STANDING COMMITTEE ON FINANCE

FINANCING THE STARTUP ECOSYSTEM

TWELFTH REPORT

ABSTRACT

This report discussed the Startup Ecosystem of Indian Economy and its contribution towards the financing of the startups. It was further followed with several recommendations by the committee to channelize the startups and make India self-reliant with sustainable economic growth.

INTRODUCTION- A STARTUP ECOSYSTEM OF ECONOMY

A startup ecosystem enables the **flow of high-impact innovations into the economy**. Innovators and entrepreneurs develop and launch solutions to solve real-world problems at a large scale. It also accelerates job and wealth creation to drive national power. The growth of the startup ecosystem is an important national priority in all major economies. India's ability to rise and show resilience in the post pandemic period vitally depends on the quality of the startup ecosystem. **Such an ecosystem includes incubators, startup accelerators, venture capitalists, private investors, foundations, entrepreneurs, universities, government, corporations, mentors and the media**. These factors play a key role to realize India's potential at a global scale and help in achieving the goal of Aatmanirbhar Bharat.

India is on its track to become one of the biggest consumer markets in the coming year. Entrepreneurship is one of the key pillars to drive India's growth. India must ensure to support its innovation hubs that bring together entrepreneurship, industry, capital, and research. The startup ecosystems are a composition of specialized talent, research, entrepreneurs, optimistic market and capital funds.

India has produced **more than 50 unicorns - that have reached $1 billion in equity valuation**. These unicorns are now worth more than $500 billion collectively and have contributed to job and wealth creation. These startups are started with institutional investors such as venture capital and private equity funds. Their business success is majorly due to their proprietary intellectual property, innovative business models and entrepreneurial hustle. IT services, telecom, financial services, airline, e-commerce, and retailing industries have the maximum unicorns.

In the past decade, India created about 35 unicorns and 60 soonicorns (businesses with the potential to become a unicorn) that raised about $40 billion in equity financing. Therefore, to reach unicorn status at a nation or global scale, startups initially have to raise capital in equity financing otherwise India won't be able to tackle the global scale competitors. According to the industry data, more than 80% of startup finance is channelled through the venture capital, private equity industry and foreign capital. The goal of the Aatmanirbhar Bharat can be only achieved by strengthening its financial system.

A. The Startup Ecosystem in India

The Startup India initiative was launched by the Honourable Prime Minister on 16th January, 2016 with an objective to construct a strong ecosystem for strengthening innovation and startups in the country. The initiative is managed by the Ministry of Commerce (Department for Promotion of Industry and Internal Trade) to boost economic growth and induce employment opportunities at a large scale.

There are six broad categories of Startups in India for Entrepreneurial activity.

***Category I:* Scalable in Emerging / Fast-businesses in growth sectors (Unicorns)**

These ventures have scaled up with countrywide operations. Multiple rounds of funds have been received from venture capital. More than 80% of capital is coming from foreign sources while China has invested over Rs. 30,000 crores in 18 of 30 unicorns of India.

***Category II:* Hyper-growth technology businesses**

These ventures have innovative business models to create new markets or to survive in existing markets with an aim of high growth revenue.

Category III: **Innovation driven by Intellectual Property (IP)**

These ventures focus on Research and Development (R&D) and to create unique products and services, and have low returns in revenue.

Category IV: **Priority Sector Enterprises**

Such ventures aim to work in rural areas such as agriculture, affordable housing loans etc with low profitability.

Category V: **Me-Too Enterprise**

These ventures focus on a previously-proven business model. They emphasize on minimising cost and maximising revenues.

Category VI: **Grassroots Innovation**

This innovation aims at delivering everyday products and services at low cost by incorporating local knowledge.

I. India has become the third largest startup ecosystem in the world. It has grown by 17% each year between 2012 and 2019. While the funded startups have shown annual growth of 19%. The Department for Promotion of Industry and Internal Trade (DPIIT) has introduced the National Intellectual Property Rights, 2016 with an objective to establish an IP framework and enable the promotion, creation and commercialization of IP assets. Thereafter, other schemes were also made to encourage innovation in startups, colleges and universities.

II. To encourage the startup ecosystem in India, several direct tax and administrative reforms have been provided to companies.

(a) Reduction in corporate tax rate for all existing domestic companies at the rate of 25.17% with specific conditions. Also, for those companies who are not able to pay Minimum Alternate tax (MAT) has been reduced from 18.5% to 15%.

(b) The Finance Act, 2020 has removed the Dividend Distribution Tax (DDT) with effect from 01.04.2020 that provided relief to a large class of investors.

(c) To promote investments from Sovereign Wealth funds (SWF), the Finance Act,2020 exempted the interest, dividend and capital gains income of such funds from Income-tax Act,1961. Further incentives have been provided for future borrowing.

(d) Eligible startups can avail 100% profit for three consecutive years out of ten years. The benefit is available to such startups who have incorporated on or after 1st April 2016 and below 1st April 2021.

(e) Units in the International Financial Services Centre (IFSC) have been provided several incentives such as 100% profit-linked deduction for 10 years out of a block of 15 years subject to some conditions.

(f) Several Startup cells have been built to redress grievances and address tax related issues in order to ease the compliance burden of startups.

B. About Venture Capital/ Private Equity and Its Contribution

These funds invest in young and developing startups as well as existing companies. They can be classified as Onshore and Offshore funds such as Alternative Investment Funds (AIFs) and Non-AIFs.

I. Alternative Investment Funds (AIFs)

Securities and Exchange Board of India (SEBI) manages the Alternative Investment Fund, as any fund incorporated in India whether from India or Foreign investors. AIFs can be further classified on the basis of their investment types and leverages to startups.

II. Non-Alternate Investment Funds (AIFs)

These are the funds incorporated to Indian companies from foreign investors.

The Indian VC/PE investment is the single largest source of FDI to the nation. Almost 80% of investment is raised by foreign sources, pension funds, banks, etc.

CONTRIBUTIONS

VC/PE investments are important catalysts of economic growth and socioeconomic value creation. They can play a meaningful role in solving the problems faced by the companies with innovation, create new jobs, construct new infrastructure, promote capital efficiency etc. Investments made by VC/PE turns into job creation, skill development. Thus, it can play an important role in "Vocal for: Local" and "Atma Nirbhar Bharat". As a result of VC/PE funding, the Indian Startup Ecosystem has emerged as one of the largest startup ecosystems in the world by 17% each year between 2012 and 2019 with some major startups like OYO, Big Basket, Swiggy, Ola, Zomato etc.

C. Way Ahead to Strengthen the Financing of the Startup Ecosystem

The Startup Ecosystem conveyed several reforms for the Economic growth of the Nation such as the Government should encourage banks, insurance companies and pension funds to channelize a ratio of their entity into AIFs. It was also mentioned that allowing the (VCFs) to invest in non-banking finance companies (NBFCs) will help the companies to grow and AIFs should be listed on capital markets, thereby creating a permanent source of capital for investee companies.

The representatives of the Startup ecosystem highlighted that multiple other sources of capital could also be encouraged to invest in startups. Listed companies shall also invest directly to the startups not necessarily through VC/PE funds. It was further mentioned that the International Finance Centre (IFSC) needed to be closer to the financial and industrial markets.

OBSERVATIONS/ RECOMMENDATIONS

The Covid-19 pandemic has vastly impacted the economy with demand contraction, disruption of supply chains and obstruction of investment. Under such circumstances, India has shown its ability to grow and show resilience. There are several pillars of the startup ecosystem which play a significant role in creating the larger value of the ecosystem such as startup accelerators, venture capitalists, private investors, foundations, entrepreneurs, universities, government, corporations, mentors and the media.

The committee further believes the startup ecosystem is driving the next wave of innovation and ideas to support. the role of Private Equity/ Venture Capital, larger companies, HNIs, and other institutional investors needs to be encouraged. As they have the potential to increase the productivity and growth of the economy.

The Government should also **promote innovation** and encourage the young people for expanding the startup culture through various schemes. The **sustainable growth capital** from Indian MNCs are required to scale up startups in India particularly, unicorns, decreasing the dependency on foreign investors and make India self-reliant.

Another opinion was to **expand the Small Industries Development Bank of India (SIDBI) Fund-of-Funds vehicle** to play an important role to anchor the investment. It could release more funds to help startups and unicorns to scale up for a better economic destiny. The **mobilization of domestic institutional funds** could be conducted by major banks joining hands for financing the startups. Insurance companies must be given freedom to invest in funds-of-funds by IRDAI as well as directly in VC/PE funds.

Foreign Development Finance Institutions should be encouraged to engage in local asset management companies to build funds structure, particularly in social impact, healthcare and venture/startup sectors.

The committee believes that India being one of the largest economies has a potential to bring high economic growth. All these recommendations could play an important role for India to become self-reliant and achieve Sustainable Development Goals (SDGs).