REPORT

" Ways & Means Towards Robust Indian Startup Eco-System "

An Initiative of

Policywatch Foundation

भारत नीति प्रतिष्ठान
India Policy Foundation

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Finance Industry Development Council

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INTRODUCTION

Startups may be small companies but they can play a significant role in economic growth. They are the centers of innovation and create jobs which means more employment, and more employment means an improved economy.

The Startups have a direct-impact on the cities that they make their homes. Look at how Infosys has changed Bangalore, Alibaba impacted Hangzhou, Microsoft changed Redmond and Google transformed Mountain View, California. They improved employment patterns providing job opportunities to both experienced and young professionals. This led to a surge in inflow of graduates and relocation of experienced professionals from different cities. The “dynamism gap” between the large cities and the rest of the country narrows down due to startups;

These Startups boost the economy with revolutionary technology and create new industries over time. When these startups go public, they truly become money-making engines for not just the owners but also for the employees and shareholders;

More importantly Startups contribute to changing the image of the country.

The emergence of the start-up wave in India is a relatively new phenomenon. Today India is undergoing a fundamental shift with entrepreneurship and innovation being the primary catalyst in job creation and solving everyday problems. A decade ago, there were only a handful of start-ups such as Make My Trip.com and Naukari.com. But, now with the success of such as Paytm, Flipkart, Zomato, Nykaa, etc the Indian startup eco-system has indeed come a long way.

Start-ups require a multi-pronged approach, including-Increasing access to capital, Improving access to talent, Opening up access to markets; and Cutting red tape and instituting a pro-innovation regulatory and fiscal policy.

Startups require governments to do things differently than before with access to overseas markets, which means supporting cross border funds flows.

Strong leadership can bring together universities and businesses to create the sort of talent pools that attract startups. Moreover, pro-innovation policy on the part of local political leaders can clear away some of the regulatory obstacles that hamper startup growth.

An overall lowering of the corporate tax rate would help the most successful new businesses put more money back into their business and the economy, and free up capital for large companies to invest in new startup growth through corporate venture capital, angel investment, and R&D.

Entrepreneurship has to be taught at an early age with schools to provide students with mentors from the startup community in addition to project-based learning to spur entrepreneurial thinking and integrating technology and computer science into all aspects of the curriculum.

The government needs to invest more in research and development in order to fuel the next startup boom.Instituting a permanent startup visa program would help. We need an immigration policy that encourages entrepreneurs to come and stay, rather than making them jump through hoops or wait in an endless line filled with red tape.

India being home to the third-largest base of technology startups in the world after the US and China. With a growing entrepreneurship culture, a supportive ecosystem, India's startups and small businesses are not only expected to further drive economic and business transformation but also cement its position as a key growth driver to India's dream of becoming a $5 trillion economy.

EXECUTIVE SUMMARY

Startup ecosystem is a community of startups, entrepreneurial programs, international investors and venture capitalists working collaboratively to develop and grow new businesses. A startup ecosystem provides the necessary resources to create a thriving environment where startups can flourish. The idea behind these ecosystems is to provide an environment that makes it easier for people with good ideas but without background in business or finance to access resources, mentors and capital.

Start-ups have seen increasing traction in India over the past few years. Fuelled by significant funding from global investors, some firms have become unicorn start-ups providing huge gains to their investors. Scaling up a business without the required capital is next to impossible and hence, these investors have catalysed the growth of start-ups.

India has emerged as the 3rd largest ecosystem for startups globally with over 69,000 DPIIT-recognized startups across 647 districts of the country.

India ranks #2nd in innovation quality with top positions in the quality of scientific publications and the quality of its universities among middle-income economies.

The innovation in India is not just limited to certain sectors. India has recognized startups solving problems in 57 diverse industrial sectors with 13% from IT services, 9% healthcare and life sciences, 7% education, 5% professional and commercial services, 5% agriculture and 5% food & beverages.

Over the last few years, a bold new breed of entrepreneurs bursting with ideas have emerged on the Indian business landscape. Nimble and confident, they are raring to scale up their global ambitions. This is the startup generation.

What all this indicates is the existence of a dynamic and thriving business ecosystem, a major part of which is driven by that very important facet called funding.

In addition, adoption of digital technologies is transforming India into a new-age digital economy. The Aadhaar-based biometric ID has provided a digital identity to each Indian, helping companies quickly and conveniently verify identities and customer information. As per the RBI, financial inclusion improved 24% between March 2017 and March 2021, enabling more sections of the society to be brought into the fold of a formal economy, gradually expanding the consumer base for relevant start-ups.

Consumer and business habits are changing rapidly with increasing penetration of digital payment solutions, fast internet connectivity and cheaper smartphones. COVID-19 has accelerated digital adoption and now, even small offline retail merchants are keen to have an online presence and accept payments through online channels. With this new normal, technology-led start-ups are leveraging this digital wave; the industry witnessed a surge with 1,600+ new start-ups in 2020.

Indian Startup Ecosystem has seen exponential growth in past few years (2015-2021):

- 9X increase in the number of investors.
- 7X increase in the total funding of startups.
- 7X increase in the number of incubators
- The Indian Unicorns are flourishing in the fast-paced and dynamic economy of today. These startups are not only developing innovative solutions and technologies but are generating large-scale employment.
- Till FY 2016-17, approximately one unicorn was being added every year. Over the past four years (since FY 2017-18), this number has been increasing exponentially, with a whopping 66% Year-on-Year growth in the number of additional unicorns being added every year.
- As of 09th February 2022, India is home to 88 unicorns with a total valuation of $ 295.99 Bn. Out of the total number of unicorns, 44 unicorns with a total valuation of $ 94.37 Bn were born in 2021 and 7 unicorns with a total valuation of $ 9.12 Bn were born in 2022.

What triggered the unicorn rush during 2021?

- While work from home during the pandemic fueled the growth of digital businesses in India, the incident also resulted in a long unicorn list. Mainly three factors, a thriving digital payments ecosystem, large smartphone user base and digital-first business models, have come together to attract investors.
- Tech companies, which have become household brands, are contributing to the unicorn boom in India, as smartphone penetration and digitization of commerce in every aspect of life has increased manifold during the pandemic. Besides fintech, e-commerce grocery, SaaS and marketplace players are contributing the most to the unicorn universe.

Unicorns Of India

- India is home to 88 unicorns with a total valuation of more than $300 Bn.

- The year 2021, 2020, and 2019 saw the birth of the maximum number of Indian unicorns with 44, 10, and 9 unicorns coming each year, respectively. COVID-19 has caused a great amount of socio-economic suffering globally, but it is during this time when the resilient Indian Entrepreneurs have worked effortlessly to not only contribute to the economy but to also contribute toward COVID-19 relief efforts.

- In 2020, India witnessed the birth of more than 10 unicorns. 'Its raining unicorn' has been the motto of the year 2021 with 44 unicorns pumped into the ecosystem and many soonicorns waiting in line.

- Geographically, the center of India's high-tech industry, Bengaluru is India's unicorn capital with the largest number of unicorn headquarters followed by Delhi (NCR) and Mumbai. While we see unicorns active in Tier I cities, this ecosystem is not restricted and is proliferating across the country till the last district.

- Traditional sectors such as Fin-tech, E-commerce, Supply Chain & Logistics, Internet Software & Services do dominate the arena but a strong wave of unconventional sectors such as Content, Gaming, Hospitality, Data management & analytics, etc are making their place on the list.

- While every startup has its unique journey to becoming a unicorn, the minimum and maximum time taken by a startup to become a unicorn are 6 months and 37 years, respectively. Mensa Brands took only 6 months to become a unicorn in 2021, making it one of fastest unicorns in Asia.

Indian Startups turned Unicorns in 2021

Investors in Unicorns

- There also has been a shift in the traditional way of funding, wherein startups are now looking at exercising alternate routes such as crowd-funding, revenue-based financing, venture debt, bank loans, etc. Startups such as Zerodha, which have been bootstrapping since inception are changing the unicorn funding norms and promoting independence and revenue generation since the early stages. Since the onset of COVID-19, an unconventional trend observed is the new entries to the unicorn club without any billion-dollar ticket size investment.

- While India's tech and finance start-up scene grew rapidly over the past decade, there are several reasons why 2021 has been a breakout fundraising year. India was long a second choice for investors after China. But now it is benefiting from China's corporate regulatory curbs that are prompting some investors to pivot to different geographies.

- Another attraction towards India has been the vast commercial possibilities from India's underpenetrated consumer market of 1.36 billion people. (India's population is expected to overtake China's by 2030). India has 825 million internet users, which means more than 500 million are still to come online.

- India's digital consumer economy, covering sectors from retail and education to food and pharmacy services, will balloon into an US$800-billion market by 2030 from an US$85 billion to US$90 billion market in 2020.

Next Stage: Going Beyond the Unicorn

- The global startup ecosystem is witnessing a shift as the world is increasingly realising the potential carried by the startups. We are gradually transitioning from the age of unicorns to the age of decacorns.

- A decacorn is a company that has attained a valuation of more than $ 10 Bn.

- As of January 2022, 46 companies world over have achieved the decacorn status. India has four startups namely, Flipkart, BYJU's, Paytm and Swiggy, added in the Decacorn cohort.

- By 2025, India is estimated to have 100k+ start-ups, which may create 3.25+ million jobs.

- With more policy push from the government and flow of funds from generous investors, formalising entrepreneurship as a career choice is slowly getting easier, although we still have a long way to go in terms of creating world-class products and services compared with global peers.

- Startups need consistency in policy, friendly tax laws, ease of procedures, and simple regulatory architecture, which the government has been providing over the last seven years.

- India is slowly becoming an innovation hub of AI, with 4,000+ patents filed between 2015 and 2020—6x more than the previous five-year period. In the years to come, India can brace for more home-grown innovations on the back of surging technology adoption, young consumer base, increasing financial inclusion as well as a start-up-friendly environment.

- Rising digitisation has led to mushrooming of start-ups in tier 2 cities, which helps leverage the local talent pool and reduce cash burn. Even before the pandemic, as per the Economic Survey of 2018-19, a whopping 50% of the 16,500 start-ups (registered by March 2019) were based in tier 2 and 3 cities. Jaipur, Ahmedabad, Pune, Chandigarh and Indore are some tier 2 cities to witness spiralling start-up activities.

- Unconventional sectors and sub-sectors marked an entry into the unicorn space including, NBFCs, Conversational Messaging, D2C, social commerce, agritech, Cloud Kitchens and many others.

- Indian unicorns are also exploring the public listing avenues as a next step to realise the growth potential. Some big unicorn names that offered an IPO include Zomato, Nykaa, PolicyBazaar, Paytm and Freshworks, while many are already in line such as Delhivery, Mobikwik and CarDekho.

- Today, 1 out every 10 unicorns globally have been born in India. Overall, 2021 experienced an exponential boom when it comes to startups entering the unicorn club. This is a testament to the vibrant startup ecosystem present in India.

Government Initiatives and Schemes

Government schemes and grants for start-ups are one of the reasons for accelerated growth of these companies, paving the way for a new-age economy. Without government support and encouragement, it becomes difficult for start-ups with novel ideas to follow through on their initial work, resulting in a dearth of innovative products that are truly Made in India. Hence, the government has launched a host of schemes and initiatives to nurture start-ups and innovation. Some of these are discussed as follows:

Start-up India Initiative

A flagship initiative of the government to support, build and recognise start-ups and create an ecosystem of innovation and entrepreneurship. Launched in 2016, the initiative has various micro-schemes and programmes that address different needs of a start-up broadly under three categories – compliance and legal support; funding and tax grants; and incubation and industry partnerships.

Atal Innovation Mission (AIM)

AIM was launched in 2016 with an objective to create a culture of innovation and entrepreneurship in the country. The scheme involves schools, research centres, NGOs and MSMEs at district and state levels. To oversee the innovation ecosystem in India, it offers labs, incubation centres, innovation centres, mentor networks as well as strategic public-private and country-to-country partnerships.

Support for International Patent Protection in Electronics & Information Technology (SIP-EIT)

When companies file international applications for IP, they find it difficult to protect their intellectual property rights due to high costs. Initiated by the Department of Electronics and Information Technology (DeITY), SIP-EIT is a scheme offering financial assistance to tech-based start-ups as well as MSMEs for international patent filing. (Note: As per the Ministry of Electronics and Information Technology website, this scheme is under review).

Promoting Innovations in Individuals, Start-ups and MSMEs (PRISM)

Initiated by the Department of Science & Industrial Research (DSIR), PRISM supports individuals who have innovative ideas and want to create a prototype or working model. The ideas considered under the scheme could belong to green energy, industrial materials, waste management, affordable healthcare, clean energy or any other technology-based field.

Aspire – A Scheme for Promotion of Innovation, Rural Industries and Entrepreneurship

To promote entrepreneurship and create jobs in the agro industry, the Ministry of MSME launched ASPIRE so that a network of technology and incubation centers can be established. Under the scheme, 50% of the cost of plant and machinery (land and infrastructure not included) or Rs. 50 lakhs (~US$ 68500), whichever is less, is granted for setting up incubation centers.

Apart from the above-mentioned schemes, there are more than 100 other schemes and initiatives undertaken by the government to encourage a culture of entrepreneurship and innovation in the country.

The startup arena, however, has lots of challenges ranging from finance to human resources and from launch to sustaining the growth with tenacity. Being a country with a large population, the plethora of opportunities available are many for startups offering products and services ranging from food, retail, and hygiene to solar and IT applications for day to day problems which could be delivered at affordable prices. It is not out of place to mention that some of these startups would become unicorns and may become world renowned businesses by expanding into other developing and underdeveloped countries.

Challenges faced by Indian Startup Ecosystem include lack of funds, funding sources, less number of customers and customer interest, unsuccessful business models. Lack of funds is one of the most important problems that a startup faces. The startup needs money to survive, otherwise it will go astray. In order to solve this problem, the stakeholders have different approaches.

With funding starting to dry up due to global macro-economic factors, the startup ecosystem in India is bracing itself for a "long and bitter winter" and potential mass lay-offs in the next 12-18 months, particularly in sectors such as ed-tech and gaming that got a significant push during the pandemic, according to experts.

In the last quarter (April-June), start-up funding for the Indian startup ecosystem plummeted by a staggering 33% to $6.9 billion from $10.3 billion in the first quarter (Q1) of this calendar year.

The scenario of slowdown in start-up valuations, dried out funding and massive job losses may continue for the next 12–18 months. The global slowdown and tightening monetary conditions will likely add to investors' uncertainty and the situation may not improve till the US economy revives.

Issues & Challenges

There are typical challenges that startups all over the world struggle with. Certain obstacles, however, are more peculiar to the Indian business environment. In this study, India was often described as a harsh environment for startups.

I Building and Scaling an Indian Startup

The challenges faced by Indian startups begin with essentials such as hiring and managing a team, dealing with customers, and developing a marketing strategy. In particular, many Indian founders have a technical background and lack business knowledge.

Dr Radhika Pandey senior fellow at NIPFP (Senior Fellow, National Institute of Public Finance and Policy, Govt. of India) , most appropriately summed it up in her elaborate remarks at the Roundtable Discussion "Ways & Means Towards Robust Indian Star-Up Eco-System", organised by India Policy Foundation (IPF) , Finance Industry Development Council (FIDC) & Policywatch India Foundation on July 15th, 2022 at New Delhi.

Dr Radhika Pandey senior fellow at NIPFP

So, some of these is going to have a bearing on the financing of startups. Particularly at this time, because now we see a very important report by NASSCOM which says the number of startups coming up in Tier 2 and Tier 3 cities has really gone up. So these are the entities that would require funding at the initial stages. Currently we see interest rates are high so this is one of the challenges.

For running a startup, a significant amount of working capital is required. Many startups, especially at early stages, are bootstrapped, i.e. self-funded through the founders' own savings, or using capital from friends and family. Some startups have enough paying customers, so that they are or become self-sustaining through the revenue and profits they generate and are able to grow organically. Thus, while not every startup needs external investment, many of them start looking for investors as they plan to scale their business. However, finding the right investor and raising funds is difficult, even if they have received positive responses on their product and have some proven market validation.

II Diversity and the Digital Divide

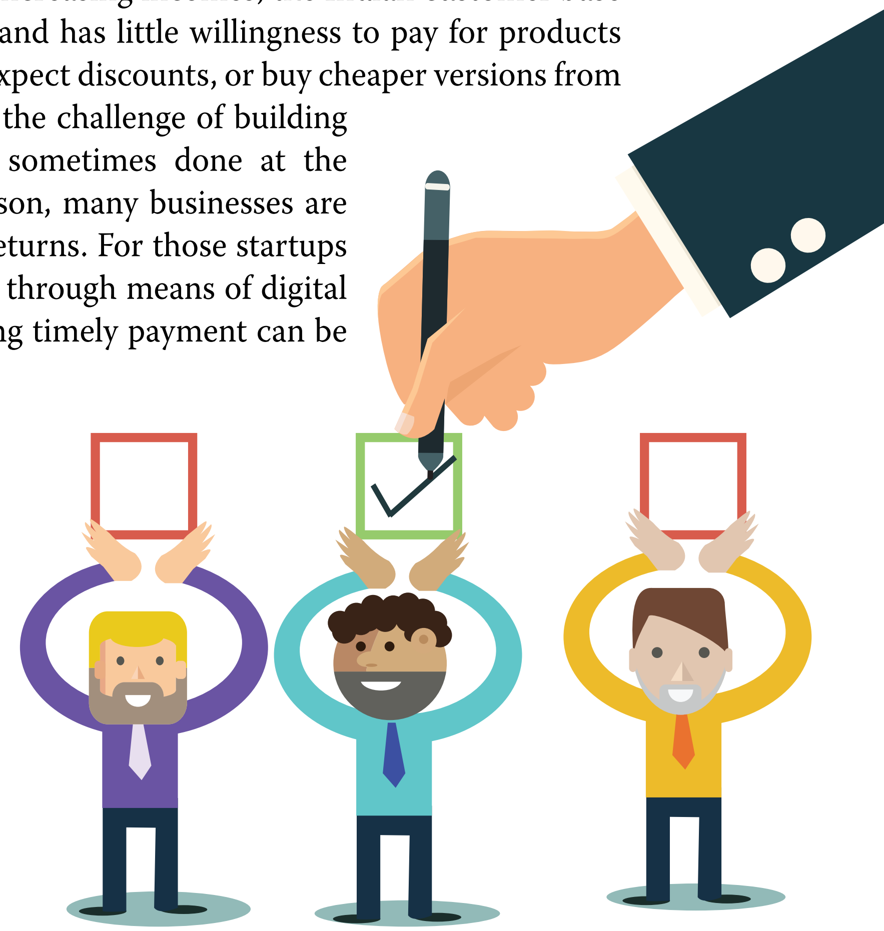
In general, an information gap exists between those who provide solutions and those who are supposed to use them. In order to build successful products, startups need to bridge this gap and develop an in-depth understanding of the customers and their needs. This is particularly difficult in the Indian context: India is a highly diverse country with a plethora of cultures, languages, ethnicities and religions. Because Indian customers are equally diverse, the startups' understanding of them is often limited to certain regions, which they know well and where they know local people to work with. In that sense, comparative advantages are linked to specific regions. Therefore, building up a pan-Indian startup is more difficult, because they have little understanding of customers in other regions.

In addition, there is a disconnect between the startup founders and the customers, for whom they aim to build products. Most startup founders are well-educated and come from well-off backgrounds in urban metro cities. However, as nearly 70 percent of the Indian population live in rural areas,[xxi] the customers of the mass market tend to come from low-income backgrounds in villages. Due to different living environments, startups often have an insufficient understanding of the customers and their needs.

Taking Products to Market and Low Willingness to Pay

A further challenge for startups is to take their products to the market as Indian markets appear difficult to penetrate. One reason is the competitive landscape: Often, many firms are already present and many more enter the market, including copycats. A second reason is that startups are at a disadvantage compared to large companies. On the one hand, this is due to the fact that big market players are more capable of dealing with bureaucratic regulations. On the other hand, public procurement is seen as weak and the government prefers to sign contracts with established companies. However, if startups are promoted by large companies (for instance, through partnering with them in the context of their open innovation initiatives), they may find it easier to capture a market. A third reason is that communication with and retention of customers takes time and effort. Convincing Indian customers is difficult, especially if the startup develops innovative products and caters to new market segments.

Furthermore, it is hard for startups to generate willingness to pay for their products and services. Despite increasing incomes, the Indian customer base continues to be price-sensitive and has little willingness to pay for products and services. Often customers expect discounts, or buy cheaper versions from China. Therefore, startups face the challenge of building affordable solutions, which is sometimes done at the expense of quality. For this reason, many businesses are volume driven, with marginal returns. For those startups which do not charge customers through means of digital payment, collecting and ensuring timely payment can be another issue.



Hiring Qualified Employees

For many job-seekers, joining a startup as an employee is not an attractive career option, due to the inherent risk that the startup might fail. Instead, the majority prefer to work for large corporations, which promise more stable jobs. In addition, startups can rarely compete with the reputation and compensation structures which large companies can offer. Many of those who start working for startups, switch to established companies after a few years. Job changes in the opposite direction occur less likely, because many get used to the benefits of a corporate job.

A second reason is that many job applicants are not sufficiently skilled. Startups see a gap between the knowledge taught to students in colleges and the knowledge needed for the jobs, especially in sectors in which technologies change at a fast pace. Because they have little awareness of industry needs, fresh graduates are usually not readily employable from the beginning. As a consequence, when hiring new staff, startups have to invest significant amounts of time and cost to train new employees.

A **third factor is th**at a significant number of highly qualified specialists move abroad for jobs. At the same time, and in contrast to many other startup hubs globally, Indian startups are yet to attract international talent. Bureaucracy and visa requirements make it difficult to hire employees from outside India and expatriates are more attracted to places like Singapore, where the living standard is higher.

IV Complex policies

The government of India has introduced policies that aim to ease the business environment for startups. However, startups in India often feel encumbered by bureaucratic processes, which appear to lack underlying standards. They have insufficient possibilities to find information, and there is little planning security about how long processes can take. In addition, regulations can suddenly change or startups receive random notices. As a result, startups have to find frustrating workarounds, waste valuable time or pivot their business model.

Dr Radhika Pandey senior fellow at NIPFP, GOI, talked about this in the roundtable.

Dr Radhika Pandey senior fellow at NIPFP

"From the regulation side, it is a very complex challenge to tight rope walk between innovation and financial inclusion. On one hand, regulators need to promote innovation because fintechs have new business models. That is why there is a kind of regulatory sand box mechanism, which we also have in India. We need to accelerate that mechanism. There is a need for greater collaboration".

Other challenges concern the legal incorporation and registration as a startup as well as the closing of a business. Despite the government's declared intention to hasten the setting up of a business, the process is generally described as lengthy and costly. It requires many approvals, constituting a high entry barrier. After the legal setup is accomplished, formal registration as a startup is a necessary requirement to qualify for tax exemptions and further benefits. There are specified criteria linked to the government's startup definition, but few startups fulfilled them. The criteria were lowered subsequently, but startups still seem to face difficulties obtaining registration certificates. Some startups fail, but closing down a business was described as even more difficult than setting it up.

Dr Kuldeep Ratnoo ji from Director, India Policy Foundation said that striking the right equilibrium between innovation, regulation, financial inclusion and consumer protection is critical.

Dr Kuldeep Ratnoo, Director, India Policy Foundation

Technological innovation, regulations, financial inclusion, and consumer protection are things where we need to find the balance. We need to ensure that innovation is not killed due to over-regulation and financial inclusion doesn't get disrupted because of uncertainty in regulations".

The tax policy and its enforcement are considered unfriendly for startups. This, on the one hand, applies to the Good and Services Tax (GST), which was introduced in July 2017. There is still a lack of clarity on how it works and which items are applicable as tax base or not. The startups are required to file their taxes regularly, even if they do not yet generate any revenue. Moreover, if payments from customers are delayed (which is not uncommon), startups run into the danger of a liquidity squeeze. If they fail to file the tax on time, they risk huge penalty payments.

Financial resources Availability of finance is critical for the startups and is always a problem to get sufficient amounts. A number of finance options ranging from family members, friends, loans, grants, angel funding, venture capitalists, crowd funding etc are available. The requirement starts increasin**g as the bus**iness progresses. Scaling of business requires timely infusion of capital. Proper cash management is critical for the success of the startups . A recent report paints a gloomy picture with 85% of new company's reportedly underfunded indicating potential failure.

Urvashi Sahay group General Counsel for Paytm (Insert exact designation) summed up the criticality of funding for startups illustratively.

Urvashi Sahay, group General Counsel for Paytm

What is crucial for a startup is funding. The challenge is that where from the long term funding going to come from. When the money comes into the country every level of scrutiny is required. But what should we do once that money is in, what is the level of scrutiny that should have been at that point of time? For example, in the case of multiple down-stream investments, should it be permitted or not because the money that we already have, has been scrutinized. Those are the kind of thoughts we need to get into.

Regulations: Starting a business requires a number of permissions from government agencies. Although there is a perceptible change, it is still a challenge to register a company. Regulations pertaining to labor laws, intellectual property rights, dispute resolution etc. are rigorous in India.

Manglesh Yadav, Programme Director, NITI Aayog was of the view that too much regulation should not come in the way of innovation.

Manglesh Yadav, Programme Director, NITI Aayog

"We also have to be careful that we don't kill innovation by putting a lot of regulation around it and hence there are couple of models that are already in progress one of them RBI stand box that already exists for regulation the second model which are working very closely IFSC model, both these models what we are trying do is really trying to understand when we are looking at innovation with respect to finance and Fintech".

Sugandh Saxena, (CEO, Fintech Association for Consumer Empowerment (FACE), echoed similar views in the context of the sunrise fintech industry.

Sugandh Saxena, (CEO, Fintech Association for Consumer Empowerment (FACE)

The fintech startup eco-system cannot be fully regulated through regulations alone because it can be very stifling and too early in the day. This industry is very young. It is not even 6-7 years old industry. It is very important that the government should also work closely with a subordinating body and research for market feedback.

Policy architecture: The government of India has introduced policies that aim to ease the business environment for startups. However, the present regulatory framework in which startups operate is widely seen as difficult, inefficient and unpredictable. Startups in India often feel encumbered by bureaucratic processes, which appear to lack underlying standards. They have insufficient possibilities to find information, and there is little planning security about how long processes can take. In addition, regulations can suddenly change, upsetting plans. The case of Press Note 3 is a case in point.

Mr Rajnish Kumar, Chief Corporate Affairs Officer (insert exact designation), Flipkart, raised some pertinent points, particularly with respect to policy consistency and stability.

Mr Rajnish Kumar, Chief Corporate Affairs Officer

Over regulations is a problem. But the bigger challenge is certainty of regulation. The challenge is where it keeps on changing rapidly without any consultation process. We have seen this in our own case. We have a horizontal platform not just on product merchandising, but also services insurance and other pieces. In May 2018 Walmart invested in Flipkart. The investment was approved by November. Suddenly, on December 26th, a law came which made business unviable because they changed the rule completely overnight without any consultation."

Umesh Revankar MD of Sriram Transport Finance Corporation (Insert exact designation), too favoured lighter regulations.

Umesh Revankar MD of Sriram Transport Finance Corporation

strongly believe in lighter regulations and certainty in regulations. This helps startups take a long term view. The government and regulators need to work on this and give a long term perspective for the foreign investment to come, because it is obvious that India doesn't have the depth in capital. We don't have depth in the corporate bond market. We don't have enough venture capitalists and angel investors"

Quality Manpower: Startups normally start with a team consisting of trusted members with complementary skill sets. Usually, each member is specialized in a specific area of **operations. Assembl**ing a good team is the first major requirement, failure to have one sometimes could break the startup

Supporting infrastructure There are a number of support mechanisms that play a significant role in the life cycle of startups which include incubators, science and technology parks, business development centers etc. Lack of access to such support mechanisms increases the risk of failure.

Lack of mentorship: Lack of proper guidance and mentorship is one of the biggest problems that exist in the Indian startup ecosystem. Most of startups have brilliant ideas and/or products, but have little or no industry, business and market experience to get the products to the market. It is a proven example that a brilliant idea works only if executed promptly. Lack of adequate mentoring/ guidance is the biggest challenge which could bring a potentially good idea to an end.

The peculiar case of Press Note 3

Press Note 3, aimed at curbing predatory takeovers by foreign entities, needs to be reviewed in the current economic situation

As companies across the globe battled the uncertainty that the pandemic brought on in 2020, several economies began to raise concerns about opportunistic takeovers of entities stressed by pandemic in their country.

Therefore, they imposed restrictions on foreign investments which could be 'predatory' in nature and to ensure that assets in sensitive sectors do not end up in foreign hands, jeopardising national security. Against this backdrop, India introduced Press Note 3 (PN3) in 2020, which required all foreign direct investment (FDI) proposals from an entity based in a country that shares a land border with India, or where the beneficial owner of such FDI is situated in a country which shares a land border with India — both referred to as "restricted entities" — were brought under the government approval route.

A report titled "Chinese Investments in India" by Gateway House estimates that the total value of Chinese investments in Indian startups between 2015 to 2020 is approximately US $4 billion. In fact, as of March 2020, 18 out of 30 Indian unicorns are heavily backed by Chinese investments. The recurring Chinese investing firms have been highlighted in the following table.

The Government of India has changed its foreign direct investment policy ("FDI Policy") pursuant to a Press Note No. 3 (2020 Series) dated April 17, 2020, (the "Press Note"). The Press Note seeks to curb "opportunistic takeovers/ acquisitions of Indian companies" due to the current COVID-19 pandemic.

In terms of the Press Note, (i) all investments by entities incorporated in a "country which shares land border with India or where the beneficial owner of an investment into India is situated in or is a citizen of any such country" ("Restricted Investor") will require prior approval of the Government of India; and (ii) in the event of any transfer of ownership of any existing or future foreign direct investment ("FDI") in an entity in India, directly or indirectly, resulting in the beneficial ownership falling within the restriction/purview of (i) above, such change in beneficial ownership will also require prior government approval. The countries which share a land border with India are Afghanistan, Bangladesh, Bhutan, China, Myanmar, Nepal and Pakistan ("Bordering Countries").

The Press Note changes the FDI Policy in two fundamental respects: First, it expands the list of countries whose investors are no longer eligible to invest in India under the automatic route. Second, an investment in India – that would otherwise fall under the automatic route – now falls under the government route if it is from an entity whose "beneficial owner" is from such a Bordering Country. These changes have far-reaching implications on the overall FDI regime. Set out below are some key considerations arising from these changes.

Beneficial Ownership

While the Press Note covers investments in India where the "beneficial owner" of such investment is situated in or is a citizen of any Bordering Country, it does not elaborate the manner in which the beneficial ownership test is to be calculated and applied. The term "beneficial owner" has different meanings under different laws in India. Depending on how it is defined it could mean (i) an entity with a prescribed shareholding level in the investing entity (as is the case under the Companies Act of 2013) or (ii) the owner or holder of ultimate control over the investing entity (as defined under the Prevention of Money-laundering Act, 2002). A somewhat similar concept is also used by the Securities and Exchange Board of India to identify the ultimate beneficial owner for the purposes of certain securities laws.

If the term "beneficial owner" is not linked to control or a prescribed shareholding threshold, the requirement for prior government approval could arguably be triggered even if a single share of an investing entity is beneficially held by an investor from one of the Bordering Countries. This ambiguity could significantly impact foreign investments into India from across the globe as Chinese investors have stakes in hundreds of companies around the world.

The challenging part for the implementation of press-note 3 was that it did not define the threshold for identifying the beneficial owner.

Considering that investors often have multi-layered structures, spread across various jurisdictions, this ambiguity has led to a conundrum on the ambit and method of computation of beneficial ownership.

The ambiguity in the implications of 'beneficial ownership' under PN3 has ensued an increase in the volume of FDI applications from foreign investors seeking the government's approval thereby causing delays and extension of deal timelines.

The ambiguity in identifying beneficial owners cast a wide net which caught in its radar all investments flowing into India where the investing entities had any shareholders/capital from a land-bordering country. The wide-net was perhaps unintended to the spirit of press-note 3. These factors make a fitting case to study the possibly unintended impact of the press-note 3 and issue clarifications to address the same.

Defining the beneficial-ownership

To define beneficial ownership, the DPIIT may take a leaf out of the existing regulations. Beneficial ownership has already been defined under two-different Indian laws. Under the respective regulations, thresholds for identifying a beneficial owner spans from 10% to 25%

One of the definitions corresponds to the benefits available to the shareholding-entities/individuals (including voting rights) (Companies Act – Significant Beneficial Ownership Rules), while the other one corresponds more to the control that shareholding entities can exercise over the company they are invested in (Prevention of Money Laundering (Maintenance of Records) Rules, 2005)

To identify which definition of beneficial-ownership should be considered for the press-note 3, it makes sense to refer the text of the press-note 3 to understand its spirit. Press-note 3 was enacted to curb ‘opportunistic takeovers of Indian businesses’ – by entities situated in land-bordering countries, or entities which may have beneficial owners from these land-bordering countries.

The seeming intent of the press-note to include ‘beneficial owners’ in addition to the entity itself, implies that the beneficial owner within that organization should be in a position to control the management, policy decisions of the board, so as to be able to drive that organization to do an opportunistic takeover of an Indian business.

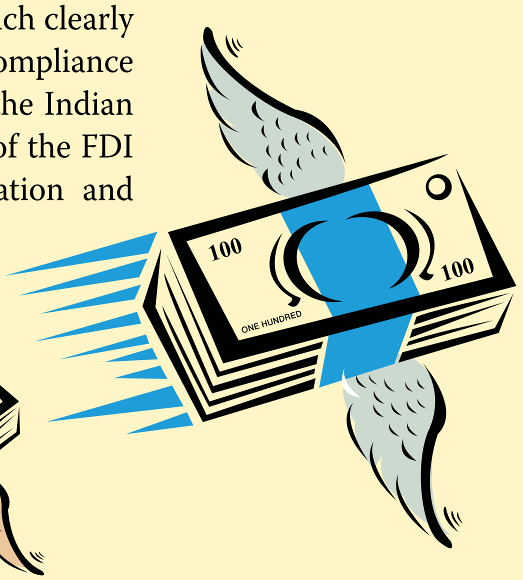
In this framework, the beneficial-owner defined under the Prevention of Money-Laundering (Maintenance of Records) Rules, 2005 seems suitable. Beneficial Owner – defined in PMLA (MoR) Rules – is an individual who either has a “controlling ownership interest” (25% ownership) of the entity or can exercise “control” on the management or policy decisions of the company.

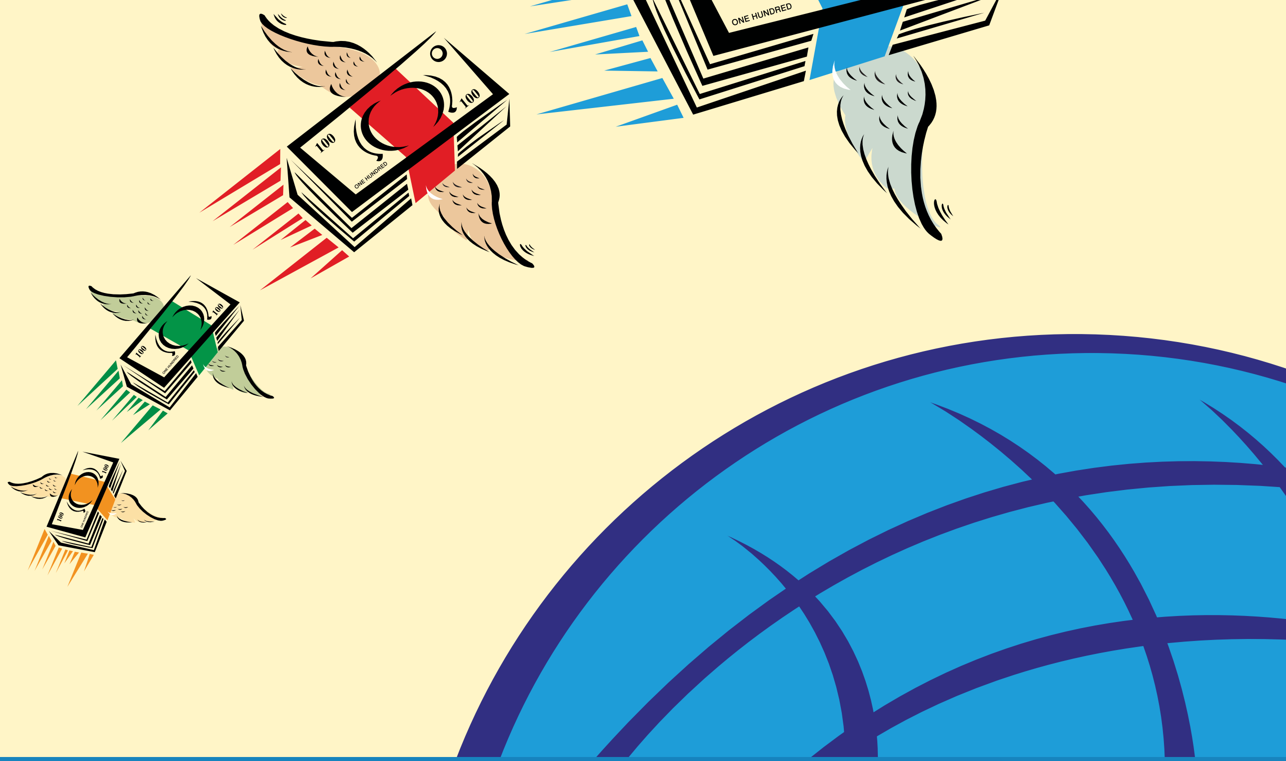
The other option for defining the beneficial-ownership would be to consider the definition under the Companies Act (SBO Rules) which identifies a Beneficial Owner as a person who holds more than 10% shares of the entity and its voting rights. While the beneficial-owner under the SBO Rules also has access to voting rights, it overall has lesser teeth in comparison to a ‘controlling’ beneficial owner defined under the PMLA (MoR) Rules.

There are varying options available to define beneficial ownership, and the most adequate definition will play a strong role in bringing clarity, and facilitating FDI that has been adversely affected in the absence of such a definition.

Statement by the Ministry of Commerce and Industry

Nearly two years after the PN3 was enacted, the Minister of State in the Ministry of Commerce and Industry issued a press release in the Lok Sabha on 23 March 2022 stating that a beneficial owner of an investment based in any country sharing land border with India, can invest only under the government route. Further, in the event of the transfer of ownership of any existing or future FDI in an entity in India, directly or indirectly, resulting in the beneficial ownership falling within the purview of the PN3, such subsequent change in beneficial ownership will also require government approval. The press release also refers to the provisions of the FDI Policy which clearly lays down that the onus of ensuring compliance of provisions of the FDI policy is on the Indian investee company and any violations of the FDI regulations would result in investigation and enforcement action in terms of penal provisions under FEMA.





Indirect Foreign Investment

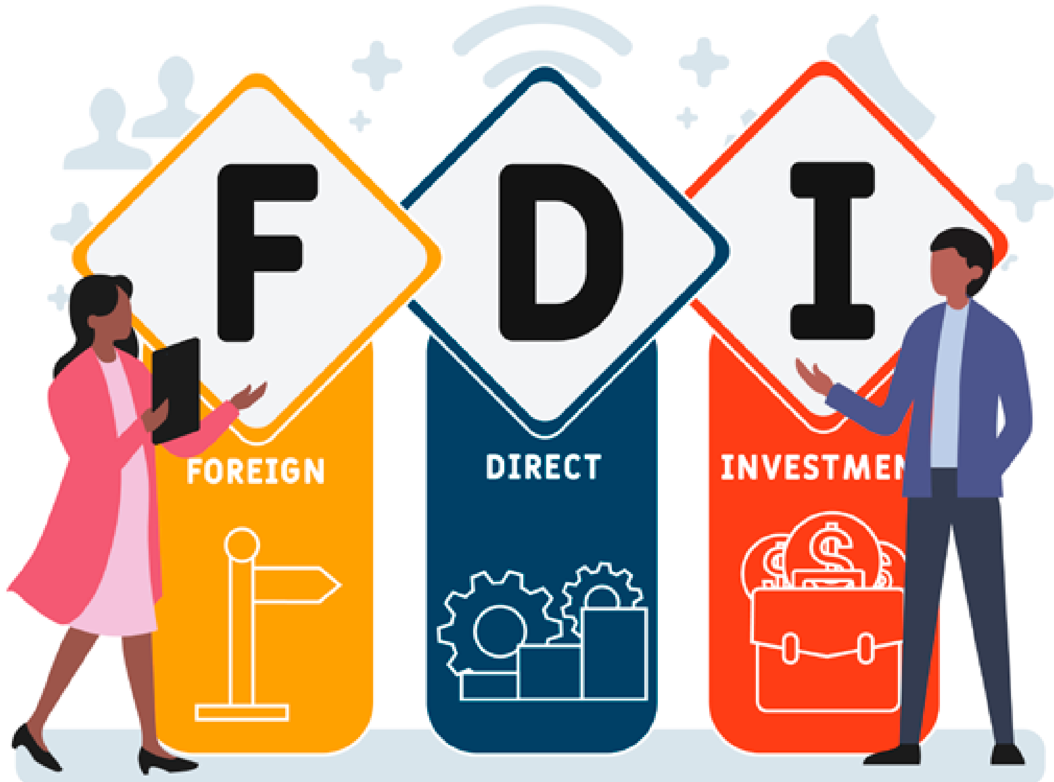
Investment by an Indian entity which is not owned or controlled by Indian residents ("FOCC Entity") into another Indian entity ("Downstream Investment") is required to be made in compliance with the applicable foreign investments conditions as if the target entity was directly receiving foreign investment.

Pursuant to the Press Note, government approval will also be required for any Downstream Investment made by an FOCC Entity that has received FDI from a Restricted Investor. This will apply even if the Indian entity receiving the Downstream Investment operates in a sector covered under the automatic route.

Ongoing Transactions

Partly paid-up shares and warrants

The FDI Policy allows foreign investors to acquire partly paid-up shares and warrants in sectors that are under the automatic route without any approval. In case of warrants, a foreign investor is required to pay at least 25% of the consideration up-front and the balance within 18 months. As an example, a Chinese investor could have acquired such warrants of an Indian company last year by paying 25% of the purchase consideration at the time of acquiring the warrants. However, if the Chinese investor were to convert its warrants and pay the balance 75% consideration, it is not clear if such conversion will require prior government approval.



Mergers

Restricted Investors in Indian companies that are currently undergoing a merger and awaiting final clearance would likely face a similar situation. Given the rationale for the Press Note and the ensuing uncertainty of mandating government approval for such ongoing transactions, an exemption for such transactions can be considered by the government.

Options

Investors from the Bordering Countries may have entered into binding call or put option arrangements with other shareholders of their Indian portfolio companies at the time of their original investments. In situations where the exercise of such options involves the transfer of shares to investors from the Bordering Countries, such exercise will now require government approval.

Bonus and Rights Issue

Ordinarily, further issuance of shares to existing shareholders by an Indian company covered under the automatic route would not require government approval. However, based on a plain reading of the Press Note, the acquisition of shares by an investor from the Bordering Countries that is an existing shareholder of an Indian company pursuant to a rights issue or bonus issue will, henceforth, require government approval.

Since the objective of the Press Note is to regulate acquisitions by Restricted Investors, an exemption could be considered for such share issuances to Restricted Investors who are existing shareholders to the extent required to maintain their shareholding.

CONCLUSION & RECOMMENDATIONS

India offers many opportunities for startups and in turn, startups carry great hopes to promote growth and create employment. Over the last two decades, more startups emerged in India and the associated ecosystem has developed dynamically. Consequently, support has increased in many dimensions: office space and infrastructure, business support in regards to mentoring and networking, as well as the availability of financial capital. There is palpable optimism that the ecosystem will continue to mature. Nevertheless, Indian startups face significant challenges. Overcoming such hurdles will require efforts of all stakeholders, i.e. the ecosystem actors, governmental authorities, as well as the startups themselves. In addition, changes in the broader cultural milieu would be helpful to encourage people taking risks and possibly developing impactful solutions.

Startups do not exist in silos, but are part of the broader economy. Policy reforms improving general economic conditions as well as investments in digital and physical infrastructure (for instance, internet connectivity, roads and public transportation, power and electricity), are expected to also benefit startups. With regards to the regulatory framework, improving the implementation of existing startup policies and removing inefficiencies within the bureaucracy is considered crucial to ease doing business for startups.

While the industry continues to evaluate different positions on what the threshold for 'beneficial ownership' under the PN3 would be, the response from the Ministry of Commerce and Industry hasn't provided any clarification on this aspect. Further given that the onus of compliance is that of the investee companies, it must be ensured that any investment/transaction directly or indirectly involving beneficial owners from bordering nations needs to be carefully examined to ensure compliance with the FDI policy.

Formal clarifications and possibly, relaxations, are long awaited from the government. It is hoped that going forward, the process will be streamlined to reduce the waiting period on FDI applications, which creates uncertainty in deal timelines.

Clarity will also be required on how the beneficial ownership test is to be applied in cases where the entity looking to invest in India under the FDI route is a private equity fund. Several private equity funds have Chinese limited partners. In the absence of clear guidance, investments by such funds could hit a regulatory roadblock.

In this situation, there is a need to review PN3 to boost legitimate investments, particularly from sources like 'pooled funds'. These are investment vehicles that pool money from multiple investors and are managed by fund managers who independently and professionally drive the investment strategy for delivering returns for their investors. There are some additional areas for simplifying PN3 which could also be considered:

Exemption of low hanging fruits: Effectively, investments from restricted entities constituting less than 10 per cent (or even 5 per cent) of the economic interests of an Indian company, in non-strategic sectors, regardless of investment route, could be exempted from the prior approval requirement.

The rationale would be that such minority shareholding of 'restricted entities' may not be able to influence control/direction of the entities.

Clarification on scope and ambit of 'beneficial ownership': As the ambit and extent of "beneficial ownership" has not been elaborated under PN3, considerable discussion has taken place on acceptable threshold of 'beneficial ownership'.

Taking a cue from several other regulations, one may be tempted to effectively impose a beneficial ownership threshold of less than 25 per cent and, therefore, there could be a mechanism involving relaxation for investors where the ultimate beneficial ownership or control is less than 25 per cent.

This could also include companies listed on overseas stock exchanges wherein restricted shareholders hold less than 25 percent of listed stock.

Further investments into Indian companies where restricted entities are existing shareholders: It is well known that a number of start-up sectors (e-commerce, technology, social media, etc) in India have substantial amounts of Chinese investments. Considering the curbs placed on fresh investments under PN3, incoming and existing investors looking to participate in fund-raising rounds by such start-ups might hesitate.

As the intention behind PN3 has been to prevent opportunistic takeovers, screening future rounds of funding or acquisitions by restricted entities in companies already owned and controlled by such restricted entities may be relaxed since the question of an opportunistic takeover may not arise.

Policy clarity and consistency:

India's digital eco-system is need of Policy consistency, friendly tax laws, ease of procedures, and simple regulatory architecture.

Startups often feel encumbered by bureaucratic processes, which appear to lack underlying standards. They have insufficient possibilities to find information, and there is little planning security about how long processes can take. In addition, regulations can suddenly change or startups receive random notices. As a result, startups have to find frustrating workarounds, waste valuable time or pivot their business model.

There is also challenge is certainty of regulation. The challenge is where it keeps on changing rapidly without any consultation process a case in point has been Press Note 2. The sudden change brought out in December 2018 asked for major change in the business model of e-commerce companies. It said that the e-commerce marketplaces will not exercise ownership or control over the inventory and that the entity with equity stake by e-commerce companies or its group companies or control over its inventory will not be allowed to sell its products on the marketplace.

"The government needs to have consistency in policy to build confidence and drive in investments from the private sector if India aims to become a globally competitive market and have products that are in line with global standards"

Need for greater transparency and expediency in the approval process: Another challenge in the context of PN3 has been the time taken for security clearance of the proposals. According to recent reports, since 2020 nearly 347 proposals have been received under PN3, of which, only 66 (80) have been granted approval so far.

While the security risk posed by Chinese entities persists, there is an urgent need for Indian entities to raise funds, particularly in the current geopolitical situation and more so in strategic sectors.

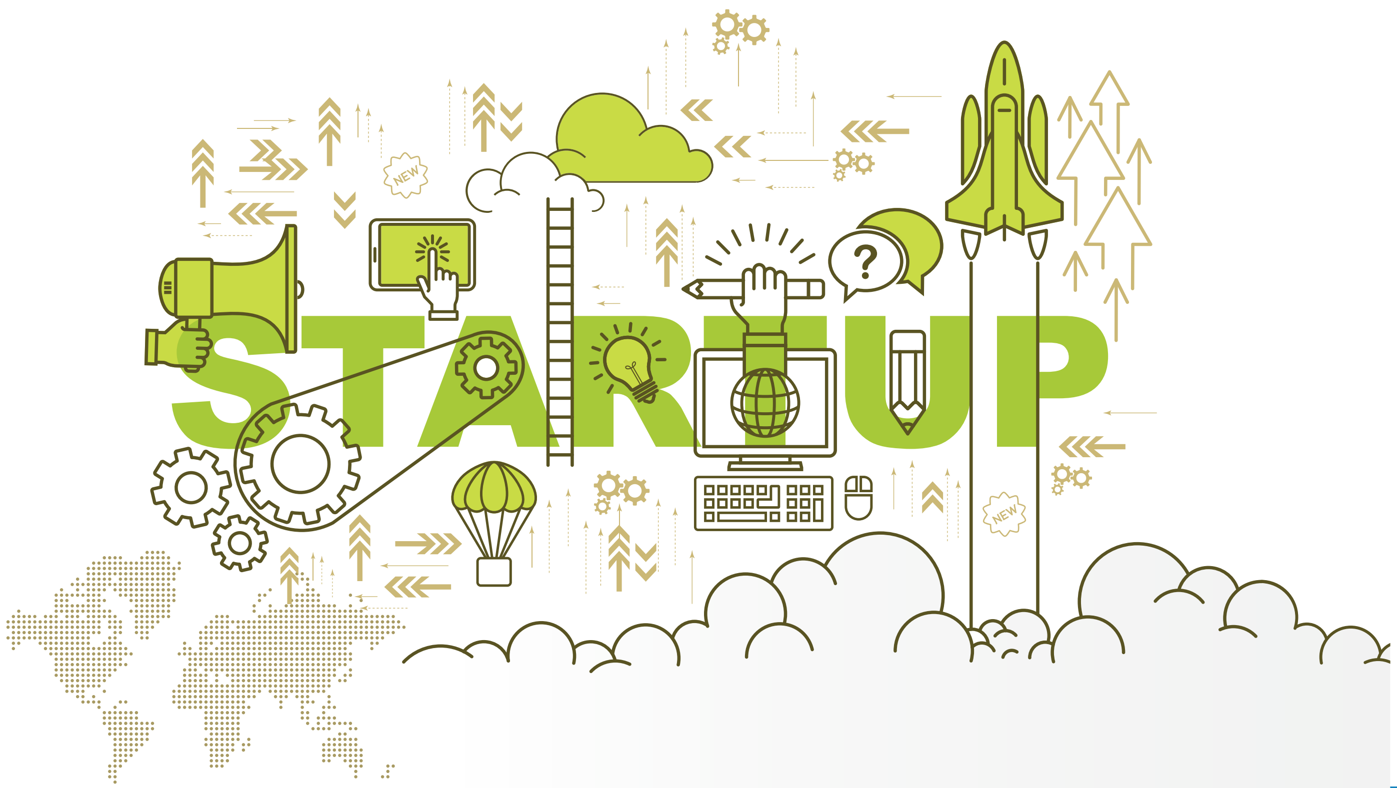
Funding winter

There is always a question that keeps popping up: is startup funding required? There is also a growing need for a credible knowledge base, which can simplify the answer to the universal question: why funding is required by startups?

The truth is out there in plain sight however and it says in big bold letters: funding is critical for every startup. So here is a shortlist that tries to answer why funding is required by startups.

Working Capital:

Perhaps the most important allocation of the startup funding received will be diverted to working capital. This enables adequate financial resources to be made available for the multiple expenses required for the smooth running of an enterprise. It also enables the availability of cash reserves to tide over any financial contingencies. Working capital goes a long way in ensuring short term financial well-being, scaling up operational efficiencies and on hand liquidity. The quantum of working capital needed is determined by the operational cycle of the business, market projections as well as the business goals envisaged in the short term. It is calculated as the difference between a company's current assets and current liabilities. Having a positive working capital, meaning when current assets exceed current liabilities, indicates a healthy financial status. The gap between production and revenue generation is also a good indicator of working capital requirement. The smaller the gap, the smaller the working capital is the general thumb rule.



Hiring Personnel:

A critical part of every startup is definitely the team it assembles. The intrinsic quality of its think tank and the team sharing the workload, is what can be the difference between a "has been" and a unicorn in the making.

So, from its founders to its key personnel, to its workforce, everyone needs to be adequately compensated for their efforts. A startup needs to be funded to be able to bear these salary expenses. It needs funds to attract, pay and retain the best talent it can afford to hire so that it can sustain and grow in the long run.

Clearances, Licenses & Certification Fees:

Startups have to register themselves with the statutory government body to qualify as a startup in India. There are certain registration fees payable here. Also a startup, given its operations may require certain licenses, or certifications from relevant authorities. All this requires finances, which can come from the funding it receives.

Trademark Registration & Patents:

Startups are very often about a unique solution, product design, technology or processes. These may need to be trademarked or patented so that it remains exclusive to the enterprise, becomes its identity and a source of revenue for it. These processes too require priority funding as they determine what the whole business is all about.

Legal Fees:

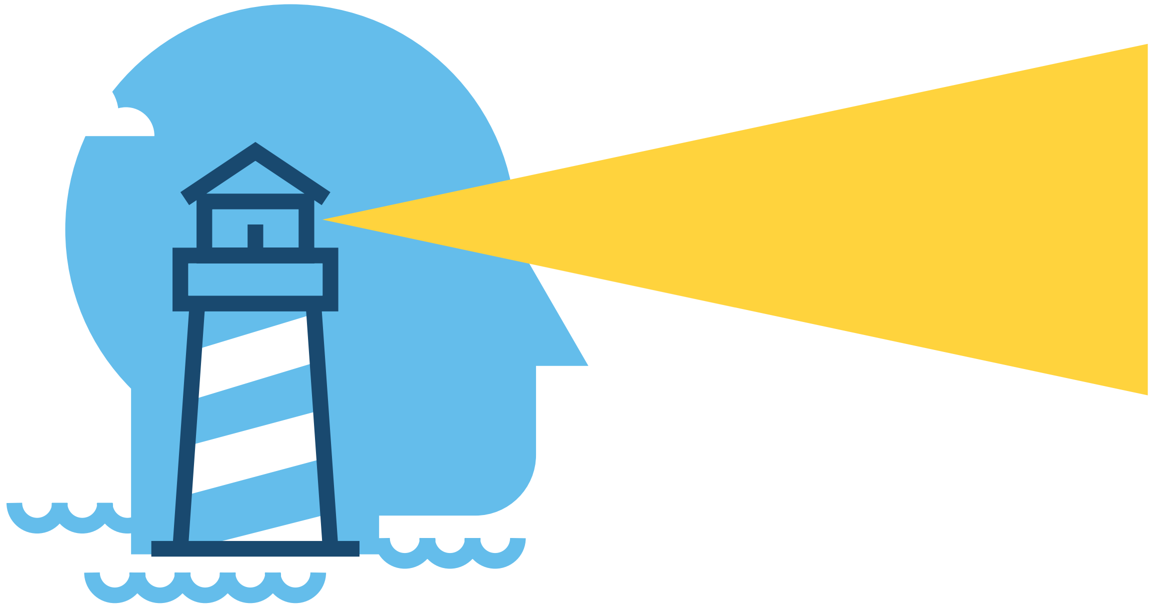
This is another important facet where funding is needed, since there are a whole lot of compliances and statutory filings that are needed, to establish the legal identity of an enterprise and its operations.

Office Space & Other Working Expenses:

Investing in a proper workspace takes priority for a startup. Funding is definitely needed to set up a modern workspace and all the necessary working assets like work stations, computers, printers and other peripherals that go into the making of a modern workspace.

Technology, Machinery & Raw Material:

These are big ticket capital investments that will make the business run. So the necessary investments in these areas are a must for which adequate funding is needed to not just purchase, but also install, operate and move on to full scale production.



Prototyping And Testing:

Making a working model, something tangible to test the market or even get an infusion of a fresh round of funding, is very important. Every startup needs appropriate funds to enable this to happen.

Product Development & Launch:

Every product goes through various stages. From research & development, through testing and market launch, it is a process that requires capital. Product equals revenue and so this becomes a critical area of why funding is required by startups.

Marketing & Sales:

Everything said and done when a technology, service or a product is ready, it has to be seen, heard and experienced at places where the customer is. Driving a marketing campaign across media requires deep pockets. A pool of funds dedicated to marketing can make a big difference in these competitive times.

The Indian economy has exhibited great resilience and upswing during and after the Covid pandemic, as evidenced by reassuring FDI inflows and growth of a record number of unicorns, which has just crossed 100 during the period. Now when the economy is accelerating, there is a need to ensure greater facilitation, transparency and time-bound decision-making.

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