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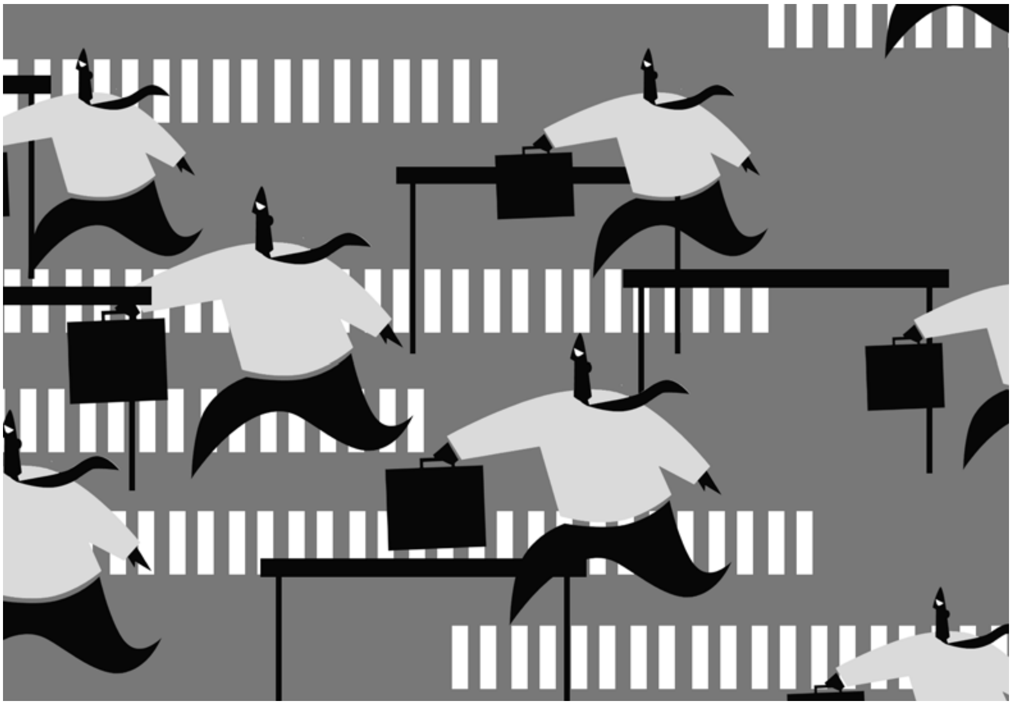

Threats to the Startup Spring

Some policy fixes are needed to develop an indigenous risk capital system

Shadows may soon start to loom over our dream of thousands of startups that will produce breakthrough products and services, create great and plentiful jobs for young people streaming out of our colleges and polytechnics, and generate immense wealth for investors – if, that is, we do not quickly and proactively take some steps. And the reason for this is that India's decades-old institutional framework for creating and financing innovation and enterprise may not be up to the task of dealing with this Startup Spring.

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The first shadow that threatens our Startup Spring is the Indian financial services industry's tendency to steer practically all capital flow into real estate and gold trading schemes. This gravitational force is so overwhelmingly strong that even some marquee technology investors from the United States, once they operate for a few years in India, abandon their plans of investing in technology ventures and play the Indian real estate market. My mail inbox is already starting to flood with investment proposals for incubation spaces – real estate to be rented out to startups.

The second shadow that looms is that, as soon as early teething troubles emerge in technology startups, their board members and other advisers will push these startups to abandon their dreams and adopt a "services model" – hire, train and place people at customer premises and charge a monthly fee for each person so deployed. The arguments such board members use will be compelling: Look at all those great Indian computer companies that tried to make products in the 1990s Personal Computer era; the ones who persisted with the product dream died, only the ones who transformed themselves into Information Technology services companies supplying Indian programmers to international companies survived to tell the tale.

Central to the issue of innovation and enterprise in India is that the size of Indian markets for sophisticated products of the kind that the new startups are going to make is actually very small, notwithstanding India's much vaunted middle class and our 1.3 billion population. According to the National Council of Applied Economic Research, India has about 30 million individuals in the managerial class, another 50 million in the professional and technical class, 50 million more who identified themselves as clerical, shop assistants and so on, a massive 135 million "hawkers, peddlers, street vendors", and an even more massive 420 million "farmers, fishermen, hunters, loggers" and 320 million in "informal workshops, transportation". Startups tend to create sophisticated products and services and end up addressing the first two segments with a total population of a mere 80 million individuals or 16 million households — and that could be the problem to start with.

But, for a startup in India to be revolutionary enough to create products for segments beyond these two high-end groups would mean creating products and services which may not have exact equivalents in the US market, and this means being greeted with disbelief by the largely US-origin venture capital (VC) system in India.

What stands in the way of an indigenous risk capital system developing in India? A critical piece, the Limited Liability Partnership (LLP) firm, has been enacted into existence; recent amendments have made it possible that the income of the LLP be taxed not at the firm level but at the level of the individual who is a limited partner in the LLP. However, it is still unclear whether losses incurred by the LLP can be set off against the income of the limited partner from his other businesses. If we need 10,000 startups, we will need, at the rate of three-four, at least 30,000 or so angel investors. Each angel investor may put in ₹25 lakhs to ₹50 lakhs, but needs protection from the liabilities that an LLP provides as well as returns from tax set-offs against current income — because less than one out of ten angel investments normally get to a stage where profitability and "returns' can even be dreamt of. A smoothly working LLP system is needed for the angel investment movement to take off. The Securities and Exchange Board of India (Sebi) has created the framework for starting venture funds in India, but the minimum investment that a person needs to make to join such a fund is too high, at ₹1 crore. While Sebi's goal of keeping this bar high is well-intentioned (to prevent small investors from joining what is essentially a high risk investment vehicle), this bar may restrict the participation of many knowledge professionals who can't come up with this scale of personal investment.

A final note of caution comes from a VC fund founder operating in India, Thomas Hyland, who points out that not all otherwise sound startups may be able to deliver the 5X growth in market capitalisation in five years that VC funds typically want. What many, if not most, startups in India need is relatively low-cost debt for working capital, which is impossible to get in India (a country where banks charge interest rates in excess of 14 per cent for startup businesses) and that may well be the true barrier to success in India for startups.

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