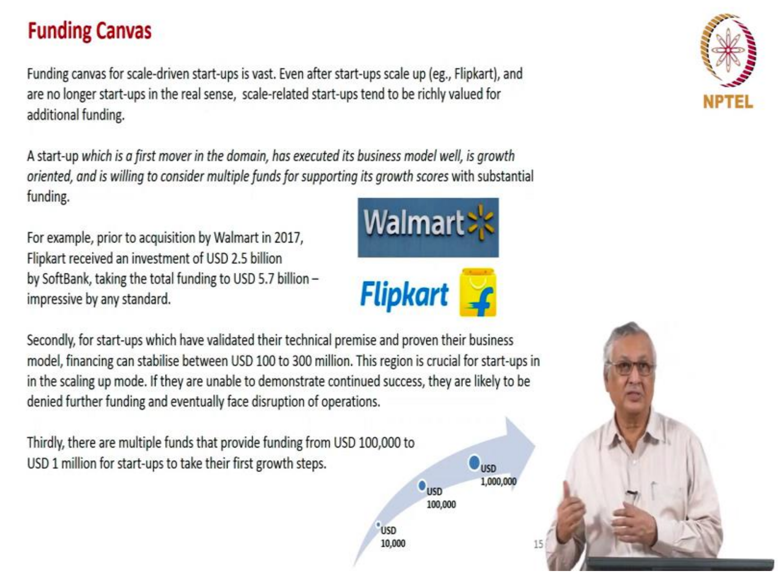

So, if you look at this kind of scenario where not really the banks but the whole new generation of investors which is supporting the start-up system one can say the funding canvas scaled driven start-up is indeed vast. Although we say that starting a start-up is really challenging because there is no ready finance available, but in terms of the availability of financing resource and financing instruments, you will find that the canvas is really vast and we will try to cover these kinds of activities and instruments as we go forward.

One of the important thing is that where the idea has already been proven, where the prototype of the product or service is already built, where the operation model is in existence and when the operation model has been completely scaled up, sky tends to be the limit for the kind of investments that could support start-ups. That is how Flipkart prior to the Walmart acquisition could secure an investment which is as high as 2.5 billion dollars from Soft Bank and that has enabled further growth in scale.

That has also enabled the 17 billion dollar acquisition by Walmart into the company. Therefore, the fundamentals which we have of running a company that is having a good and secure product which is accepted by customers and then expanding the market footprints is the same for start-ups as well as for the established businesses but start-ups have got an additional advantage compared to the established businesses.

Because in start-ups we have an investment ecosystem which is willing to fund the losses as long as you are able to achieve the market share and market presence. Interestingly many companies are there today which will offer funding from 10,000 dollars to 100,000 dollars for start-ups to enable their growth journey.

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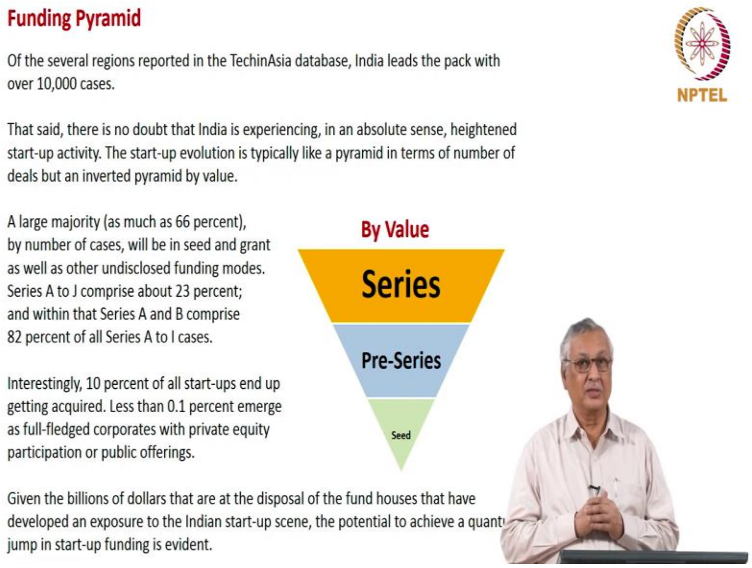

When we look at the funding while the deals in terms of the deals, it is the pyramid, Nature of the funding, if you consider seed, pre-series and series funding as kind of a 3 tier hierarchy, you will find that by number of deals the pyramid is classic, most number of deals are found in the seed stage, little less is found in the pre-series stage and very few in the series stage.

But when we look at by the value, you will find that the amount which is spent at the seed stage is very less followed by an increased spending in the pre-series and dominated by the most overwhelming funding in the series stage. That is how? So, there is a classical pyramid by the number of deals and there is an inverted pyramid by the amount of funds which are pumped into the starting business.

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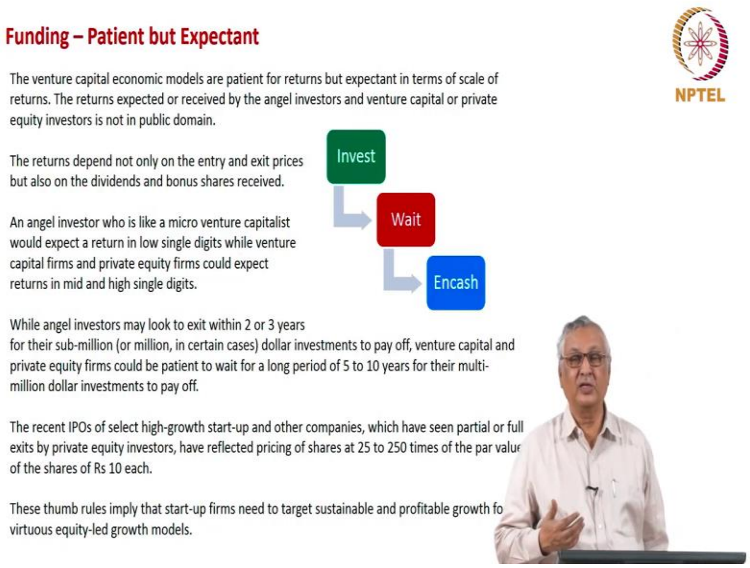

But this funding is also governed by certain principles. When we do the funding by the banks, the parameters are very fixed, the interest rate is fixed, the amount which is provided is fixed, the margin money is fixed, the collateral is fixed. Therefore, the rules of the game are quite clear. But when we look at the funding in terms of the investor funding, theoretically these are all equity investments by nature of risk capital.

However, the fact that a company cannot go on funding by itself based on the investor funds. There is also a pressure that comes with these kinds of investments. There is a kind of psychology which says that, If you prove yourself and provide a certain returns to me, you are likely to get better investments through another agency which is more tuned to your new stage of growth.

So, typically the venture capital economic models are based on investment, a wait period and then encashing after the wait period is over which means that a 2 to 3 year cycle happens for the angle investors, a 3 to 5 years cycle happens to the venture capital investors and 5 to 7 year cycle happens to the private equity ventures.

This is because most of these funds are funds specially created for investment in the start-up areas and they have got mandates of their own that they should provide returns to the people who have invested in certain time frame. So, the start-up movement while it looks very interesting in terms of getting funds at times to fund losses, eventually the returns have to be shown in terms of the valuation of the companies and the returns they are able to provide to the investors. So, this thumb rule imply that start-up firms need to target sustainable and profitable growth for virtuous equity growth models.

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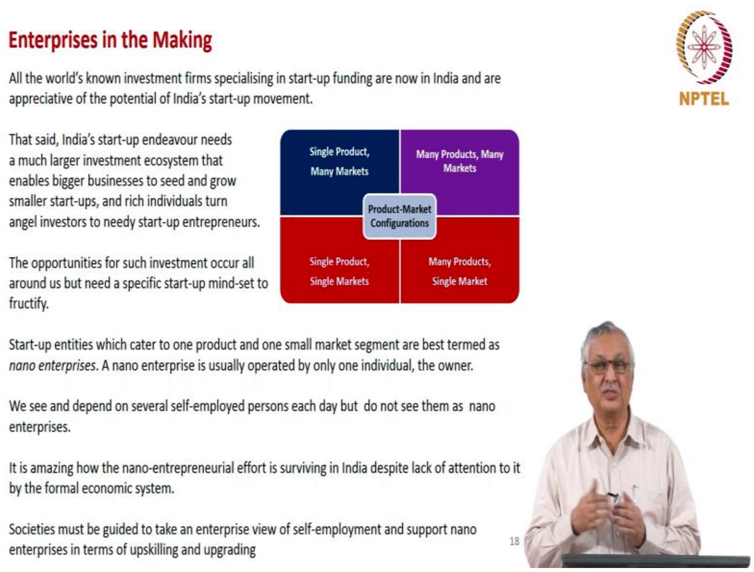

Now, when we look at start-ups, we can classify the start-ups in terms of different parameters but one we can look at here based on the product market configuration. There could be a start-up which is doing single product and a single market which is let us say development of, as I said digital laundry business for simple market of home users.

Second could be many products single market which is typically a digitized retail store, which meets the average consumer with different products. The other could be single product many markets, it could be a very interesting stationery item which could be useful for the individual as also for the business and finally you can have many products many markets. Based on this kind of configuration you can have companies which are very small to very big companies.

So, before we launch ourselves into the funding possibilities, we can see that how this entrepreneurship is giving rise to different kinds of companies from very small to big companies. In the past we had self-employment that is a vegetable vendor who does the vending of vegetables coming to our homes to companies which are processing vegetables and providing readymade vegetables, cut vegetables for home use.

So, between the 2, we have got different types of enterprises and the formal sector has been growing substantially in terms of technical use and customer interface. Nevertheless, it is a self-employment which is still surviving and is also growing. It is amazing that the nano industrial enterprises or the nano business enterprise continues to grow despite the growth of the formal organized employment system.

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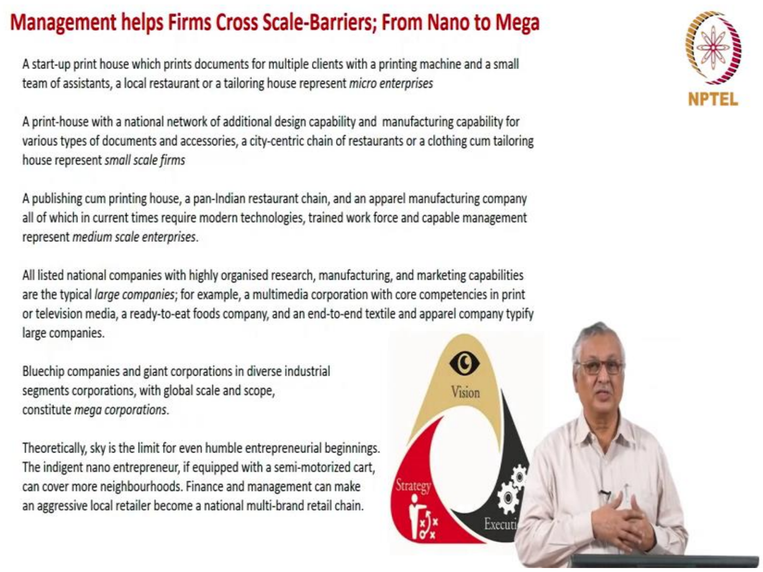

Now, management helps those kinds of companies move across the barriers. If we say that smallest company is there today’s management ensures that the smallest company need not remain small, it can actually graduate into a medium company and also become a mega corporation. So, typically we need vision, typically we need a strategy and we need an execution.

So, you take the case of somebody who is let us say serving tea and his vision could be that he would continue to serve tea by going to different homes on a bicycle and then provide this as his livelihood. This is a typical self-employment. But he could also have a vision that my role is not merely serving tea, my role is mainly to provide all the items which office goers as well as the homes require.

So, he might move from a bicycle to a tricycle so that he will be in a position to have more products on delivery and sale, but then his vision may not stay with that also. My vision could be that I should be a restaurant owner by myself and that could lead to a hyper local restaurant which he sets up along with the delivery arm he retains. But then he could also stay I would not stop with this, I would make this restaurant a chain of restaurants.

So, the way you can start your nano entrepreneurial system from whatever has been the smallest miniscule portion of industrial horizon into a kind of notable chain of restaurants of chain of businesses is entirely due to management. So, if you have good vision whatever be your start-up scale, if you have got a very clear strategy where you will move from which place to which place in terms of the business situation and how well you execute, these 3 would help a company even if it is a start-up company to move ahead.

So, this prescription of vision, strategy, execution triad is not typically a big company or a mega corporation prescriptive triad, it is very useful for even nano start-ups and micro-enterprises, small scale enterprises to growing the business.