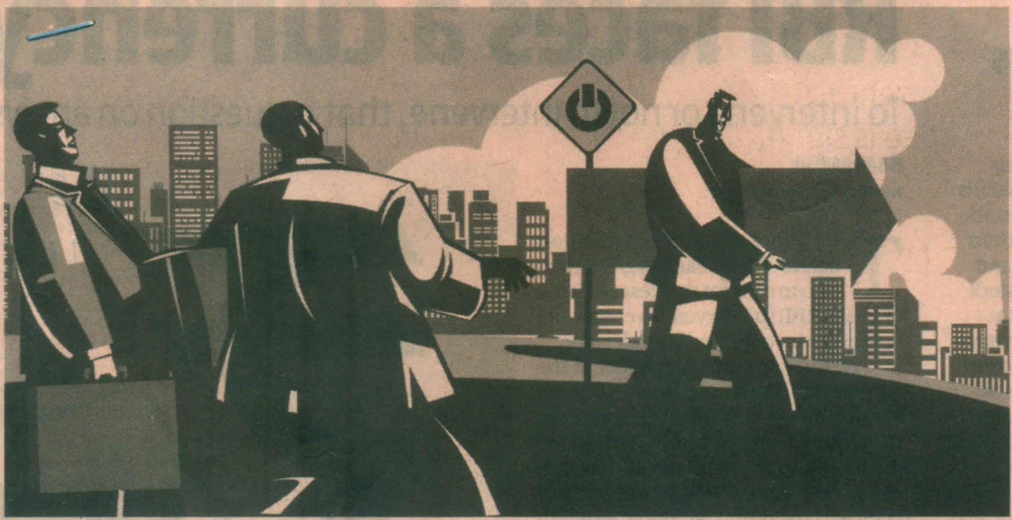
ILLUSTRATION BY AJAY MOHANTY



Jumpstarting India's start-up dream

A minor fix in tax laws can make start-ups bloom

Last weekend a group of serious-faced men came to see me. When they called me, they'd said they needed some tips to make their venture to assist Indian start-ups successful, and I was only too happy to meet them. As soon as they came in, they eyed my dining-table and, once there, spread out a large sheet of paper on which was a perspective drawing of a three-storeyed building with a grand entrance.

"This is a building which can house several dozen start-ups," said one of them.

"How will this help start-ups?" I asked.

"Once this building is finished we will be able to provide low-cost office space to many dozens of start-ups," he said. "As you know, finding low-cost space for their office is the most important ingredient for a start-up."

I was struggling to find words polite enough to tell them that what they were attempting was to do a real-estate play on the current enthusiasm about start-ups in India, when a series of images flashed through my mind: Political leaders of every hue and every level posing for press photos with youthful start-up founders; a Government of India website, startupindia.gov.in, dedicated to start-ups, spelling out that they need not worry too much about things like labour laws and environmental laws, describing how a portion of government procurement is going to be reserved for them, and so on.

What's brought on this sudden twist in policy making, where "de-regulation" and "reform" as buzzwords have been replaced by "start-ups"?

At one level, it is easy to understand this twist. India is not creating enough jobs for its young people. Industries that were the fountainhead of jobs — textiles, leather, metals, automobiles, gems & jewellery, transport, IT/BPO — are hiring very little or even cutting down on their manpower in a struggle to stay alive. And what's worrying policymakers even more is that even in industries that are seeing growth, jobs don't seem to be growing at the same pace.

Since start-ups seem to be the shining light in the distance that will solve the job problem in our country, it's worth our while to understand this new animal in our landscape, the "start-up". Wikipedia, a great source of definitions that everyone has agreed upon, defines a start-up as "an entrepreneurial venture which is typically a newly emerged, fast-growing business that aims to meet a marketplace need by developing...an innovative product, service, process or a platform". In one sense, then, a "start-up", as distinct from the many other mom-and-pop businesses that exist, bases its future on "innovation" (= an innovation using internet-based technology) to solve a market need.

AJIT BALAKRISHNAN

Experience (and scholarly research) has established that a start-up goes through certain defined stages. In its first stage, the primary risk is whether the start-up can actually build a prototype of the product or service at a cost and with the features that it set out to build and whether a few early customers are ecstatic about it. This is the "Product Risk" stage. Once a start-up gets past this first stage, the next risk it faces is whether sufficient numbers of customers exist to make the business viable. This is the "Market Risk" stage. Once a start-up gets past this stage, life, even if stressful, is relatively easy to negotiate — the founders can hire people experienced in operations and they can help them scale up their business, take it public, and so on.

What level of investment and what type of investors are needed at these two stages? My estimate is that in India start-ups need about ₹50 lakh to ₹1 crore over a period of about nine months to a year to get past the "Product Risk" phase. To get past the next "Market Risk" stage, start-ups need another ₹1-3 crore and another six months. If a start-up finds a successful path through these two stages, venture capitalists and others will rush to fund it. So, the real issue is getting past these first two stages.

Well-meaning people have proposed "incubators" to help entrepreneurs past these two stages — the current start-up policy, for example, has set aside very generous funding for such incubators in IITs, NITs, IIMs, and so on. In addition, practically every state government has some incubator project under way. All these efforts will help to some degree but a crucial element will still be missing.

At the micro-level, the start-up entrepreneur needs two or three people who will put in ₹25 lakh each. These are called "angel investors". Ideally, they should be people who are a little older and wiser than the entrepreneur himself, but, more importantly, respect his product vision and understand enough about the technology space that the business is in. At the next stage, the "Market Risk" stage, the same angels, or some additional others, need to be able to put in another ₹25 lakh to ₹50 lakh each, and, more important than money, help by introducing the young entrepreneur to prospectively scale up customers or help him hire people of the right kind to scale up skills. This means that the right angel investor is likely to be an experienced professional with deep skills and experience in the industries that the start-up is getting ready to disrupt.

What's a smart way to encourage the right type of angel investors to step up? We have put one crucial piece in place, the Limited Liability Partnership (LLP), which came to life in India in 2008. An LLP is a corporate and legal entity separate from its partners. An angel investor who may be an experienced corporate executive can, thus, invest in an LLP, and not worry that the enterprise's liabilities don't become his. At the same time, an LLP is governed by the partnership's deed and does not have to deal with our byzantine Indian Companies Act.

What we need to do is to go one step further: Amend the Income Tax Act such that the losses that the start-up LLP incurs in its early stage can be set off by each LLP partner against his other income. This means that the LLP investor will get tax savings as his return even during the initial stages when the start-up is losing money. If the start-up does not go past the initial stages, no harm is done — the angel investor would have got his return. This will bring in a flood of high-quality angel investors who are vitally needed to kickstart our start-up dream. And that's the crucial missing piece today.

The writer is the author of The Wave Rider, A Chronicle of the Information Age. *ajitb@rediffmail.com*