Economics

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Conceptualizing Start-ups in India: The way ahead

The Prime Minister had announced in August 2015 a new campaign "Start-up India, Stand up India" to promote bank financing for start-ups and offer incentives to boost entrepreneurship and job creation. This initiative will encourage entrepreneurship and it is envisaged that each of the 1.25 lakh bank branches would encourage at least one Dalit or tribal entrepreneur and at least one woman entrepreneur. Under this approach, besides the existing systems to facilitate start-ups, loans would also be given to add a new dimension to entrepreneurship and help set up a network of start-ups in the country.

The growth of start-ups will be an important factor in the quest for the 'Make in India' campaign come true as it will be driven simultaneously by these entrepreneurs – more often than not, first time ones. From the economic standpoint this becomes important for the following reasons.

- Most of them are driven by people with initiative which adds to the employment dimension of the economy.
- Most of these enterprises are linked to other production and service activities and hence have the potential to forge very strong connections that bring about more efficiency in the way in which these inter-connected businesses are run. The aggregator type of enterprise which has been quite widespread is an example of how these links may work.
- Invariably these start-ups would by intrinsic nature be technology oriented or would be harnessing the same for efficient solutions.

Concept of start-up

There are different ways of defining a start-up. It can be looked at as a company working to solve a problem where the solution is not obvious and success is not guaranteed. Alternatively it can be viewed as a fledgling business exercise in an overall culture and mentality of innovating on existing ideas to 'solve critical pain points'. The key attribute of a start-up is its ability to grow. They often adapt technology to solve problems and the ubiquity of that technology allows the required critical growth.

In the USA, one way to measure a start-up is by the '50, 100, 500' rule which means a revenue greater than $ 50 million, 100 or more employees, and entity worth more than $500 million. As a corollary it is believed that when any of these three are exceeded, then it is time to 'hang up the start-up uniform'. In India however, there is no fixed definition of a start-up.

How do define start-ups in India?

In order to be more focused on driving forward the start-up business, it is necessary to conceptualize the same in our context so that the policies that are being devised can address a well-defined subset. A start-up has to be differentiated from a SME even though it would resemble the latter in size. For an enterprise to be called a start-up it may be taken to be satisfying the following criteria:

- A new product or service is offered to the system
- A new idea which addresses an existing challenge
- The enterprise is scalable over time
- Typically should be able to reach as size of USD 50 mn (Rs 330 crore) in a span of 3-5 years with investment of at least USD 10 mn (Rs 66 crore)

Hence, in the Indian context the 5-10-50 thumb rule may be applied to account for number of years, size of investment and turnover by the end of this period respectively. While this may be a standardized formula, there would be exceptions that could exceed these limits based on the intrinsic nature of the enterprise. However, the viability of such projects has to be evaluated separately and independently by potential lenders or investors.

The Indian experience

According to a report by NASSCOM the start-ups industry can be characterized by the following statistics:

- India has grown to secure the third position in the world in terms of the number of start-ups. There are 4200 start ups expected by end of 2015 with growth of 40%.
- There will be $5 billion worth investment in 2015
- There are about three to four start-ups emerging every day.
- The number of active investors in the ecosystem has grown from 220 in 2014 to 490 in 2015, depicting a 2.3X growth.
  - Further, 8 out of every 10 top VC/PE Firms in India are foreign, and global investment in the Indian ecosystem is leading to an increased FDI.
- Global private equity (PE) and venture capital (VC) firms spent $2.2 billion (Rs 14,300 crore) in 179 Indian start-ups in 2014. Till October, these firms doubled their investments to $4.9 billion (Rs 31,900 crore) and expect to increase them to $6.5 billion by the end of the year.
- Total funding in 2015 has grown by about 125% over 2014.
- The boom in the start-up ecosystem has generated employment for around 80,000 to 85,000 people in total.
- More than 65% of the start-ups are located in NCR, Mumbai and Bangalore.
- 72% of the founders are less than 35 years old making India home to the youngest entrepreneurs in the world, with gender breakup of 91% male and 9% female.
- Most of the 1200 new start-ups are in B2C field and concentrated in 3 major segments namely
  - e-commerce,
  - consumer services and
  - aggregators
  - Followed by hyper local, health-tech, Edu-tech and analytics.

Role of government

Governments at different stages, central and state, are the major enablers of entrepreneurial ecosystem. Government's role in ease of doing business and helping companies start is vital to ensuring success. There is evidently need to improve on this aspects as can be seen in the following table on ease of doing business.

The table below gives some indicators of the areas that need to be strengthened in terms of ease of doing business. Based on World Bank data, the table compares the numbers across some parameters for India along with those in South Asia and developed OECD. As can be seen for a start-up company, there are several challenges posed by institutional factors that need to change. Low coverage by credit bureaus means that procuring funds through official channels would be difficult given the risk involved in most of these enterprises.

Indicator	India	S Asia	Developed OECD
Procedures for starting business (Nos)	14	7.9	4.7
Time taken to start business (days)	29	15.7	8.3
Cost as % of Per capita income	17.0	14.0	9.6
Credit bureau coverage (%)	22	12.7	66.7
Hours spent per year paying taxes (Nos)	243	299	176.6
Number of tax payments	33	31.1	11.1
Total tax rate %	60.6	38.9	41.2

World Bank: Doing Business, 2016

The government's role has so far been limited to enabling grants and loans; but without an effective, enabling environment, implementation is far off the target. In this regard it will be interesting to see the contours of the recently announced Start-up Fund in this year's budget. For startups to thrive and succeed, the government has a lot to do and understand the importance of entrepreneurship in economic development.

Challenges for Startups

- Skills: It is difficult to point out a number but skilled manpower is required progressively to take it forward. While the enterprise can start with friends and relatives it needs to be scaled up for which we must have well trained employees. Given that it cannot offer the comparable pay scales in the private sector, attracting talent is a challenge.
- Funding: Conventional sources like venture capital, private equity or banks may not be adequate given the pace of growth in these start-ups. Angel investors would be one option going ahead. The enterprise has to scale up fast to meet the creditors and investors’ expectations.
- Mentorship: Another challenge is of mentorship where the entrepreneurs may have good ideas and/or products, but have little or no industry, business and market experience to effectively get their products out. This is important because the markets are fragmented with consumer behaviour being different in different regions.
- Branding. Branding of the enterprise becomes important and with a plethora of such start-ups in the same field, differentiation becomes important.
- Upgradation: Start-ups have to reinvent themselves constantly with changing times especially so with the proliferation of competition across the sectors.

Some Initiatives taken in related fields

1. The Government has established a mechanism known as SETU (Self-Employment and Talent Utilization) under NITI Aayog. SETU will be a Techno-Financial, Incubation and Facilitation Programme to support all aspects of start-up businesses, and other self-employment activities, particularly in technology-driven areas.
2. Department of Electronics and Information Technology (DeitY) is implementing a scheme titled Technology Incubation and Development of Entrepreneurs (TIDE) which was launched in 2008. TIDE has a multipronged approach in diverse areas of Electronics, ICT and Management. It aims to assist institutions of higher learning to strengthen their Technology Incubation Centers and enable young entrepreneurs to initiate technology startup companies for commercial exploitation of technologies developed by them.
3. Some state governments have exempted startups from labour laws allowing for more flexibility.

4. Various state governments have taken initiatives such as skill development, training, incubation centres etc.
5. SEBI has notified a set of listing norms for such entities, including e-commerce ventures, on a separate platform of domestic stock exchanges. The new norms provide significant relaxations in the disclosure requirements. SEBI has relaxed its delisting, takeover and Alternative Investment Fund (AIF) regulations for such new-age entities engaged in information technology (IT), data analytics, intellectual property, bio-technology or nano-technology like activities.

USA experience

Historically it has been noticed that almost 90% of all start-ups fail. In terms of money foregone just 1% of total start-up funding comes from VCs with balance from self-funding and friends and family. A problem has been extravagance in the form of wild parties and lavish offices. This reduces the chance of success and abusing the trust of investors.

Sources of finance

a. **Online lending.** Online lending services such as OnDeck and Kabbage have become a popular alternative to traditional business loans. Online lenders have the advantage of speed. An application takes only up to an hour to complete, and a decision and the accompanying funds can be issued within days. In contrast, the traditional loan process can take weeks, or even months, to complete.
b. **Factoring** Services like factoring and invoice advancing may help ease growing pains for small businesses. Through this process, a service provider will front the money on invoices that have been billed out, which can be paid back once the customer has settled its bill.
c. **Product presales.** Selling products before they launch is an effective way to raise the money needed for financing such business.
d. **Friends and family.** Borrowing from friends and family presents an interesting alternative to traditional forms of financing, and can have some unique advantages, including low or no-interest payments and avoiding the hassles of bank contracts.
e. **Side business.** New business owners can try "double-dipping" as a means of funding their startup.
f. **Selling assets.** This is done by some entrepreneurs who sell their houses or cars to raise funds for their enterprise.
g. **Credit cards.** Business credit cards are among the most readily available ways to finance a startup, and can be a quick way to get the business up and running. However, this is a high cost of finance given that the interest rate paid on cards is one of the highest in the list.
h. **Angel investors.** Angel investors have helped to start up many prominent companies, including Google, Yahoo and Costco. This alternative form of investing generally occurs in a company's early stages of growth, with investors expecting a 20 to 25% return on their investment. The principal advantage of an angel investor is that there is a friendlier atmosphere and a quicker decision-making system in place.
i. **Venture capitalists.** For small businesses that are beyond the startup phase and already have revenues coming in, a venture capital investment may be appropriate. Fast-growth companies with an exit strategy already in place can gain up to tens of millions of dollars that can be used to invest, network and grow their company quickly.
j. **Crowd funding.** Crowd funding on websites like Kickstarter and Indiegogo have given a big boost to the financing aspirations of small businesses. These sites allow businesses to pool small investments from a number of investors instead of looking for a single investment. Many sites allow companies to raise money in exchange for rewards or products. Others have an equity-based model in which businesses give

up a bit of their share. However, the fine print needs to be understood as often Sites also charge a payment-processing fee for money enabled on the platform.

k. **Grants.** If the business is geared towards science or research grants from the government can be accessed for the venture.

The way ahead:

As Start-Up India would be a major programme for the government, it would be necessary to address the problems that they confront.

First, to begin with, the ease of doing business must be relaxed with simple online forms being made available for registration of these units and granting approvals in a time bound manner. This will cut down the time taken to commence operations as well as reduce the human-interface making the system more efficient. Ongoing compliances also must be streamlined with less human-interface and paper work.

Second, funding issue needs to be addressed from various viewpoints. The regular institutions would still be important but it is the non-conventional sources that have to be dipped into. Some of them would be:

- FDI which can have an upper limit.
- Angel investors and PE funds
- Crowd funding with SEBI having the ground rules in place to ensure that the credibility of the system is not compromised.
- As part of priority sector lending, banks could be asked to lend to a certain number of start-ups to ensure that these targets are met. A sub limit could be placed here – say 1% of credit.
- A guarantee fund has to be set by the government that can be done through MUDRA Bank or SIDBI to cover potential losses emanating from their failure.
- Credit rating for all loans provided would be supportive of borrowing by these units which can be taken up by the Ministry of Commerce. There will have to be a separate methodology drawn up for the same given that there is uncertainty in cash flows. A higher credit rating would act an enhancement for the lending entity.
- SEBI's announcement on bringing simpler regulations for listing of Startups is useful as it will help raise resources from a larger base and enhance efficiency while bringing about transparency in functioning.

Four, the government too has a role to play at all levels: central, state and district/municipal layers. This has to be through a system of incentives and subsidies which cannot be eschewed for an economy which can be driven by innovation and enterprise.

- Having a separate department for start-ups would be helpful to begin with.
- It has to work towards spreading the 'start-up ecosystem' such as providing incubating appropriate physical spaces at zero/low cost, training facilities for potential employees/consultants, specific concessions in sales tax and other local taxes, etc.
- The NSIC subsidy for SME rating not only needs to be scaled up from the allocated Rs 26 cr for FY16 but a separate provision has to be made for start-ups. Subsidy may be at a lower rate for start-ups and should also continue for a period of at least 5 years

Fifth, the skill development programme of the government also has to be scaled up at different levels so that there are the necessary skill sets in the youth to take forward this challenge.

CARE's Forays

CARE Ratings has already has entered into an agreement with GREX Alternative Investments Market, a seamlessly integrated exchange-like platform to assess and grade start-ups and SMEs and their securities registered on GREX. The framework is to be co-developed by CARE and GREX whereby information will be useful for investors to make an informed decision in regards to the attractiveness of a specific company and its potential risk. CARE is to be the first rating agency to grade/rate securities of start-ups and unlisted companies registered on GREX. Together CARE and GREX are developing a framework to analyze the companies on the GREX platform. The grading is being developed keeping in mind the expectations of various market participants and the methodology will be formulated after discussing with various stakeholders the parameters they would be looking at when investing in an unlisted company on GREX platform.

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