Proposal for Software Product Development Fund (SPDF)

An iSPIRT Policy Blue Paper[1]

Background and Context

There is acute shortage of early stage capital for India Software Product Industry (SPI) startups[2]. Availability of angel and seed stage capital is a key driver in the growth of the Software Products Industry and has number of multiplier effects. These range from follow-on innovations to deepening of the entrepreneur pool to creating winners by increasing speed of execution.

We recommend a Rs 5,000 crores Software Development Fund (SPDF) patterned on Electronics Development Fund (EDF). SPDF should have three features. First and foremost, it should support many small angel and venture funds. Second, it should not try to pick winners. Third, it should foster relationships between Indian, Israel and US angel and seed investors.

In effect, we do not recommend an approach where there is a single venture fund managed by SIDBI. Given the fast pace of technology change in SPI this approach is unworkable. In terms of picking winners, governments and even venture capitalists themselves have a poor record of trying to guess which industries will grow the fastest over a 10-year horizon. The most successful investors in startups have therefore been those that remain flexible, able to adapt to unexpected innovations and the changing economic environment.

Early-stage investing operates locally because only those embedded in the community have the information needed to place wise bets on unproven managers. But as companies grow and mature, later-stage investments increasingly play out on a global stage.

Addressing the early stage-financing gap will reduce mortality before the product-market fit stage. An iSPIRT survey has shown that currently 67% of the SPI startups are pre-product-market fit stage.

Objective

Objective	Strategies
Create corpus to promote indigenous R&D, IPR creation, entrepreneurship, and deployment of state-of-the-art Software Products.	To harness India's entrepreneurial energy and Intellectual capital for the cause of Software Product R&D

[1] This is a draft Policy Blue Paper Comments may be sent to nakul@ispirt.in. Final version is expected in Jul/Aug 2014.

[2] This has been surfaced in Sep'12 Report titled "Creating a Vibrant Entrepreneurial Ecosystem in India" by Committee on Angel Investment and Early Stage Venture Capital, appointed by the Planning Commission, under the chairmanship of Shri Sunil Mitra, former Revenue Secretary, Government of India.

	To encourage the young entrepreneurs by making available needed funding (pre-venture and venture capital), management and mentoring support. To assist entrepreneurs to develop and commercialize Indian products. To strengthen the links in the complete value chain from basic research to IPR generation, product design and development, product commercialization, and simultaneously achieving economies of scale, thereby enabling the product to compete internationally. To create fund to promote indigenous R&D, IPR creation, entrepreneurship and deployment of state-of-the-art Software Products. Emphasis will be given to creation of Indian IPRs, which go into international standards as a vehicle to develop **Brand India.**

Israel Experience

To develop the project strategy, the experience of some other countries, which have attempted to develop the R&D and innovation ecosystem, was studied. More specifically, we deal with the experiences of Israel, which has a very strong Software Product industry.

The Israeli government's 1992 Yozma programme is an example of an extremely successful initiative which not only launched the private capital into software products but also led to creating a huge R&D and innovation ecosystem for the country. It also created a solid base for a competitive Venture Capital (VC) industry with critical mass; a network which enabled entrepreneurs in Israel to learn from foreign limited partners; and to acquire a network of international contacts. Yozma was started as a $100M Government owned Venture Capital fund (with the same name) oriented to two functions: a) fund of funds- investment in 10 private VC funds ('Yozma Funds'-$80M); and b) direct investments in high tech companies-$20M (through the Government –owned 'Yozma Venture Fund'). The result was establishment of domestic, private VC industry that invested in young Israeli high tech startups ("early phase investments") with the support of government and with the involvement of reputable foreign financial institutions (generally a foreign private equity **or** venture capital company). Each Yozma fund was managed by an independent, Israeli VC Management Company. It would have to engage one such foreign institution together with a well-established Israeli financial institution. This emphasizes the point that the Yozma program favoured entry of professional managers or of individuals with VC-related abilities. Moreover, the insistence on formal organizations as a pre-condition to become a Yozma fund, suggests that its initiators understood the significant role of institutions in the process of learning, generating capabilities and reputation. In an approved fund that fulfilled these conditions, the Government would invest 40% (up to $8M) of the funds raised. Thus $100M of Government Funds would draw $150M of private sector funds (domestic and foreign).

These "sibling" funds were the backbone of a now vibrant community that invested in excess of $1 billion in Israel in 1999. Yozma did not simply provide capital and risk sharing incentives to investors-- as was common in other Government VC support programs; its main incentive was in the "upside" - each Yozma fund had a call option on Government shares, at cost (plus 5-7% interest) for a period of five years.

The Yozma programme invested primarily into start-ups / early stage companies. The Yozma funds invested in over 200 startup companies." Also, immigrants played a key role in development of technology and combined with Israel‟s strategic relationship with the US and its own military technology development programme, led to the formation of a successful combination.

Funding Model

Recognizing the fact that R&D and innovation in the Software Product sector is extremely rapid and industry competing in the market is best equipped to undertake such rapid ongoing innovation, we propose a model of channelizing adequate financial support wherein risk capital can be made available for R&D and innovation through professionals. Two inherent features of this model is that funding is made available to both public sector and private sector and that the decision to fund a particular R&D and innovation project is handled by experts familiar with the domain.

A general analysis of various structures establishes the ineffectiveness of grant programmes and subsidies both direct and indirect for development of R&D and innovation. However, venture investment with an incentive for private sponsor‟s performance has proved successful in the examples referred to above. Policy level interventions of the government like tax pass-through status, enabling creation of required social and educational infrastructure, duty free import of capital equipment and reduced borrowing costs for investee companies may also contribute significantly to chances of success. Therefore, it is recommended to that the proposed SPDF would invest into Sister Funds focused on R&D and innovation in the all verticals of the Software Product sector.

To mitigate the risks, it is important for government to be at arm's-length from the day-to-day Fund Management and operations; as such intervention in other countries has been counterproductive. However, government may guide overall focus of the direction of fund flow through the high level guidance to each sister fund and by suitably specifying the requirements at the time of creating a sister fund. Strict auditing of the Funds is a must; as per established industry norms in this regard.

Software Product Development Fund (SPDF)

The scope of the proposed SPDF includes all software product companies. This could be done through a Rs. 5,000 crores for investing into IPR, Product Development and Technology Innovation in Software Product Industry. The SPDF would deploy funds in sister funds in the areas of Innovation, IP development, product development and commercialization. They sister funds could also be categorized based on the Seed, Early and Growth Stage Companies and also for Software Product Companies which are developing products for Defense, Aerospace and other sensitive areas which are important for the security of the Country.

SPDF Framework

A body having representatives of government and industry may be constituted to manage the fund. This could be called the SPDF Managing Board and would function under the overall guidance and directions of DEITY. The SPDF Managing board would have representatives from Government, Industry, and Fund Manager Representatives.

SPDF would be invested into smaller “sister funds”, which would leverage SPDF‟s capital to raise investment from other investors, to enlarge the pool of investible funds. These funds would need to be registered with the Securities Exchange Board of India (SEBI), which is the regulator for venture capital funds in the country. The funds are typically structured as trusts, with an asset management company (AMC) providing investment advice. Basically, the AMC carries out all activities of screening investment proposals, negotiation of terms, execution of legal documents with the investee companies, disbursement of funds, monitoring, mentoring and other advice to the investee companies aimed at building up the investee companies. After staying invested for a typical period of 5 years, the fund manager (AMC) looks to exit the investments. Those funds which are registered with SEBI are eligible for tax pass-through status.

The structure of the SPDF is proposed below:

1. 1.SPDF would be a Government of India sponsored, revolving fund with an corpus of Rs. 5,000 crores with the purpose of fulfilling the objectives mentioned above.
2. Within the overall project objective and the thrust for R&D and innovation, the focus sectors/activities of SPDF to be decided by the SPDF Managing Board under the guidance of DEITY.
3. SPDF would work as a Fund of Funds and invest into “Sister Funds”. SPDF‟s disbursements would take place out of Government of India’s budgetary allocation from year to year. As such, SPDF would be a virtual fund.
4. “Sister funds” would be managed by professional managers.
5. SPDF would be managed by a body known as the “SPDF Managing Board” with members drawn from government, and industry experienced in early and growth stage venture investing.
6. Drawdown of funds by the sister funds from SPDF would be after execution of necessary agreements with the Government.
7. Each investment would typically contribute between 25% - 49% of the Sister funds. This would catalyse between 2 - 4 times the investment by the SPDF both by way of domestic and foreign money. In specific cases, such as funds dedicated to Innovation and R&D, incubation and allied activities, 100% of the fund could be contributed by SPDF.
8. Each daughter fund may range between Rs. 250 – 500 crores.
9. The above structure could lead to focused funds e.g. “seed stage fund for Innovation, IPR and R&D”, “early stage fund for commercialization of R&D”, “growth stage fund for acquisition” etc.

Financial and economic impact expected

SPDF is expected to leverage about Rs. 5,000 crores from other investors. Thus, the total investible corpus could be in the range of Rs. 10,000 crore, which is expected to benefit the Software Product Industry. The major benefits are expected to be in the technology domain as the investments are expected to generate ownership of valuable technology for the country. This would result in acceleration of the software product industry. Further, it is also expected to have a positive impact with respect to the strategic industries such as defense, aerospace and electronics.