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Opportunity or Bane? Studying the Impact of Covid-19 Pandemic on the Venture Capital Industry in India

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Abstract

Covid-19 is transforming the way business is conducted. Innovative ideas and solutions to solve existing problems and the ones that have come up due to the pandemic are being encouraged. All this is not possible without adequate funding to these new ideas. The paper attempts to understand the changing paradigm of capital provided in India to new ventures due to the pandemic. The trend shows that overall entrepreneurial funding has increased when compared to the last 2 years, although majority of this has been garnered by two existing matured companies. The pandemic comes as an opportunity for the sponsors to cherry pick and hunt for a better bargain. The venture capitalists are funding those portfolio companies which have a higher rate of survival.

Keywords: Venture Capital, Covid-19, Private Equity, Funding Pattern

Introduction

Venture Capital (VC) is defined as money invested towards longer term, unquoted, risk equity funding by professional investors in new companies. The biggest reward of the funding is the chance of capital gain along with the potential regular income in the form of dvidend. Venture capital is primarily patient capital which augments other traditional sources of finance such as external commercial borrowings, private placement and so on. Sequoia Capital, Accel, Bessemer Venture Partners are some of the top VC firms in the world.

Indian Private Equity & Venture Capital Association (IVCA) (Private Equity, 2020) defines 'Private equity (PE) funding which is primarily invested for medium & long term and in exchange for an equity stake in private companies which have the potential to outperform the market.' Such funding is usually made to ensure a turnaround for distressed companies or to provide liquidity in cases such as an IPO or to facilitate sale to a public organization. Few of the top PE firms are The Carlyle Group, KKR, and Blackstone.

Venture Capital and Private Equity are at times used interchangeably as both represents "risk equity finance" to business ventures, but in definition both are different. The major difference between the two lies in the stage of financing and the percentage stake acquired by the funds. VC funding generally represents early-stage financing: pre-seed, seed, and early rounds and involves acquisition of minority stake in the company whereas PE represents funding for those companies which are relatively matured, looking for expansion and growth financing and involves acquisition of large and sometimes majority stake in the company. VC financing is riskier as it invests in early stage of the investment cycle of a company.

Corona Virus Disease (Covid-19) has impacted various industries across the globe. A global crisis of this magnitude which brought the world to a standstill will have long lasting impact. Money which is an essential commodity for any economy, more so for a fast-developing nation like India becomes tough to come by in such times of crisis. Venture Finance which is a very important source of funding for startups as well as matured companies nosedived immediately after the announcement of the nationwide lockdown imposed by the Government of India (GOI) in March 2020.

VC-PE investments in India rose to their highest levels in the last decade at $45 billion[1]. This was due to rise in average deal size as well as increase in quantum of large deals. India has been growing at a fast pace and in order to achieve the vision of a $5 trillion economy by 2024-25, India needs to attract a lot of investment. VC-PE investment has been growing steadily as an alternate source of financing; thus, it becomes important to study the impact of Covid-19 on the quantum as well as the funding pattern of VC-PE investments.

Covid-19 undoubtedly has changed the contours of investment as investors are cautious funding riskier bets and look to negotiate for more favorable terms and conditions. A paper on the Harvard Law School Forum on corporate governance which has discussed the impact of covid- 19 on investment terms of VC mentions change in the terms of liquidation preference, changes in priority of funds that will be invested, change in participation rights, and expanded preferred stock voting protections as some of the changes to investment terms applicable to future PE deals. It also remains to be seen how the investment firms use the current COVID-19 crisis for bargain hunting as new companies look for 'survival funding rather than growth capital'.

Literature Review

The ongoing COVID-19 pandemic has led to a very large economic shock which is much bigger than what was linked with the 2008 Financial Crisis which originated in the US and akin to the level of uncertainty created during the 1929 Great Depression (Scott R. Baker, 2020). The 2020 recession is expected to be one of the most serious recessions since the Second World War (Francisco Linan, 2020). The study revealed that the pandemic will be generally damaging, but it might not be as bad as it was initially thought. The pandemic will have an effect on the sources of entrepreneurial finance all across the world.

Traditionally venture finance requires in-person interaction between the potential investors and the entrepreneurs and such a relational nature of risk financing is expected to make VC more susceptible to the ongoing crisis (Ross Brown, 2020). The quantum of new equity deals has substantially declined in the United Kingdom since the onset of the pandemic with seed stage being the most affected.

A lot of research is being conducted to study the impact of the pandemic on various funding sources. A survey of institutional venture capitalists at the height of the pandemic in September 2020 revealed that they have slowed their pace of investment by 71% of regular and expect to invest 81% of regular in 2021 (Paul Gompers, 2020). Overall, VC's expect little effect on their fund performance in terms of Internal Rate of Return **(IRR**, -1.6%) and Multiple on Invested Capital (**MOIC**, -0.07).

High growth companies create employment, fuel innovation, and add to the economic growth of a nation, and thus VC-PE funds, angels and crowdfunding platforms play a critical role in facilitating a financial 'runway' that helps the start-ups with an opportunity to attain profitability (Mason, 2020). Mason documents that Covid-19 will lead to a decline in entrepreneurial finance, both in number of deals as well as total funds invested which will lead to a negative impact on the economic growth, as investment firms shall lose their enthusiasm for VC as an alternative investment option.

VC saw a sharp decline following the covid-19 pandemic and was not limited to any particular sector or category. The downturn is seen across industries and is largely concentrated in early-stage ventures which is consistent with recessions over the past 40 years (Sabrina T. Howell, 2020). PE managers are of the opinion that 4 out of 10 of their portfolio companies have been moderately negatively affected and 1 out of 10 has been very negatively affected by Covid-19 (Paul A. Gompers, 2020). Despite the pandemic, the PE fund managers are looking for new investment opportunities and viable business opportunities to invest in. The PE managers though are more pessimistic than the VCs that were surveyed by the authors.

Covid-19 has led to startups leveraging successfully the resources which are available for survival as a first and immediate response to the crisis but at the same time the crisis has put the innovation and growth of these companies at risk. Thus, policies should help startups by mitigating the pressure of constrained cash-flow and at the same time it should aim at long-term measures with support from the broader entrepreneurial ecosystem which can ensure fast paced recovery and eventually growth (Andreas Kuckertz, 2020).

In order to minimize the impact of the pandemic, countries through the central banks are forced to pump in more funds in their economies. Since money is of limited supply and more so at the height of a pandemic, primary point of discussion should be prioritizing those industries which have been or are likely to be hit the hardest and accordingly prioritize funding for such categories of companies and other support instruments (Prohorovs, 2020).

Global crisis of such a magnitude will have a long-term impact on how money is allocated across sectors and industries (Andrea Bellucci, 2020). The paper examines the reallocation effect due to the ongoing pandemic on the VC industry and explains a shift which is happening in the funding related activity in deals in crisis related categories. They have established a positive relationship existing between the spread of Covid and venture capital investment in the deals happening in the pandemic, in terms of volume of invested funds and the frequency of transactions. It also establishes that the venture capitalists experience and origin affect the magnitude of the reallocation. Such research studies which study the impact of the current pandemic on the Indian Venture Capital market is limited and the current paper tries to fill this gap.

Objectives of the study

Venture Capital is an important source of innovation, job creation and as a result contributes towards economic growth (Colin Mason, 2020). India is a developing economy and aspires to become a $5 trillion economy by 2024-25[1]. With increase in VC-PE fund raising over the years ($41 billion in 2020)[2], entrepreneurial financing through VC-PE route is emerging as an important alternate route of financing. Covid-19 and follow up measures (lockdown and social distancing) to deal with the pandemic by the government has led to a slowdown and recession in India.

Thus, to bring out the actual impact of the pandemic induced crisis on the VC-PE industry is of utmost importance especially due to its increased importance as a funding source in the recent years. The primary objective underlining the current study is as follows:

1. To document the impact of Covid-19 on the VC-PE flows in the Indian economy
2. To investigate the VC funding pattern as a result of the crisis

Research Methodology

Data for the current study has been collected from the Crunchbase database, regulatory sources, and company reports. Crunchbase is one of the leading and reliable providers of VC-PE data for Indian companies.

Collection of VC-PE data in India has its challenges like incomplete or unavailability of information, duplicate transactions and authenticity. This is due to the fact that there is no regulatory requirement for private companies to report such funding transactions in public domain.

In order to overcome such challenges, different databases follow different guidelines to comprehend public data available through news aggregators, news agencies, company filings, or information sourced directly from investment firms.

In light of the above challenges, current study uses the following parameters for selecting and filtering the secondary data for VC funding considering data arrangement in crunchbase.

- Only equity funding has been considered as debt funding is not clearly defined and can include term loan, convertible loan, or venture debt

- No private investment in public equity (PIPE) and post-IPO deals have been taken, so all the portfolio companies are private companies

- Data doesn't include any corporate round. Corporate round is a strategic investment which is made by a company rather than an investment firm.

Crunchbase uses various terminologies to depict the funding stage and to demarcate the funding type for the portfolio company. Only the funding stage terminologies relevant to this study have been mentioned below.

Funding Stage	**Definition as per Crunchbase**
Seed	• Angel • Pre-seed • Seed
Early-Stage Venture	• Series A • Series B
Late-Stage Venture	• Series C- Series J
Private Equity	• Late-stage round led by a PE firm

The funding stages- Early Seed, Seed, Early-Stage Venture, Late-Stage Venture, and Private Equity have been linked with funding type on the basis of data collected from crunchbase. Detailed explanation of funding type as used by crunchbase above has been mentioned in the appendix[#].

Certain data points have been taken from periodic private equity reports by Indian Private Equity and Venture Capital Association (IVCA) prepared in association with consulting firms EY and Bain & Company. Data from all the sources have been checked for inconsistencies and only those transactions have been included which fulfill the above filters and criteria, like transactions will no deal size have been eliminated for consistency.

Findings & Analysis

Government of India (GOI) announced the nation-wide lockdown on March 24, 2020. Thus, in order to assess the post-covid impact on entrepreneurial finance, VC-PE data has been collected for the financial year 2020 (referred as post-covid 2020 thereafter). Since the lockdown was announced in March, so FY’ 20 data doesn’t include March figures.

Post-Covid Data Range	Period	Referred As
FY 2020	April’ 20- February ‘21	Post-Covid 2020

For pre-covid comparison, VC-PE data has been collected for 2 years before covid-19. For consistency with FY 20 data, March data has been excluded in both FY 19 and FY 18 period.

Pre-Covid Data Range	Period	Referred As
FY 2019	April’ 19- February ‘20	Pre-covid 2019
FY 2018	April’ 18- February ‘19	Pre-covid 2018

There were a total of 1071 VC-PE transactions for post-covid 2020 as compared to 1398 for pre- covid 2019, a 23% decline compared to last year. When we compare this to 1683 deals of pre- covid 2018, the decline comes out to be 36%. As previously highlighted in challenges with VC data, the above VC-PE data also has some deficiencies. Out of 1071 post-covid 2020 transactions, only 724 have a disclosed deal size. In order to further study the available data and draw conclusions, only those transactions have been studied which had a disclosed deal size.

724 post-covid 2020 transactions with disclosed deal size translates to a 27% decline when compared to 997 transactions of pre-covid 2019 and a 15% decline vis-à-vis pre-covid 2018. But the total deal size for post-covid 2020 transactions stood at a whooping $27 billion as compared to $17.7 billion in pre-covid 2019 and $14.2 billion in pre-covid 2018. This translates to a 53% rise over FY 2019 and 90% over FY 2018.

Table 1: Total Funding amount (Billion $)

Quarter / Year	FY 2020	FY 2020*	FY 2019	FY 2018
Q1	11.1	1.6	4.1	3.8
Q2	7.6	3.8	4	4
Q3	6.2	3.2	7.0	4.5
Q4	2.1	2.1	2.7	1.8
Full Year	**27**	**10.7**	**17.7**	**14.2**

*Figures without Reliance Jio & Reliance Retail funding
Source: Crunchbase

The surprising rise in total deal value for FY 2020 especially in period of covid crisis can undoubtedly be attributed to bargain buying by investment firms as portfolio companies were looking to raise "desperate capital" due to complete stoppage of business and uncertainty in opening up of the economy. This was also due to new business opportunities and segment that have come up as a result of the crisis.

But a deeper look into the post covid-2020 numbers show that Reliance Jio and Reliance Retail accounted for over 60% of total equity funds raised by investment firms in FY 2020. A total of 14 rounds of fund-raising totaling $16.3 billion inflated the total figures for FY 2020.

So, excluding the Jio & Retail investments, total VC-PE investments for post-covid 2020 stands at $10.7 billion which is a 40% decline from FY 2019 and 25% decline from FY 2018 figures. As expected, figures for Q1 FY 2020 represents a marked decline as this is the time when GOI announced the lockdown and hence most affected.

Table 2: Funding Stage –Wise (%)

Funding Stage	Seed Stage	Early Stage	Late Stage	Private Equity
FY 2020				
Q1	42%	24%	15%	6%
Q2	55%	17%	12%	6%
Q3	56%	17%	11%	5%
*Q4	50%	18%	11%	5%
Full Year	**51%**	**19%**	**12%**	**6%**
FY 2019				
Q1	52%	21%	21%	3%
Q2	48%	23%	10%	6%
Q3	51%	21%	13%	5%
*Q4	48%	24%	14%	3%
Full Year	**50%**	**22%**	**12%**	**4%**
FY 2018				
Q1	54%	18%	7%	5%
Q2	50%	16%	9%	4%
Q3	46%	25%	9%	5%
*Q4	51%	23%	11%	6%
Full Year	**51%**	**20%**	**9%**	**5%**

*Q4 denotes January to February;

Source: Crunchbase

Table 3: Total Funding Received Stage Wise (bn $)

Funding Stage	Seed Stage	Early Stage	Late Stage	Private Equity
FY 2020	0.4	1.25	4.17	19.43
FY 2019	0.46	2.52	8.6	4.18
FY 2018	0.29	1.44	5.11	4.75

Source: Crunchbase

Table 2 shows the funding pattern for all the three periods quarter wise. It is evident that immediately after the lockdown, number of seed funding rounds in Q1, FY 2020 stood at 42% of all the transactions in the year which is drastically lower when compared with the annual average of 51% and with 52% in Q1 2019 and 54% in Q1 2018. But 6% share of private equity funding in Q1 FY 2020 shows a 100% increase Y-O-Y.

This can be attributed to the fact that investors became wary of investing in new startups in the period of uncertainty and held back investments in riskier new investments. It can also be drawn that investment firms continued to fund their more established portfolio companies which had higher chances of survival in the aftermath of the crisis as is evident by uptick in late stage and more so in private equity numbers in FY 2020.

Although the figures for seed and stage financing might garner the majority number of transactions (see table 2), but they represent a miniscule number in terms of total deal value. 42% of the total seed transactions in post-covid 2020 represent just 1.5% of the total deal size of US $27 billion whereas 6% of the private equity represent 72% of the total deal size (see table 3), although that figure comes down to 30% without the Reliance Jio & Retail investments.

Conclusion & Discussion

There were a total of 1071 equity VC-PE transactions in 2020 in India, which is a 23% decline to 2019 VC-PE transactions and a 36% decline vis-a-vis 2018. This is in line with the existing literature which argues that covid-19 will lead to a decline in number of deals in the immediate future.

When we only consider transactions with a disclosed deal size, post covid 2020 total deal size stands at a total of US $27 billion. This shows a rise of over 50% over 2019 and nearly 90% over 2018 figures. This is in contradiction with the existing literature which predicts a fall in deal volume all around the world post covid.

On the other hand, if we remove the 14 rounds of funding received by the Reliance group, the remaining total deal size of just over billion shows a completely different picture which translates to a decline of 40% and 25% vis-à-vis pre-covid 2019 and pre-covid 2018.

This brings us to the point where we can clearly see the covid impact on number as well as quantum of funding received from VC-PE transactions. The lockdown did impact supply chains across the globe, suppressed or zero demand in certain categories and fear of the pandemic did keep the venture capitalists out of action. But at the same time US $16 billion worth of transactions which were garnered by just two entities of the same group (Reliance Jio-8 rounds and Reliance Retail-6 rounds) clearly show that there is no dearth of capital for the right venture.

It is also evident from the quarterly distribution of stage wise funding data that seed stage funding showed a sudden decrease in Q1 after covid, but it suddenly picked up in the next 2 quarters and normalized in Q4. This can be attributed to judicious usage of funds as investors were vary of investing in small companies as chances of their survival was less when compared to late stage or growth startups. This is clear with a high and stable private equity investment data in all the quarter of post covid 2020. A pick up in seed funding in Q2 and Q3 of post covid 2020 can be attributed to bargain buying as these small seed stage companies needed survival funding and hence depressed valuations and bargain buys for venture capitalists.

Covid- 19 has slowed down the venture funding activity in the aftermath of the crisis but with the systematic and quick roll out of vaccine all over the country it looks like we will be in for an interesting year ahead for the entrepreneurial world. The post covid world will bring the forgotten as well new categories and industries in focus which will be an interesting area of further research.

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Appendix

#Funding Type:

Seed and angel depict funding in the pre-seed, seed and angel rounds. Crunchbase includes various rounds of venture financing in unknown series, equity crowd funding rounds as well as convertible notes at $3 million or less (depicted in USD/ or on converted USD equivalent).

Early-stage funding consists of Series A and B, as well as other round numbers. The database includes unknown series of venture rounds, corporate venture rounds with deal size between $3 million and $15 million.

Late-stage round consists of Series C, D, E and later venture funding rounds fand follows the Series followed by ‘Letter’ naming convention. It also included venture rounds which are of unknown series, corporate venture rounds and other rounds with deal size above $15 million.

Technology growth round of funding is a PE (Private Equity) round which is raised by an entity that has previously raised a VC (venture capital) round. So, it includes any funding round as defined above.

Quantum of Reliance Funding quarter-wise

Investments ($billion)	Q1	Q2	Q3	Total
Reliance Jio (8 rounds)	9.5	0.35	Nil	9.85
Reliance Retail (6 rounds)	Nil	3.4	3	6.4