

# Do You Have Enough Money For Square One?

Your start-up needs funds to start up! Angel investors, early-stage venture capitalists, incubators, and other institutional investors will be glad to stand by you if your idea is good. But you need to prove that to them, and build the faith—by staking your own money first. Lay square one, strongly, and they'll pile in with the remaining bricks.

issue theme



**g**reat ideas deserve fruition. No wonder, then, that entrepreneurs stake their all on such ideas. If they do it right (and if Lady Luck favours them), their company grows, brick by brick, goes for an IPO—and continues to grow. If not, they remain at square one, or worse, even a few steps behind that. But what matters is that they managed to begin—at square one. And with the experience gained from the journey, they will win some time soon.

Much has been said about the thrill of technopreneurship, and many of you are probably raring for a taste of it too. But most people get discouraged when they find they do not have enough money to start or run a company. After all, starting a business in a knowledge-based industry like information technology (IT) is not easy—you might not have real estate or machinery to mortgage and get a bank loan! That said, this perception is more due to a lack of information than a lack of funds itself. After all, if your idea is worth it, and if you approach the right sources, you can surely get the money needed to see you through the quintessential ‘start-up’ stage—and thereafter.

Through discussions with experts, this article explores the different stages of a start-up, the different sources of funds, what works best, and when.



### The fortune cookie

Good start-ups deserve to be funded, and invariably they will be—if the founders do the groundwork right!

## How many bridges have you crossed?

**O**n a poetic note, start-ups are like trees—the seed bursts and the first green shoot is out, and then the leaves, the flowers, and the fruits. And at every stage -- the sapling, the plant, and then the tree, different quantities of water are required. You should not over-water a *sapling*; you do not really need to water a *tree* much; but you need to give the *plant* adequate water. A company is also like that. At the concept (seed) stage, the validation

service yet, and haven’t shown it to prospective customers for feedback.

Then, at the validation stage, they develop a prototype, and receive initial feedback. “Note that even here, the model isn’t firm yet, and while the founders know how to solve the problem and the direction of the approach has been validated, there is still tweaking to do to get it down to a science,” explains Rohit Agarwal, author of *How Innovators Connect*, and founder-CEO, techTribe.



Things become more concrete in the growth stage, where the concept has not only been validated by an initial set of customers, but also been accepted by the market. The company is obviously ready to scale the model to great proportions.

It is important for an entrepreneur to understand the ‘real’ monetary needs of the company

(early) stage and then the growth stage, it needs varying amounts of funds, and the entrepreneur shouldn’t over-do or under-do it. Therefore, the first step is to understand the different stages of a start-up.

At the concept stage, the founders have the ‘seed’ for a company—they have identified a problem that they wish to solve, and have also zeroed in on a potential solution that they think will work. However, it is still an ‘idea’, which *they* think will work. They haven’t built a product or a

at every stage, and raise only that amount of funds. Early-stage funding is difficult and expensive, and therefore the entrepreneur must exercise discretion. “Typically, each start-up has an in-built limit beyond which it cannot function without funding. This might be the development stage of a complex project, or the replication of the pilot, or the go-to-market phase,” says P Sridhar Reddy, chairman and managing director, Ctrl S Data Centers Ltd. And the thumb-rule is that you should wait till then to raise funds!

# The concept stage

## “Convince me that you have a seed there...”

“I have great faith in a seed. ... Convince me that you have a seed there, and I am prepared to expect wonders,” said Henry David Thoreau. Investors will go a step further than expecting wonders; they will fund (and also guide) the realisation of your idea! But then, the issue of convincing them about the seed persists to this day. And the only way to do that is to get your ground research and ‘concept’ right. And to use your own money for it!

The first inflow of money for a project always comes from the entrepreneurs themselves. Sudhir Sethi, founder, chairman, and managing director, IDG Ventures India, is known in the field as a ‘Start-Up Specialist’. He points out that the initial investment for researching the idea and its feasibility and coming up with a more concrete plan is always thrown in by the entrepreneurs—by pooling in all their savings, taking a soft loan from the bank, mortgaging a house and assets, or borrowing from relatives



and friends. It shows their commitment to the idea, and how much faith they have in themselves and the success of the venture. For that reason, it is also rightly called ‘faith money’.

After all, why would a third-party investor be interested in a project at this stage—when even the idea has not taken shape? They need to be convinced of the promise, the seed, before they step in. Moreover, Agarwal points out that involving an investor at this stage might also be painful, because they might curtail the independence to experiment. “And this is the time for experimentation.

One has to figure out what solution works,” he says, adding that, “Hopefully, they have targeted the right problem.”

### Exception to the rule: An exceptional team!

As always, there are exceptions. Sethi points out that an investor might start funding the project from the ground up (truly!) if the team has an excellent track record. And the case of Mindtree Consulting shows that it is possible to get an investor even *before* there is an idea! In this case there was no business plan, nor a unique idea. There were just three excellent resources expressing their desire to work on some new venture. Sethi believed in each of them, and made them meet—confident that ‘1+1’ would be ‘11’.. The rest, as they say, is history.

IDG Venture’s Entrepreneur-in-Residence programme was also an exception. When Manjula Sridhar, a gifted technologist, came to him for money to fund her start-up, Sethi and T C Meenakshi Sundaram, partner—IDG Ventures India, believed she would win, by virtue of her knowledge and experience in the field of network security. Ms Sridhar was made an Entrepreneur-in-Residence, and mentored. The team came up with an idea, which IDG funded, and Aujus—a managed security services company—was formed.

## Validation stage

### Of seed capital, and angelic grace

Once you have an idea in place, you will have to validate it by building a prototype and testing it on customers. This is a very crucial stage, because the results can make or break your start-up (even before it happens). Do this right, and it might not be too tough to find investors.

Most serial entrepreneurs and

mentors agree that you must try to go through this stage too, on your own, without seeking outside investment. But can you? “It depends,” says Vijay Anand, founder, Proto.in, and head of incubation, IIT Madras’ TeNeT/Rural Technology Business Incubator. “If you are a company in the Internet space, you could probably bootstrap with nothing more than six months of

saving for you and your partner. With that you would probably be able to build a prototype, pilot it, and even initiate market traction.”

But what if you make bigger plans, what if your product needs state-of-the-art R&D that you cannot fund yourself; and if the market you are targeting is rather big? In such cases, you would have to seek investment at

this stage itself. And this is usually known as 'seed capital'.

Seed capital is an early investment for a start-up company. "[It is] basically to test the waters, for proof-of-concept, market research, or initial product development," says V K Mathews, CMD and CEO, IBS Group (a global travel, transportation and logistics solution provider). "But once you get your seed money, it will help move the project forward and increase the prospects of raising the launch financing. Indian tech start-ups are realising the importance of seed capital for prototyping their products, or offering an early version of their service—any proof of concept that can demonstrate your idea's potential and offer evidence to strengthen the business case. This is especially important if the entrepreneurs are building a new technology, or have a different business model that has no precedent."

Seed capital could come from your own savings, or from friends and family. From outside, you could look at aid from angel investors, who are there precisely for this reason—mortal angels who help competent souls with big dreams! Although the general impression is that there isn't much angel investment doing the rounds in India, Sethi says he does see a lot of tech start-ups getting angel-funding. And he also feels that venture capitalists treat angel-funded start-ups with more respect, because their idea and business plan is already validated by an expert individual, and some of the angel investor's experience and reputation also adds value to the start-up—a 'rub-off effect' as he calls it.

In India, an entrepreneur could approach investors like Indian Angel Network, very-early-stage VCs like the SeedFund Advisors, Erasmic Venture Fund, SIDBI Ventures, Venture East and Ojas Venture Partners.

Or you could look at a successful tech firm in that space, to which you can pitch your idea—they might be interested in incubating it. Educational institutions like the Indian Institute of Management, Indian Institute of Technology, and the Indian School of Business also have incubators. Alternate options are grant programmes from government institutions, such as the Department of Science and Technology and the Department of Information Technology that do offer monetary support for entrepreneurs.

Today, there are several off-beat options too. For example, you could enter a business plan competition to get this seed money.

### Suggestion: Avoid external investment at the seed-stage

Vijay Anand emphasises that the best source of money that a start-up should aim for is 'customer money'. Everything else is loaded with liability clauses—many more than what most start-ups envisage. He believes that building a prototype and the initial traction does not

require so much cash-burn for most of the ventures that come out these days, especially in the IT sector. Companies should really focus on a way to manage their financial requirements without having to go to an investment agency.

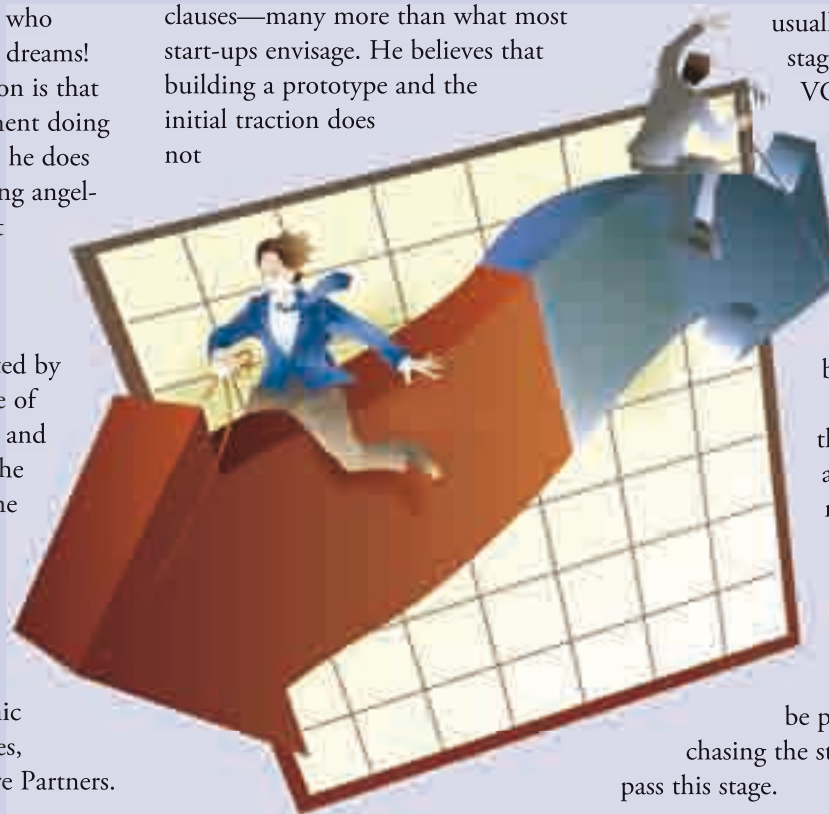
It is clear that the longer you wait to go to an investor, the more 'tested' your plan will become. This increases your chances of getting funded, and you will need to part with less equity in return. Your company will also be valued higher.

As always, Agarwal presents a less-discussed but interesting argument in favour of delaying the search for funds: "In the validation stage, there's still a lot of tweaking to be done in the model, and so, it's best for the founders to devote time to it, rather than spend months raising money from VCs. I see a gap between the attention needed, and what's given, by the start-ups. Since there aren't many sources of seed capital in India, I see start-ups spending time trying to get

VCs to invest, who usually don't, at this stage. There are some VCs who do, and almost every VC will tell you they do, but in reality, they usually do so only when they find the team to be rock-solid."

He also suggests that start-ups should avoid trying to raise millions of dollars, when all they need to get through this stage is 1/10<sup>th</sup> of that. According to him, there'll

be plenty of money chasing the start-ups when they pass this stage.



## Insight: The good side-effects of getting seed capital

The concept stage is almost always funded by the entrepreneurs themselves. At the validation stage, there is a choice of funding it yourself, or seeking investment from outside. While many experts recommend avoiding outside funding at this stage, the start-up might need seed capital if the validation is complex. Plus, the advantage of getting an institutional investor at the seed-stage is the added 'hand-holding' that comes with it.

Anand Lunia, the CFO of SeedFund Advisors, says that the seed VC provides crucial mentorship, motivation, and experienced advice on all aspects of the business like developing a scalable business model, setting up teams for operations, headhunting, and setting up advisory boards. VCs also offer expertise in sales, marketing and networking, strategic planning, PR activities, managing IP and legal issues, and fiscal planning and discipline.

If you have a non-investing mentor whom you can turn to for advice, then this might not be crucial for you—otherwise, it can be an indispensable value-add.

## Decide: How important is seed capital to you?

Anand Morzaria, CEO of Pennywise Solutions and tolmolbol.com, expresses his



## Models of funding

Anand Morzaria, CEO of Pennywise Solutions and tolmolbol.com, charts out his views on what models of funding generally work best for a start-up at each stage, and the order of his preferences.

Stage	Source	Equity/Debt
Seed Capital	Friends and family	Equity or short-term debt
	Self-funding	Equity or short-term debt
	Angel investors	Preferred equity or convertible debt
	VC-backed seed investments	Preferred equity
	Government funds	Equity or short-term debt
	University start-up labs	Equity or short-term debt
Early-stage financing	Business Angels or Groups of Angel Investors	Equity, debt combination
	VC companies	Equity, debt combination
	Banks	Secured Debt
	Government funds and schemes	Secured or unsecured debt
Growth-stage financing:	Banks	Typically Secured Debt
	VC Companies	Equity, debt combination
	Stock Market	Public issues
	Private Equity Placement	Equity
	Project Finance	Typically Debt

**Preference for seeking funds:** •Seed Stage: Friends and family •Early Stage Financing: Banks  
•Growth Stage: Banks, Project Finance, Stock Market by way of IPO

personal opinion that most Indian start-ups, especially those in the technology space, do pay good attention to the seed capital. However, he says, one big question that arises at the seed capital stage is how much one is willing to let go in exchange for that initial seed investment.

He explains with an example: "Let's say, a few friends decide to start a company that provides consultancy on chip design. The seed capital they need for setting up the basic environment to test their service and bring on the first customer is about Rs 20 lakhs. One of their contacts is willing to take the risk of giving them this money in return for a 25 per cent stake in the equity. How do you evaluate if it's worth it?"

"After three years, the company has a turnover of Rs 10 crores and is potentially valued at 25 crores. For a sale, they strike a deal with a buyer at Rs 18 crores. But 25 per cent of this goes to the seed capital investor who had nothing to do with the company in the last three years except for providing the capital of Rs 20 lakhs. Potentially, you would look back and wonder if the Rs 20 lakhs of seed capital was worth shelling out a crucial 25 per cent share-holding stake. This is the major

challenge most start-ups face when seeking seed capital. There is no real answer to how much stake is good for a particular amount of seed capital. It is purely dependent on the business owners' confidence, insight into their business, and the difficulty they have in attracting the seed capital at the start."

Simple though it seems, seed capital is actually a rather complex aspect of business. Too much could harm your business, while too little might end your business even before it starts. So, there is a lot to think about and compare, right from the sources, to the amount, to the debt-equity structure, and more. The fact that there are very limited sources of such seed capital in India makes it all the more tough. Getting money from friends and family is not without risk either—they would take even more liberty in pestering you for the return of the money, whilst you on the other hand might tend to take them for granted, as against an institutional investor! Work wisely, and watch your company survive this stage, and grow.

# STORY MENTORS



“An angel investor sees an individual (and the idea) and says, here is the cheque, whereas the venture capitalists come in only after they see a structure. In short, the angel investor is like a nanny while the venture capitalists are like potters, shaping the clay (company) in a definitive manner.”—**SUDHIR SETHI**, founder, chairman, and managing director, IDG Ventures India.

Sethi is known to be a “Start-Up Specialist” with several successful companies including Mindtree Consulting, Aujus, ConnectM, TechSpan (now HeadStrong) and Emploi Globale, to his credit.



“The entrepreneur should be aware of the terms of venture capital or private equity. Some of them could be extremely dangerous—especially the performance-related exit clauses.”

—**P SRIDHAR REDDY**, chairman and managing director, Ctrl S Data Centres Limited.

Ctrl S pioneered India’s first Tier-1V data centre in February 2008. This innovative company is headed by Sridhar Reddy, whose views on start-ups are pragmatic and practical, while being in sync with the spirit of daring.



“There is no one model that really fits all start-ups. There are theories that preach against angel funding, while I have also seen cases where start-ups are keen on running on angel funds as far as possible, to delay the investor funding that typically dilutes the equity.”—**MANISH RATHI**, delivery head, Version 1.0, GlobalLogic.

GlobalLogic’s Version 1.0 offering enables companies to address the challenges that arise while designing, building and launching software products, without any internal engineering staff. They enable domain experts and entrepreneurs to launch technology-enabled businesses that will be “fables” from the start.



“For start-ups, Angels and VCs are better and more popular routes than banks. Some banks like ICICI have venture arms, but usually not. I’ve never used banks for start-up capital—it just doesn’t make sense to me. Debt capital, secured by personal guarantee, would add to my stress!”—**ROHIT AGARWAL** is the founder and CEO of techTribe Networks, India’s career networking portal, where professionals accelerate their careers through knowledge, advice, and job referrals. He also co-authored ‘How Innovators Connect’, with award-winning journalist Patricia Brown. Through TiE, he also mentors young entrepreneurs.



“When the product/service is being launched, the major cost is the boost in marketing and sales expenses needed to roll out the first offerings. Meanwhile, the cash burn rate grows as new hires come on board each month. And the cash balance drops daily. This stage requires amazing fortitude.”—**V K MATTHEWS**, CMD and CEO, IBS Group.

With just around 55 staff members, IBS started operations in 1997 at Technopark, Trivandrum. The multinational company today employs over 2000 people, doing business from eleven offices/centres around the world.



“In general, the more an entrepreneur is able to postpone the absorption of capital without compromising business interests, the better is the valuation of the company.”

—**G B PRABHAKAR**, founder and CEO, Anantara Solutions.

Anantara Solutions pioneered Second Generation Outsourcing (SGO), a business model that combines business consulting and IT services to deliver unprecedented, measurable business value. The company raised \$6.5 million in seed funding from Helion Venture Partners and others, by virtue of its exceptional team. Founded in January 2007, Anantara was selected as a finalist to NASSCOM's Innovation Award 2007 and featured in the NASSCOM Top 100 IT Innovators of 2007.



“The concept of seed capital is not as well developed here in India as it is in other countries, where ex-entrepreneurs often form groups of angel investors to identify and invest in promising start-ups. Seed capital in India comes mainly from the founders and their immediate families.”

—**VENETIA KONTOGOURIS**, managing director, Trident Capital.

Trident Capital is a leading venture capital and private equity firm with over \$1.5 billion of capital under management, including \$400 million raised in its most recent fund, Trident Capital Fund VI. Trident focuses on investments in the business services, information services and software sectors across a variety of industries.



“VCs are essentially the folks who bring the nitro to the race car. When you've built a vehicle that can roll and keep moving and you have control over it, they bring you the money to make it go faster and reach new heights. Anytime before that, and you'd probably have a couple of fire accidents. Companies die faster having too much capital before they are ready.”

—**VIJAY ANAND**, founder, Proto.in, and head of incubation TeNeT/Rural Technology Business Incubator, IIT-Madras.

Proto.in, founded by Vijay Anand, has grown to become one of the most popular and reputed events for Indian tech start-ups to showcase their work.



“A promoter should look at a mix of both debt and VC funding beyond a point, so that value-creation happens for all equity holders.”

—**ANAND LUNIA**, CFO, SeedFund Advisors

Promoted by accomplished entrepreneurs including Pravin Gandhi, Mahesh Murthy and Bharti Jacob, SeedFund has investments from Google, Reliance ADA, Motorola and US-based VC firms including Sierra Ventures & Mayfield. They have a stake in Agencyfaqs ([www.agencyfaqs.com](http://www.agencyfaqs.com)) and their recent investments include [www.carwale.com](http://www.carwale.com), and [www.redbus.com](http://www.redbus.com).



“Raising capital is in some ways like wooing someone who is in turn looking for the ‘perfect’ partner. Getting the investor to say ‘yes’ can be a difficult process and requires the entrepreneur to be highly focused with regards to the vision and strategic direction of the company.”

—**ANAND MORZARIA**, CEO, Pennywise Solutions and [tolmolbol.com](http://tolmolbol.com)

Anand Morzaria and his team from the class of 2001 - BITS Pilani bootstrapped Pennywise Solutions in 2003. Right from building robust Web applications to offering Internet and search marketing services, Pennywise specialises in delivering end-to-end technology solutions for online businesses.

## What worked for them?

### Ctrl S Data Centres

"We were a start-up company 10 years ago and took venture capital from IDBI Venture Capital. The funding involved pure equity, a zero-coupon loan convertible to equity, and a pure loan. We do not think of the pure loan component as a part of venture funding; the zero-coupon convertible loan was definitely more useful than debt. Of course, now it has been converted to equity and we are actually thinking of going public and listing the company.

For Ctrl S, we have done the incubation, and now that we need hundreds of crores in equity, we are looking to work with investors. My first venture capital funding was Rs. 11 crores; now, we are looking for something 200 times that. So, now we are working with private equity funds along with venture funds. These things change with time, I guess."

### IBS Group

"I had to have significant paid up capital to invest upfront, plus a Rs 4 crore loan from commercial banks on a 1:2 equity/debt ratio. Obtaining a bank loan was indeed very, very difficult for a software company then—to the extent that I was almost about to shelve the IBS venture. Looking back, it looks strange; we paid back the entire loan in one year, and the company made healthy profits every year throughout its 10 years of operations, and is heading towards achieving a revenue of Rs 1000 crores in 2010."

### Anantara Solutions

"What worked for us was raising a fairly sizeable sum of money (US\$ 6.5 million) from illustrious VC firms, as seed capital, since we got a fair valuation of the company. We absorbed all the money in one stage, rather than seek stage-wise placement, since we had to invest in creating a minimum scale without which we couldn't have started up a revolutionary business based on Second Generation Outsourcing (SGO)."

## The growth phase Time to bring in the money



**t**he growth stage typically sets in after 3-5 years of operation. At this stage, the product has been built, the pilots have been done, scalability options are in place, the risks are lower, and mid- to late-stage VCs will be eager to invest—if the product/service offered, and the team, are great. The venture capitalist will study various factors, such as the size of the market, and most importantly the team, and then decide how and how much to invest. Depending on the stage of the start-up, the VC would also tie its funds to milestones, as well as exit conditions in case of non-achievement.

Almost always, a VC funds a start-up for equity—since the VC literally stakes its money, it also expects good rewards if the start-up succeeds. Normally, the VC might hold between 20-40

per cent of the company it funds, which gives it enough when the company does well.

The good part is that VCs typically work with you to ensure that the company does well—that is why Sudhir Sethi refers to venture capitalists as potters. They offer a lot of hand-holding, and often go out of their way to ensure that your start-up succeeds. They are with you all the way up to providing pre-IPO financing, to help clean-up the balance sheet!

There are several venture capital firms in India, including Canaan Partners, IDG Ventures India, Helion Venture Partners, Trident Capital, Nexus India Capital, Sequoia Capital, etc.

### Insight: Is the VC involvement good or bad?

The deep involvement of VCs in the start-ups they invest in can be

## Incubation

Although the term has become very popular recently, incubation is actually a very old model of 'hand-holding'. One must however be very clear about the fact that an incubator may not necessarily 'fund' the company. Rather, it provides guidance, and in many cases, provides physical infrastructure such as floor-space or compute infrastructure, for the start-ups to develop their products/services. It would also guide the start-up on several aspects, including how and where to get funds. Incubators of educational institutions like the IITs and IIMs are very well known.

There are also incubation models where the incubator funds the start-up. This typically happens in cases where big tech firms spin off small companies to research or develop some components of their solutions.

"Very often, large tech firms use an incubator model to develop new products, since it may be viewed as the best way to foster innovation and adequately compensate and retain the services of outstanding entrepreneurs who would otherwise leave the firm. On occasion, the start-up can also be viewed as a way to showcase and create demand for a company's products, in which case there can be a lot of hand-holding. If the product or service is essential to the company's future, then the goal is eventually to take over the firm, and integrate it into the company's operations," says Venetia Kontogouris.

But is the goal always to take over the start-up? Rohit Agarwal explains that it differs for each case. "A lot of them are spun off with technology from the parent, and for the IP, the parent owns say 50 per cent of the initial stock—so it's like having the parent as the co-founder. Usually, the start-up would go for funds elsewhere after a certain stage, because someone has to 'price' the start-up, and a parent company with 50 per cent equity interest isn't the best source. The most important value a high-tech firm provides is access to infrastructure, people, and markets (could be a customer themselves)."

Vijay Anand, who heads an incubation unit, explains in greater detail: "Cisco started off with a model of intra-preneurs. Wipro has a similar program, and so does Honeywell. The way it works is that if a team of people come up with a concept, and if it makes sense to the in-house incubator of the company, they set aside the team and let them work on it. Once built, and tested, and if it works and shows promise, the company is incorporated, and funded to adequately support them for some time. The parent company takes a stake in the company, with the first right of refusal for a sale offer. If the company eventually grows to a point where strategies do match and the parent company could use a product of the subsidiary's in its portfolio, there is a merger. If not, the company grows, and eventually is sold, or makes an exit. In any case, the parent company, because of its holdings, gets its returns. This is the general idea. Companies have their own twist in this tale!"



good or bad—depending on how well you handle them. Remember that it's not always the VC who picks the start-up; the start-up also needs to pick the right VCs to approach—else managing their involvement can be detrimental to the company. "The largest risk a start-up faces is to take on partners—in exchange for common equity or preferred stock—who do not share the same vision and commitment to the company's future as the founders, since there are many decisions that will have to be made together," stresses Venetia Kontogouris, managing director, Trident Capital.

"I've known VCs who've rolled up their sleeves and behaved as if they're part of the team (my kind of VC), and also those who've believed they have all the answers and expect the CEO to just follow (not my kind)," explains Rohit Agarwal of techTribe. "It is like a marriage—the red flags one sees in the courting process get bigger after you get married. The difference—with a VC, there's no divorce. You can't fire them! So be careful—I personally like having VCs on board, as their broad experience helps me brainstorm concepts, and they're trusted advisors. They also see what else is going on in

the market, and so they're a great source of market data."

## Explore: Private equity

Private equity (PE) firms typically pool in monies from high net-worth investors (HNIs) and invest these in equity—in growing firms, either pre- or post-IPO. If you look at the stages of a company's evolution, they step in after VCs. They usually invest only for a limited period of time, and step out once they get the required returns. But when they are involved, they normally interfere heavily in the operations of the company, with a senior director sitting on the board. A lot of companies approach PE investors only when they are very strapped for cash, and also need a lot of guidance to achieve their goals. However, they need to

be extremely wary of the exit clauses, as they can be quite draconian.

One interesting aspect of PE firms is the role they play post-IPO. Sometimes, firms find themselves getting too drawn into the short-term goals and unable to work out drastic changes in their strategy, by virtue of being answerable to the shareholders. In such cases, they may approach a PE investor, who will buyout the shares and transition the company to 'private' mode again, enabling major restructuring. Once that is done, the company will be re-listed afresh in the stock exchanges, and the PE investor might step out.

Private equity options in India include the Indian wings of global firms like Warburg Pincus, Blackstone and the Carlyle Group, and Indian players like ICICI Venture and Chryscapital.

## Debt or Equity—A crucial decision at every stage

Typically, when you speak of institutional investments in start-ups, you hear mainly about equity-based investments, such as angel funds, venture capital and private equity. Here, the investors fix a particular percentage of the company's shares that they wish to hold—this decides the share of profits that they get, and the 'say' they have in the company's running. As you can surmise, equity dilutes the stake the founders have in the company, and, consequently, their decision-making powers.

It is therefore not as straight-forward as debt—such as a bank loan, that you pay interest for, and return thereafter. Some forms of equity are extremely risky too. Sridhar Reddy, for instance, warns entrepreneurs against 'preferred equity', where the entrepreneur has the same responsibility towards the investor as with a bank, but pays a much higher cost for funds. "Even more loaded is the equity that comes in with a floor on the returns and seemingly generous terms at the higher levels of internal rate of returns (IRR)," he says.

He points out that equity models could also have extremely risky performance-related exit clauses, and that start-ups, especially in the initial stages, should rather consider direct debt than such models. Others, such as V K Mathews of IBS, also suggest direct debt as a good source of the initial capital, without any interference in decision-making.

While the most obvious source of direct debt that comes to mind are banks, getting loans from banks for tech start-ups is not too easy in India. Except where they have a separate venture investment wing, banks usually require collateral securities, letters of intent and agreements, and follow many such formalities, which are quite difficult to fulfil in an intellectual-property-based industry like IT. Therefore, public sector banks, which once fuelled and created the manufacturing sector, are not too active in the IT revolution. That said, it is possible to get loans to the tune of Rs 25 lakhs from SIDBI and other government agencies that promote small enterprises, without high collateral requirements.

"Banks are usually not a good source of funding, unless it is through their venture capital unit, since banks focus on providing short-term financing to smooth out the cash flow needs of a business. In a start-up, there is nothing but negative cash flow for quite a few years, with no clear source of repayment, making typical lending a real challenge," explains Kontogouris.


Despite the meagre availability of bank loans, technopreneurs should consider a capital structure that includes debt and equity—even if it comes from venture investors and not banks. VCs do agree to reasonable debt components in the funding structure, and in some cases they even arrange for debt funds from third parties while structuring the deal. Investors and entrepreneurs might also work out convertible options—where loans can be converted to equity at a later stage, depending on the success of the firm.

As G B Prabhat, founder and CEO, Anantara Solutions points out, there is no standard formula for structuring the capital required as debt or equity, as the structuring is extremely situation-specific. Pure debt financing, however, is extremely rare in tech start-ups, and happens either early in the concept stage, where the entrepreneur might mortgage some private property for a loan, or in later stages, to bridge a company's cash needs until the next round of equity financing is completed.

## Exercise discretion, and you'll do well

On considering the routes of funding available to a start-up at each stage, it is obvious that there are risks and advantages in each model. And although it comes as a surprise, it is important to note the experts' point of view that too much funding is as harmful for a start-up as too little.

While all entrepreneurs will be eager to get the money required to fire up their start-up as early as possible, it is very crucial that you analyse the inherent risks of the model of funding, the reliability of the source, compatibility with the investor, the optimum amount of funds required, the debt-equity distribution, the exit clauses, and so on, before touching the money.

And all we have to add is: Venture into the bright blue skies, but not without a parachute! 

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