



Venture Capital in India: Possibilities and Challenges

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Abstract

The finance landscape for fast-growing companies seeking to materialize their ideas has been transformed by the emergence of venture capital (VC) firms, responding to the financial needs of young entrepreneurs. This paper explores the evolution of VC and its pivotal role in fostering innovation and business growth on a global scale. In the late 1990s, formal VC markets experienced a surge, giving birth to dynamic industries but also witnessing excessive behaviours and costly mistakes. Over time, VC markets across the globe have matured, with varying features and performances between countries. To assess VC firms' performance, the study analyses profit after tax and net asset value, providing insights into their regional and global contributions. The research delves into the implications of VC financing for start-ups and entrepreneurs, emphasising mentorship, growth strategies, and value addition beyond monetary investment. The study explores the risk factors and reasons for the failure of VC financing, addressing the challenges that it is facing today. Moreover, the paper highlights the substantial impact of VC investment on long-term growth and success, citing examples of globally influential companies like Apple, Amazon, Google, and Alibaba that have reshaped the global economy. The link between initial VC investments and start-up outcomes is explored, considering the stages of growth. In conclusion, the paper sheds light on the pivotal role VC financing plays in shaping entrepreneurial strategies and transforming innovative ideas into successful enterprises. As VC continues to influence market dynamics, this research provides valuable insights into its multifaceted impact on global economies and the entrepreneurial landscape. This exploration of VC's global influence provides a comprehensive understanding of its role in fostering innovation and driving economic growth.

Keywords: Venture Capital, Start-Ups, Fostering Innovation.

1. Introduction

Venture capital (VC), often referred to as "risk capital," plays a crucial role in fostering innovative entrepreneurship in India. This form of investment, involving equity, quasi-equity, and sometimes conditional debt, is directed towards new ventures led by technically or professionally qualified entrepreneurs. VC carries substantial risks and uncertainties, making it a unique financial instrument that defies a single definition. Various perspectives on VC highlight its multifaceted nature [1-3]. Jane Koloski Morris defines it as providing seed, start-up, and first-stage financing while also supporting the expansion of companies with

demonstrated potential but lacking access to public securities markets or credit-oriented institutional funding sources. The European Venture Capital Association describes it as risk finance for growth-oriented companies, emphasising its role in maximising medium- to long-term returns for both parties. Additionally, VC involves a partnership where investors contribute not only capital but also knowledge, experience, and a valuable network to enhance the venture's success. In the Indian context, the evolution of VC can be traced back to the mid-eighties, when the need for non-conventional, risky finance became apparent. Development Finance



Institutions (DFIs) initially played a role in venture capital by offering support for direct equity participation. The formalisation of the venture capital industry in India occurred in 1988, when the government granted legal status to VC operations. Technology Development and Information Company of India Ltd. (TDICI), a joint venture of ICICI and UTI, pioneered VC operations in India in the late 1980s. Regulatory frameworks, such as the SEBI (Venture Capital Fund) Regulations, 1996, further defined the industry, with subsequent regulations in 2000 promoting foreign venture capital investment. The global scenario reflects the substantial growth of VC, with investments reaching astral heights. In India, the venture capital industry saw a surge in deals and investments during January–September 2015, [3] surpassing historical highs. The Indian government's budget for 2014–15 also signalled a positive environment for investors, with provisions and funds earmarked for start-ups. The subsequent literature review provides insights into the structure of private equity firms, different types of private equity transactions in India, and the global growth of the private equity and leveraged buyout markets. Together, these elements contribute to a comprehensive understanding of the significance and evolution of venture capital in the entrepreneurial landscape, both in India and globally.

1.1 Objectives of the Study

- Investigate the historical development and current status of venture capital (VC) funds in India
- Identify and analyse the investment criteria employed by venture capitalists in their decision-making processes
- Explore the factors influencing venture capital investments in the Indian context
- Assess and understand the impact of venture capital on the growth trajectory of VC-backed firms

1.2 Limitations of the Study

- The study is based on secondary data, potentially limiting the depth of analysis and insights.

- Due to technical and various constraints, not all aspects related to venture capital financing have been comprehensively covered.
- The study narrows its focus to four sectors - Information Technology, Telecommunications, Services Sector, and Industry Products - within the venture capital funds and foreign venture capital investors' investment scenarios in India.

1.3 Research Methodology

- The research relies on secondary data collected from sources such as literature reviews, research papers, websites, and articles.
- The study is conducted over the current period, utilizing existing information to address the research objectives.

2. Review of Literature

Chemmanur et al. (2011) examined the relationship between the use of venture capital and Total factor productivity growth, and they found that companies financed by venture capital already had higher TFP growth in the years prior to obtaining venture capital [4,5]. Moreover, they observed that obtaining venture capital financing was associated with continued higher TFP growth. Other authors highlighted the relationship between venture capital and innovation, for example Hellmann and Puri (2000) [6] showed that the firms more likely to obtain venture capital financing were the ones using innovation strategies. Also, they showed that venture capital backed companies brought their products on the market faster. This effect was more significant for innovator companies, where time to reaching the market is likely to be of greater strategic importance. Puri and Zarutskie (2011) [7] found that venture capital investors fund companies with no initial revenues but only if they demonstrate stronger growth potential. Lindsey [8] (2008) also examined the relationship between venture capital financing and the formation of strategic alliances. The author showed that companies that have a common venture capital investor are more likely to form strategic alliances. Moreover, such alliance formation is associated with better exit performance. Apart from the



analysis of how venture capital impacts innovation it is important to examine how venture capital impacts the new value creation, such as new entry on the markets, employment, and company growth. Hirukawa and Ueda (2008) [9] found no significant relationship between the use of venture capital and an industry's total factor productivity (TFP) growth, although they did find a positive relationship between venture capital and labour productivity. B) Venture Capital Financing and Start-ups Samila and Sorenson (2011) [10] using panel data examined the relationship between venture capital financing and the number of start-ups, employment and income. As a result, they found a positive relationship between venture capital financing and all these variables across a variety of model specifications. Also, they showed that increases in venture capital investments determined the increase of new business creation. Following the same line of thinking Popov and Roosenboom (2008) [11] found that higher levels of venture capital investment were associated with more entry on the market, especially in industries with high investments in research and development. Also, they demonstrated the existence of a positive correlation between venture capital, new entry on the market and employments growth. Other researches sustain these findings, for example Chemmanur et al. (2011) [12] found a positive effect of venture capital on company productivity. Davila et al. (2003) and Engel and Keilbach (2007) [13] also found a positive effect of venture capital on employment. So it can be observed that the specialized literature consistently finds a positive relationship between venture capital financing and other measures of economic value creation. Puri and Zarutskie (2011) showed that venture capital backed companies grow faster at every stage of the investment cycle, both before and after the receipt of venture capital. Winton and Yerramilli (2008) and Ueda (2004) [14] compared venture capital financing with bank financing showing that venture capital investors have better ability to monitor the firm's activity, but on the other hand they demand higher returns. In contrast,

banks are less skilled at monitoring, but demand lower returns from entrepreneurs because they themselves face lower funding cost by exposing to liquidity shocks. Venture capital financing is optimal, if firms face highly risky and positively skewed project cash flows, with low probability of success, low liquidation value, and high returns if successful, and if they face highly volatile cash flows across two continuation strategies

3. Brief History of Venture Capital

Venture capital has a historical lineage dating back to the fifteenth century in the Middle East, where traders engaging in merchant ventures also founded commercial enterprises. The early form of venture capital, known as the "Mudaraba Concept," is believed to have originated during the pre-Islamic era in the Arabian Peninsula and later spread to Italy in the tenth century before making its way throughout Europe. The term "venture capital" was officially coined by Jean Witter in his presidential address to the Investment Bankers Association of America Convention in 1939. Despite this, Witter perceived venture capital not as a modern concept but rather as a traditional practice among affluent individuals who invested in businesses for experimental reasons. Over the past six decades, the venture capital industry has undergone significant changes and professionalization, leading to the establishment of more standardised definitions. The contemporary organisational form of venture capital can be traced back to 1946, [15] with the establishment of the American Research and Development Corporation in the USA. Traditional banks at that time primarily sought collateral and evidence of borrowers' ability to make timely interest and principal payments. This approach posed challenges for entrepreneurial firms, as they often did not meet these stringent standards. Consequently, there arose a growing need for risk capital in the form of equity, giving rise to venture capital as a crucial source for entrepreneurs lacking affluent friends or family to fund their ventures. The establishment of the American Research and Development Corporation marked a pivotal moment in the formalisation of

venture capital, setting the stage for its continued growth and evolution in supporting innovative ventures.

Structure of a Venture Capital Firm A venture capital firm is generally a private partnership or closely held corporation funded by institutional investors like private and public funds, pension funds, insurance funds, endowment funds, wealthy

individuals, etc. The general function of a venture capital firm is to offer financial support to new and young companies that do not have access to the capital market. In addition, the VCs actively participate by taking a managerial seat on the board, giving their expert opinion on developing new products or services, and taking higher risks with the expectation of a higher reward

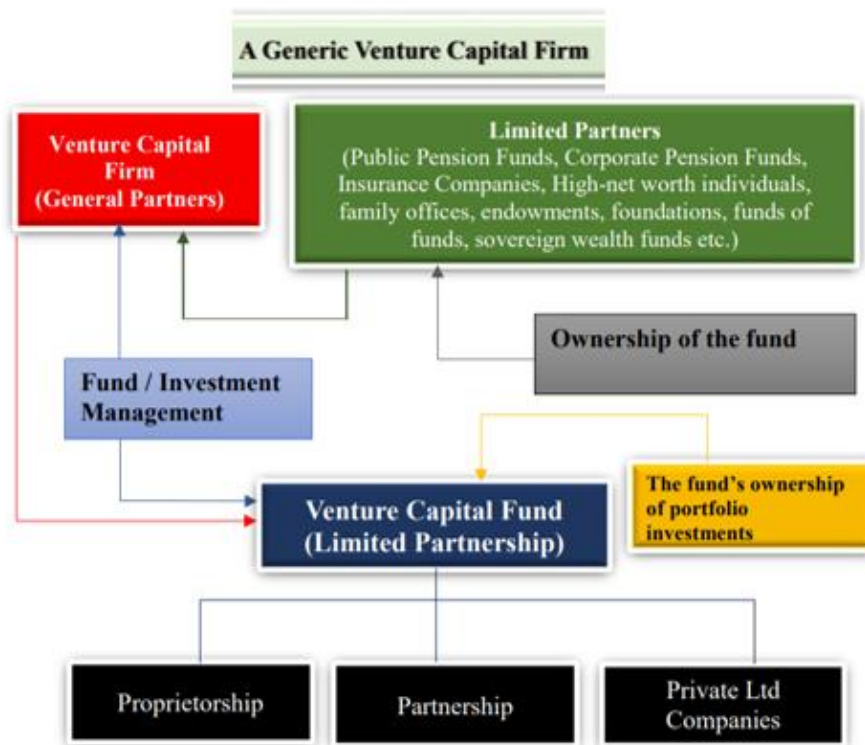


Figure 1 A Generic Venture Capital Firm

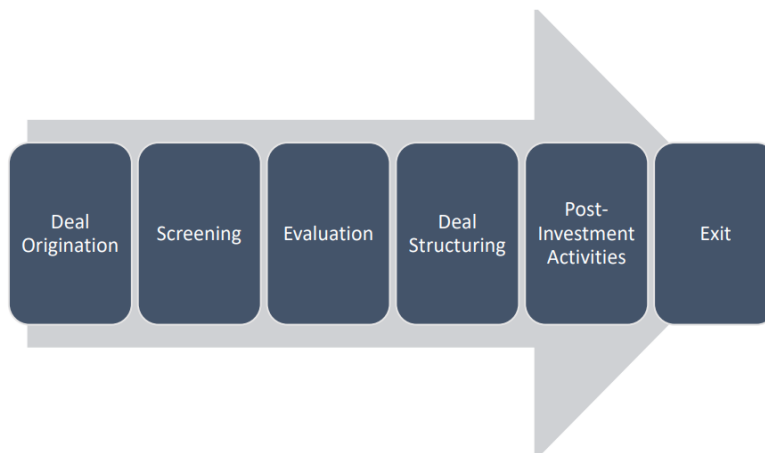


Figure 2 Venture Capital Investment Process



Venture Capital Funds under the limited partnership invest in the business either owned by sole proprietors or partnership business or Private Ltd companies which may or may not have any historical background. Today's best-famed corporates such as Google, Genentech, Facebook, Apple, Intel, Airtel, Flipkart, Compaq, and Indian telecom giants are established through as shown in Figure 1.

3.1 Venture Capital Process

An Overview The returns on venture capital entirely depend on the growth and profitability of the business. This return is generally earned when venture capital exits the investment. To achieve a successful and fruitful exit, the experienced venture capitalist invests in an orderly process by carefully investigating the deal. Hence, venture capitalists undergo different stages and screen the deal very carefully at each stage to get a successful exit Figure 2 shows the investment process.

Tyebjee and Bruno (1986) [16] describe the activities of venture capitalists' in an orderly process involving five sequential steps. These are mentioned below:

(a) Deal Origination: Deal origination is a process by which deals enter into consideration for investment prospects. Due to stiff competition and a poorly defined environment, it becomes very difficult for venture capitalists to find a potential venture. For this reason, various intermediaries play a vital role in matching venture capital investors with young and inexperienced ventures with cash needs.

(b) Deal Screening: A venture capital firm is typically run by a lean staff that comes across a large number of potential deals. As a result, only a fraction of deals is then screened, limited to some broad categories like industry sector, investment stage, size of the investment, geographic location, market scope, and the amount of capital needed.

(c) Deal Evaluation: The new ventures searching for venture capital have very little or no operating history. Hence, the venture capitalist makes a subjective assessment of the business plan presented by the management team of entrepreneurial

ventures. After weighing the perceived risk and expected returns, they decide whether to invest or not in a particular deal.

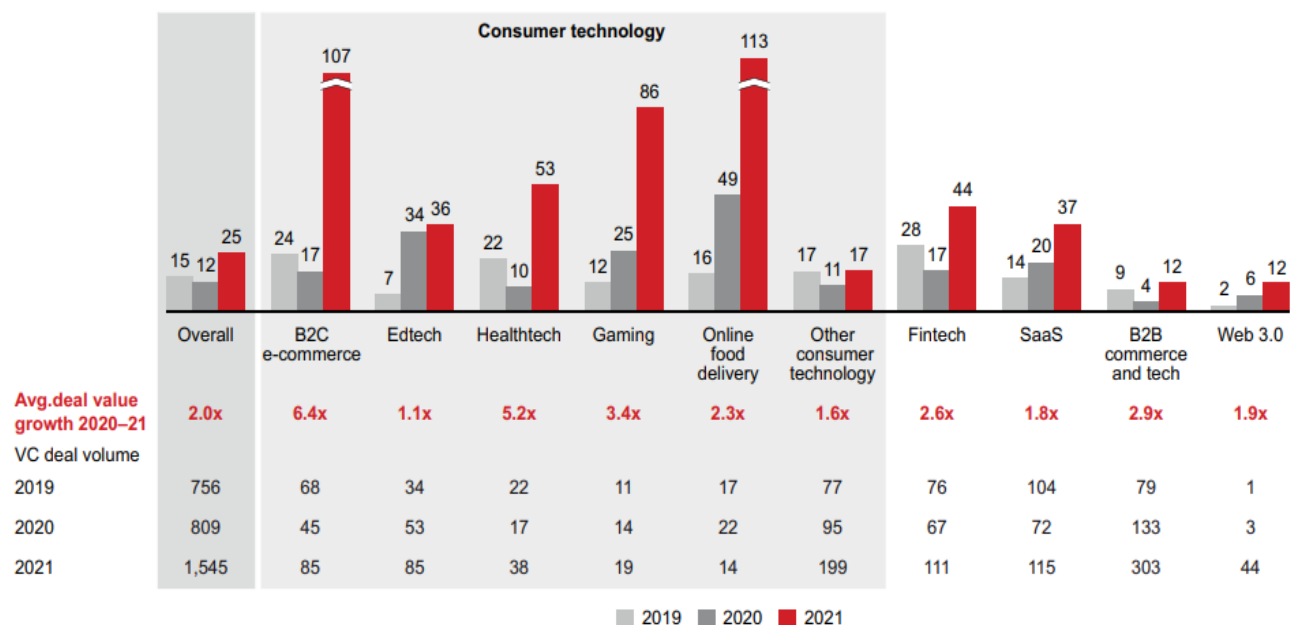
(d) Deal Structuring: Once the deal is accepted by the venture capitalist, the acceptable deals are consummated with a venture capital agreement between the venture capitalist and the entrepreneur. This agreement establishes the price of the deal, i.e., an equity share in exchange for venture capital; establishes protective covenants for venture capitalists [17] (see Tyebjee and Bruno, 1984 for details); and determines the entrepreneur's equity through earn-out management.

(e) Post-Investment Activities: Once the deal is finalised, the role of venture capitalists expands from stakeholders to collaborators. Although venture capitalists do not take control over the day-to-day operations of the venture, they may intervene and even set up a new management team if a financial or managerial crisis occurs.

Table 1 shows the trends in investment themes over a time period of five years, depending upon the availability of data. It is revealed that consumer technology has been one of the most preferred segments for making investments in all five years. Within consumer technology, other formats like video commerce, direct-to-consumer brand aggregator models, and short-form videos have drawn the attention of VC funding (Indian Private Equity Report, 2021) [18, 19]. After consumer technology, sectors like fintech, SaaS, and B2B commerce have been the preferred destinations for investments by venture capitalists. In the year 2018, consumer technology was a dominant investment theme again despite a fall in value, whereas in 2017 it was accompanied by other sectors like banking, financial services and insurance, telecom, and real estate. In 2019, consumer technology, fintech, SaaS, B2B commerce, and tech received 80% of VC investments. In 2020, consumer technology again grabbed the most funds, followed by SaaS in second place. Consumer technology, fintech, and SaaS accounted for nearly 75% and more than 75% of all VC investments in terms of value in the years 2020 and 2021, respectively. In 2021, a sharp rise in

investments in B2B commerce and tech and Web 3.0 114 Volume 15 Issue 9 March 2023 www.pbr.co.in or crypto-based. The start-ups recorded over the previous year of 2020 (India Venture Capital Report, 2022). Trends in the VC Industry in India This sub-section presents trends with respect to varied facets of venture capital financing in India. This presents the number of VC deals and the annual VC investments made in India in the last decade, respectively from the year 2012 to 2021 as shown in Figure 3 & 4. It shows the

number of Venture Capital and Change in Percentages On perusal, it is revealed that there was steady increase from 2012 to 2015, both in number of deals and annual VC investments, as vindicated by positive percentage change, barring one exception of annual investments made in 2013. This steady increase might be attributed to several factors like better economic conditions, new VCs competing for investment, rapidly evolving startup ecosystem, positive exit environment and changes in valuation expectations.



Note: Other consumer technology investments includes travel and transportation, media and entertainment, social networks, job portals, proptech, and others
Sources: Bain VC deals database; Pitchbook; Venture Intelligence; AVCJ; VCCEdge

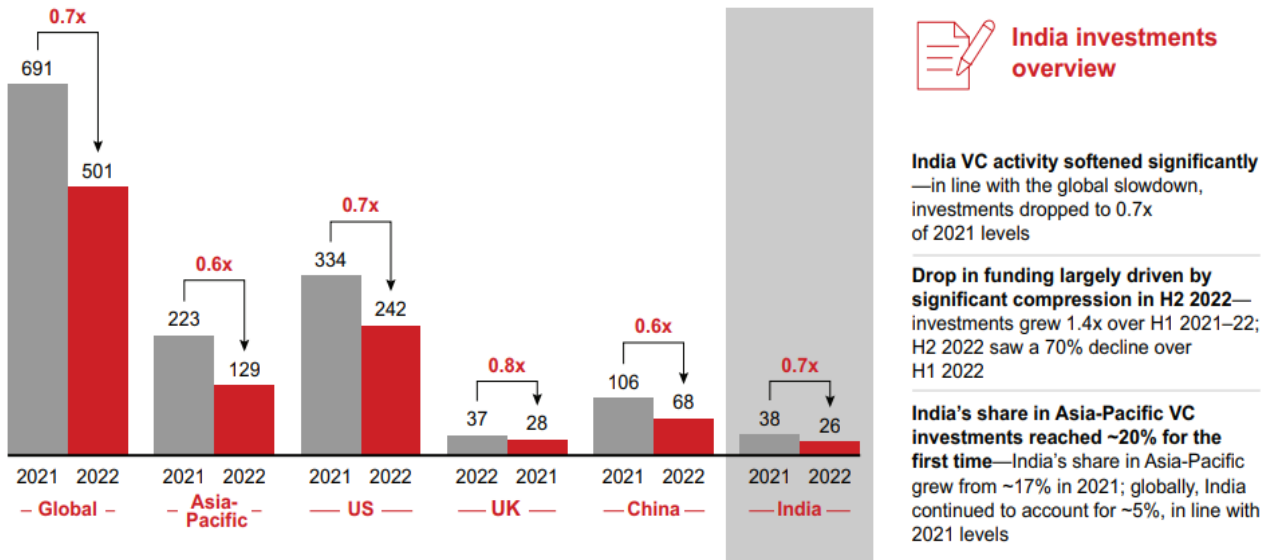
Figure 3 Average VC deal value in India for key sectors (\$m)

| YEAR | INVESTMENT THEME |
|------|---|
| 2017 | Consumer technology, Banking, Financial Services and Insurance, Telecom and Real estate |
| 2018 | Consumer Technology |
| 2019 | Consumer Technology, Fintech, and SaaS, B2B commerce |
| 2020 | Consumer Technology, Fintech, and SaaS |
| 2021 | Consumer Technology, Fintech, and SaaS |

Source: India Venture Capital Reports.

Figure 4 Key VC Investment Themes

Overview of global VC investments (\$B)



Notes: PE-VC investment figures include real estate and infrastructure deals; Investment value and volume excludes undisclosed deal value transactions (e.g., PharmEasy, Policybazaar, Qure.ai)
Sources: Bain & Company; Pitchbook; Venture Intelligence; AVCJ; VCCEdge

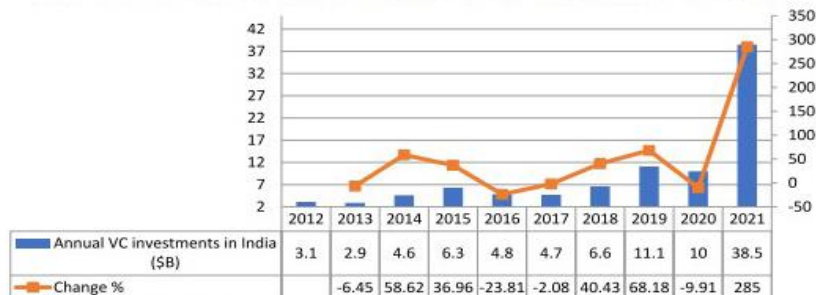
Figure 5 Overview of Global VC Investments

Number of VC Deals in India in Last Decade



Source: India Venture Capital Report 2022

Annual VC Investments in India in last Decade



Source: India Venture Capital Report 2022

Figure 6 Venture Capital Report

In addition to it, GOI's initiatives such as the Startup. Figure 5 shows India Programme with focus on encouraging entrepreneurship, make in India aiming to accelerate the ease of doing business in India, tax rationalization, fast-tracked approvals contributed to this steadiness (India Private Equity Report, 2016) [20]. Post this phase, the data for 2016 and 2017 reveal that number of VC deals and the annual VC investments decreased because VCs pursued better and quality proposals and did not throw caution to the wind on account of lacking clarity on exits. However, investor's confidence renewed with Marquee exits and the advent of new sectors for investment like Financial Technology and SaaS. Despite Covid-19, momentum carried on with investments in Consumer Tech and SaaS. An amount of \$ 3 Billion was raised by India focused funds in 2020, which is 40% higher than in 2019 (Indian Venture Capital Report, 2021) [19]. Although the momentum spilled over into 2020 yet the caution was exercised because of covid-19. The things boomeranged for Indian VC Industry in the year 2021, witnessing tremendous surge in both number of deals and the annual VC investments.

In fact, Figure 6 shows the investments in 2021 grew 3.8x over the previous year of 2020. This may be attributed to a number of factors which include digital economy catalysts like UPI-led payments, ubiquity of data, aadhare-Know Your Customer (KYC); eased SEBI regulations allowing tech-first companies in India go for IPO listings and increased exit momentum, and last but not the least, tightened Chinese regulations and crackdowns redirecting the funds deployment to Indian startups [21] (India Venture Capital Report 2022). In 2022, the world experienced a slowdown in venture capital (VC) funding, including in India. Investments in India decreased by 33%, from \$38.5 billion in 2021 to \$25.7 billion in 2022 [22]. This global caution in investing was influenced by various factors like economic uncertainty, recession fears, tightening of monetary policies, geopolitical issues, inflation, trade sanctions, and

concerns about corporate governance in VC-funded companies.

3.2 Issues and Challenges:

Here are the issues and challenges related to venture capital financing in India and private equity presented in bullet points:

Product Risk:

- Definition: There is little to no track record in the market, leading to high obsolescence rates.
- Impact: uncertainty about market acceptance and product success.

Entrepreneur Risk:

- Definition: difficulty in assessing new management and businesses without a proven track record.
- Impact: uncertainty about the capability and reliability of entrepreneurs and management teams.

Concentration Risk:

- Definition: Focusing on a small market, either product-based or geographical.
- Impact: increased vulnerability to sectoral downturns and a lack of diversification.

Technology Risk:

- Definition: difficulty in assessing new technologies, particularly for a small set of products.
- Impact: Hesitation to invest in ventures involving unproven or rapidly changing technologies.

Duration Risk:

- Definition: longer payback periods for funding.
- Impact: preference for shorter payback periods to mitigate risks and improve liquidity.

Asset Risk:

- Definition: high percentages of obsolete fixed assets; lack of collateralized assets.
- Impact: Limited security for investors; difficulty in recovering investments if the venture fails.

Small Deal Size:



- Definition: Small deal sizes are deemed uneconomical by most investors.
- Impact: Hesitancy to allocate resources to smaller deals due to perceived lower returns relative to effort.

Challenges Faced by Venture Capitalists:

1. Replication of a Business Idea:

- Risk: Private equity investors may replicate the presented business idea.
- Impact: loss of competitive advantage, potential conflicts of interest.

2. Use of Company for Other Investments:

- Risk: Private equity investors may use the company for the benefit of other investments.
- Impact: potential conflicts of interest and adverse effects on independent decision-making.

3. Performance-Driven Withdrawal:

- Risk: Investors may withdraw funds if the company fails to meet expected performance targets.
- Impact: financial challenges and instability for companies not meeting investor expectations.

4. Under-Valuation:

- Risk: Lack of market valuation for the company's shares may lead to undervaluation.
- Impact: Unfair terms for the company, potentially limiting growth and success.

Addressing these issues and challenges requires a comprehensive approach involving due diligence, risk management strategies, and effective communication between investors and entrepreneurs. Additionally, regulatory frameworks and industry best practices can play a role in fostering a more secure and transparent venture capital ecosystem.

Conclusion

The dynamic nature of the world, marked by constant change and evolving capabilities, underscores the potential of every startup to make a meaningful impact. While successful startups

exhibit higher growth rates, even those facing setbacks or failures contribute to the world by offering valuable learning experiences for investors and entrepreneurs. Recognising the transformative power of both successful and struggling startups is crucial, as lessons drawn from failures often lead to subsequent successes. Prominent technology startups like Apple, Amazon, eBay, and various online platforms stand as testimony to the journey from uncertain beginnings to becoming global industry leaders. These companies, now employing large workforces, initially faced doubts about their potential for success. However, their perseverance and strategic planning propelled them to the pinnacle of the business world. The trajectory of these successful startups emphasises the inevitability of encountering challenges in the early stages and the importance of unwavering confidence in the startup plan to attract venture capitalists. Venture capital investments play a pivotal role in nurturing the startup ecosystem. Funding is a fundamental prerequisite for any startup's success, and attracting venture capitalists becomes instrumental in providing both financial support and valuable experiential guidance from seasoned entrepreneurs. Additionally, certain startups may require government approval or assistance to navigate challenges unique to the startup process. Startups, by their nature, bring forth creative ideas and innovations that fuel business growth. Regions such as Silicon Valley and Singapore serve as exemplars of the profound impact of venture capital investments on startups and their transformative influence on countries and the global landscape. The Gross Domestic Product (GDP) of a country serves as a barometer of economic health, and the contributions of startups, driven by venture capital investments, significantly influence the balance and growth of economies. In essence, the success and evolution of startups, fueled by venture capital, are integral to shaping the economic landscape. Their impact extends beyond individual companies, contributing to the overall growth, innovation, and economic prosperity of nations. As startups continue to play a vital role in



driving change, fostering creativity, and transforming industries, the role of venture capital remains central to realising their full potential and making a lasting imprint on the global economy.

Scope for Further Research

- Explore the impact of macroeconomic variables on the risk and return of VC funds.
- Study the growth patterns of VC-backed firms using secondary data.
- Conduct a sector-wise analysis of venture capital investment criteria.
- Undertake a comparative study between VC-backed and non-VC-backed firms.
- Conduct an exclusive study on the post-exit status of VC-backed firms.
- Recognize the challenge of collecting sufficient data for meaningful results.
- Emphasize the importance of increasing the observations for improved reliability.
- Investigate the effect of variables by employing stage financing data on venture capital investments.
- Acknowledge the restriction to simple investments due to the unavailability of stage categorization data.
- Highlight limitations, such as the exclusion of factors like capital gains tax and labor rigidities, and a small sample size, leaving room for further research.

Suggestions and Recommendations

The suggestions provided in the study address key issues in the distribution of venture capital and propose measures to promote investment in Tier 3 and Tier 4 cities, as well as in specific sectors. Here are some additional insights and recommendations to complement the findings:

1. Capacity Building and Skill Development

Encourage the establishment of skill development programmes and training initiatives in Tier 3 and Tier 4 cities to enhance the capabilities of local entrepreneurs.

Collaborate with educational institutions to offer courses and workshops on entrepreneurship, business management, and technology to foster a culture of innovation.

2. Regional Investment Hubs

Establish regional investment hubs or accelerators in Tier 3 and 4 cities to attract attention from venture capitalists and provide a platform for startups to connect with potential investors.

3. Government-Industry Collaboration

Foster collaboration between government bodies and private industries to create a conducive environment for startups, provide infrastructural support, and address regulatory challenges.

4. Sector-Specific Incentives

Introduce sector-specific incentives to attract venture capital in critical areas such as renewable energy, healthcare, and sustainable technologies, aligning with national priorities.

5. Transparent Regulatory Framework

Advocate for a transparent and stable regulatory framework for venture capital funds, providing clarity from fund formation to liquidation. This will instill confidence in both investors and entrepreneurs.

6. Promotion of Innovation Ecosystems

Encourage the development of innovation ecosystems in Tier 3 and Tier 4 cities by supporting incubators, research parks, and technology clusters. This will create conducive environment for startups and attract venture capital.

7. Government backed guarantee programmes

Introduce government-backed guarantee programmes to mitigate the perceived risks associated with investments in semi-urban and rural areas, making them more attractive for venture capitalists.

8. Data-Driven Decision-Making

Promote the use of data analytics and market research to identify potential areas for investment in Tier 3 and Tier 4 cities, helping venture capitalists make informed decisions based on market trends and demand.

9. International Collaboration

Facilitate international collaborations and partnerships to bring in global expertise and investment, providing startups in smaller cities with exposure to a broader network of investors.



10. Awareness Campaigns

Conduct awareness campaigns to highlight the success stories of startups in Tier 3 and Tier 4 cities, showcasing the potential for growth and innovation in these regions to attract both investors and entrepreneurs.

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