Impact of Venture Capital on Innovation and Creation of New Business in Kathmandu Valley

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Abstract

This study examines the impact of venture capital on innovation and creation of new business in Kathmandu Valley. Innovation is the dependent variable. The independent variables are government policy, venture capital funding, industry focus of VC firms, market condition, and founder. The primary source of data is used to assess the opinions of the respondents regarding government policy, venture capital funding, industry focus of VC firms, market condition, and founder. The study is based on primary data of 125 respondents. To achieve the purpose of the study, structured questionnaire is prepared. The correlation coefficients and regression models are estimated to test the significance and importance of impact of venture capital on innovation and creation of new business in Kathmandu Valley.

The result showed that government policy has a positive impact on innovation. It indicates that supportive government policy regarding venture capital leads to increase in innovation. Similarly, venture capital funding has a positive impact on innovation. It indicate that taking venture capital funding increase in innovation. Likewise, industry focus of VC firms has a positive impact on innovation. It indicates that industry focus of VC firms leads to more innovation in the industry. Further, market condition has a positive impact on innovation. It indicates that favourable market condition leads to increase in innovation. In addition, founder has a positive impact on innovation. It indicates that investing in capable founder leads to increase in innovation.

Keywords: government policy, venture capital funding, industry focus of VC firms, market condition, founder

1. Introduction

Venture capital (VC) is a type of funding offered to innovative start-ups with high growth potential in exchange for equity in the company. This type of funding has gained popularity in recent years as a major source of funding for start-ups (Gompers and Lerner, 2001). Traditional sources of funding, such as bank loans and personal savings, often come with high interest rates and stringent repayment terms, making it difficult for start-ups to access the capital they need to grow and thrive. Moreover, these sources of funding are often only available to established companies with a proven track record, making it difficult for start-ups to raise the capital they need to start and grow their businesses. VC fills this gap by funding start-ups with innovative

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ideas and high growth potential, allowing them to invest in research and development activities, launch new products and services, and improve existing ones. In addition, venture capitalists provide start-ups with strategic advice and mentoring, help them develop business models and strategies, and give them access to networks and expertise that can help them grow and succeed (Kaplan and Stromberg, 2003). Similarly, Kortum and Lerner (2000) found that venture capital financing has a positive impact on innovation, with venture-backed firms being more likely to engage in R&D and to generate patents. Similarly, Likewise, Hellmann and Puri (2000) found that venture capital financing can facilitate entry into new product markets by providing the resources needed to develop and commercialize new products. Further, Hyytinen and Toivanen (2015) found that venture capital funding leads to higher level of innovation, increased productivity, and the creation of new jobs.

Baum and Silverman (2004) found that venture capitalists prefer to invest in start-ups with strong alliances with other firms, as well as those with valuable intellectual and human capital resources. The study also found that venture capital investment is positively associated with the creation of new businesses. Similarly, Dessi and Yin (2012) concluded that venture capital investment and innovation are mutually reinforcing, with venture capital financing leading to greater innovation, and innovative firms being more likely to receive venture capital funding. Likewise, Smith and Smith (2004) found that venture capitalist participation is positively associated with the post-issue operating performance of IPO firms, with the effect being stronger for venture capitalists who take an active role in the governance of their portfolio companies. In addition, Gompers and Lerner (1999) examined the venture capital revolution. The study found that venture capital investment is associated with a higher likelihood of patenting and the creation of new businesses. Further, Dessi and Yin (2012) concluded that venture capital investment and innovation are mutually reinforcing, with venture capital financing leading to greater innovation, and innovative firms being more likely to receive venture capital funding. In addition, Da Rin *et al.* (2006) found that tax incentives and the development of institutional infrastructure can play a critical role in creating active VC markets and promoting innovation and the creation of new businesses.

Guellec and Van Pottelsberghe de la Potterie (2004) found that stronger IP protection is positively associated with the creation of new businesses and the overall level of innovation. Likewise, Hellmann *et al.* (2009) found that

seed-stage VC investments are more likely to result in radical innovation, while later-stage investments are more likely to result in incremental innovation. In addition, Cumming and Johan (2013) concluded that the availability of early-stage VC funding was positively associated with the level of innovation in the economy, while later-stage funding had a negative association. Similarly, Lerner and Tåg (2013) found that the overall level of innovation in the economy is positively associated with the availability of VC funding for early-stage startups. Likewise, Lee and Lee (2019) found that startups that received moderate levels of funding were more likely to develop high-quality patents, while startups that received too little or too much funding are less likely to do so. In addition, O'Mahony and Robinson (2008) found that startups that received too little funding are less likely to survive, while those that received too much funding were more likely to engage in excessive spending and less likely to focus on innovation. In addition, Gompers and Lerner (2001) found that venture capital investment is positively correlated with the success of US start-ups. Similarly, Hellmann and Puri (2002) showed that venture capital investors not only provide a source of funding, but also expertise, networks, and advice to assist start-ups in developing innovative technologies and business models to do. Likewise, Baum and Silverman (2004) concluded that the experience and expertise of the entrepreneur are important factors in the success of start-ups, and that venture capital investors tended to prefer entrepreneurs with prior experience in the industry.

Cumming and Johan (2008) analysed pre-seed government venture capital funds. The study found that government venture capital funds can play a crucial role in bridging the funding gap for pre-seed ventures and promoting the growth of innovative startups. Similarly, Hellmann and Puri (2002) studied the relationship between venture capital and the professionalization of start-up firms. The study found that venture capital funds have positive impact on the professionalization of start-up firms and that this effect is mediated by factors such as board composition, human resource practices, and financial reporting. Likewise, Wolter and Breugst (2019) examined the impact of venture capital (VC) on the development of new businesses. The study found that VC investment has a positive impact on the development of new businesses, particularly in terms of job creation and revenue growth. Further, Popov and Roosenboom (2019) investigated the relationship between venture capital (VC) and new business creation. The study found that VC investments have positive effect on new business creation, particularly in industries with high levels of innovation and in regions with well-developed financial markets. Moreover, Gao and Xie (2020) investigated the relationship between

venture capital (VC), innovation, and economic growth in China. The study concluded that innovation mediates the relationship between VC investments and economic growth, suggesting that VC investments promote economic growth through their positive effect on innovation.

In the context of Nepal, Paudel and Koirala (2019) argued that venture capital can play an important role in promoting innovation and sustainable development in emerging economies such as Nepal. But the impact of venture capital investment may also be limited by the lack of infrastructure and skilled human resources in rural areas. Similarly, Shrestha and Karki (2018) stated that venture capital investment is concentrated in urban areas, where there is a higher concentration of startups and a more developed start-up ecosystem. Likewise, Bhattarai (2019) found that venture capital plays a crucial role in promoting entrepreneurship in Nepal by providing access to capital, expertise, and networks. Further, Dhakal and Paudel (2019) investigated the impact of venture capital (VC) on the growth of small and medium-sized enterprises (SMEs) in Nepal and found that VC funding has a significant positive impact on the growth of Nepalese SMEs by providing access to capital, expertise, and networks. In addition, Koirala and Maharjan (2019) found that VC funding has a positive impact on technological innovation in Kathmandu Valley by providing access to capital, expertise, and networks. Moreover, Neupane (2018) found that VC funding has a positive impact on entrepreneurship and economic growth in Nepal by providing access to capital, expertise, and networks.

The above discussion shows that empirical evidences vary greatly across the studies on the impact of venture capital and creation of new business on innovation. Though there are above mentioned empirical evidences in the context of other countries and in Nepal, no such findings using more recent data exist in the context of Nepal. Therefore, in order to support one view or the other, this study has been conducted.

The major objective of the study is to examine the impact of venture capital and creation of new business on innovation in Kathmandu Valley. Specifically, it examines the relationship of government policy, venture capital funding, industry focus of VC firms, market condition and founder with innovation in Kathmandu Valley.

The remainder of this study is organized as follows. Section two describes the sample, data and methodology. Section three presents the empirical results and the final section draws the conclusion.

2. Methodological aspects

The study is based on the primary data which were collected from 125 respondents through questionnaire. The study employed convenience sampling method. The respondents' views were collected on government policy, venture capital funding, industry focus of VC firms, market condition, founder and innovation. This study has employed descriptive research design and casual comparative research design.

The model

The model used in this study assumes that innovation depends upon venture capital. The dependent variable selected for the study is innovation. Similarly, the selected independent variables are government policy, venture capital funding, industry focus of VC firms, market condition and founder. Therefore, the model takes the following form:

$I = \beta_0 + \beta_1 GP + \beta_2 VC + \beta_3 IF + \beta_4 MC + \beta_5 F + e$

Where,

I = Innovation

GP = Government policy

VC = Venture capital funding

IF= Industry focus of VC firms

MC= Market condition

F=Founder

Government policy was measured by using a 5-point Likert scale where the respondents were asked to indicate the responses using 5 is for strongly disagree and 1 for strongly agree. There are 5 items and sample items include "Government policies in Kathmandu Valley are supportive of venture capital investments", "The government policies related to venture capital investments are clear and easy to understand." and so on. The reliability of the items was measured by computing the Cronbach's alpha ($\alpha = 0.900$).

Venture capital funding was measured by using a 5-point Likert scale where the respondents were asked to indicate the responses using 5 is for strongly disagree and 1 for strongly agree. There are 5 items and sample items include "Venture capital funding is an important source of financing for new businesses in Kathmandu Valley", "The terms and conditions of venture capital funding can be restrictive for new businesses" and so on. The reliability of the feature was measured by computing the Cronbach's alpha ($\alpha = 0.823$).

Industry focus of VC firms was measured by using a 5-point Likert scale where the respondents were asked to indicate the responses using 5 is for strongly disagree and 1 for strongly agree. There are 5 items and sample items include "Venture capital firms that focus on specific industries are better equipped to identify and invest in innovative new businesses", "Venture capital firms that focus on specific industries are more likely to provide funding and resources to help new businesses succeed" and so on. The reliability of the feature was measured by computing the Cronbach's alpha ($\alpha = 0.780$).

Market condition was measured by using a 5-point Likert scale where the respondents were asked to indicate the responses using 5 is for strongly disagree and 1 for strongly agree. There are 5 items and sample items include "Favourable market conditions, such as high demand and low competition, increase the likelihood of Creation of new businesses", "The market conditions in Kathmandu Valley are welcoming to innovative ideas" and so on. The reliability of the feature was measured by computing the Cronbach's alpha ($\alpha = 0.822$).

Founder was measured by using a 5-point Likert scale where the respondents were asked to indicate the responses using 5 is for strongly disagree and 1 for strongly agree. There are 5 items and sample items include "The experience and expertise of the founder has a significant impact on its success and growth potential", "Venture capital firms are more likely to invest in businesses with experienced and successful founders" and so on. The reliability of the feature was measured by computing the Cronbach's alpha ($\alpha = 0.775$).

Innovation was measured by using a 5-point Likert scale where the respondents were asked to indicate the responses using 5 is for strongly disagree and 1 for strongly agree. There are 5 items and sample items include "The presence of venture capital firms in Kathmandu valley has increased the level of innovation in the local startup ecosystem", "Venture capital investments have led to the creation of new businesses that are more innovative than those funded through traditional financing methods" and so on. The reliability of the feature was measured by computing the Cronbach's alpha ($\alpha = 0.829$).

The following section describes the independent variables used in this study along with the hypothesis formulation.

Government policies

Government policy refers to the actions and regulations put in place by governments to influence the economy and society. Government policies

related to venture capital investments can include tax incentives, subsidies, and regulatory frameworks designed to encourage investment and support the growth of new businesses (Gompers & Lerner, 2001). Paudel and Koirala (2019) stated that the government should develop a regulatory framework to ensure that venture capital investments are transparent, accountable, and aligned with sustainable development goals. This could include measures such as tax incentives, streamlined investment procedures, and investor protection mechanisms. Tax policies can influence the level of investment in VC funds and the returns generated by VC investments, which in turn can affect the amount of capital available for investment in innovative startups (Keuschnigg & Nielsen, 2004). Lerner and Tåg (2013) found that government policies that provide incentives for venture capital investment can increase the amount of venture capital investment and promote innovation in Europe. Similarly, Hain and Kostova (2018) found that government policy support for venture capital investment, such as subsidies and guarantees, can increase the amount of venture capital investment and promote innovation in the European Union. Policies that support innovation and create a favourable business environment can increase compatibility and encourage the development and adoption of new technologies (Chen *et al*., 2020). Based on it, this study develops the following hypothesis:

H_1: There is a positive relationship between government policy and innovation.

Venture capital funding

The type and amount of venture capital (VC) funding can have a significant impact on innovation and the creation of new businesses. Hellmann *et al.* (2009) found that seed-stage VC investments were more likely to result in radical innovation, while later-stage investments were more likely to result in incremental innovation. Cumming and Johan (2013) found that the availability of early-stage VC funding was positively associated with the level of innovation in the economy, while later-stage funding had a negative association. Similarly, Lerner and Tåg (2013) found that the overall level of innovation in the economy was positively associated with the availability of VC funding for early-stage startups. Lee and Lee (2019) found that startups that received moderate levels of funding were more likely to develop high-quality patents, while startups that received too little or too much funding were less likely to do so. O'Mahony and Robinson (2008) found that startups that received too little funding were less likely to survive, while those that received too much funding were more likely to engage in excessive spending and less likely to focus on innovation.In the context of Kathmandu Valley,

Nepal, numerous studies have explored the impact of venture capital funding on innovation and the creation of new businesses. Karki and Thapa (2019) found that venture capital funding positively influenced the growth and success of startups in Nepal. Adhikari *et al.* (2020) found that venture capital funding was associated with higher levels of innovation in Nepalese start-ups. Bhattarai and Upreti (2021) found that venture capital funding positively affected the survival and growth of start-ups in Nepal. These findings suggest that venture capital funding can be an important source of capital for start-ups in Kathmandu Valley and can have a positive impact on innovation and the creation of new businesses. Based on it, this study develops the following hypothesis:

H_2: There is a positive relationship between venture capital funding and innovation.

Industry focus of VC firms

VC firms with a specific industry focus may have greater expertise, knowledge, and networks in that industry, which can enable them to identify and support innovative startups more effectively (Gompers & Lerner, 2001). Kerr and Nanda (2009) found that venture capital firms with a narrower industry focus had a higher likelihood of producing successful start-ups. Similarly, Kortum and Lerner (2000) found that venture capital firms with a narrower industry focus were more likely to invest in start-ups with innovative technologies.VC firms with a broader industry focus may face less competition from other firms in their target industries, which can enable them to identify and invest in a wider range of startups (Agrawal & Knoeber, 2001). Karki and Thapa (2019) found that the majority of the venture capital investments in Nepal are focused on technology start-ups, followed by agriculture and energy sectors. Based on it, this study develops the following hypothesis:

H_3: There is a positive relationship between industry focus of VC firms and innovation.

Market conditions

Market conditions refer to the external economic and industry factors that influence the demand and supply of goods and services in the market. Gompers and Lerner (1999) found that market conditions, such as the level of competition and the availability of complementary resources, can affect the success of venture-backed start-ups. Similarly, Da Rin *et al.* (2015) found that market conditions, such as the size of the market and the level of competition, can affect the amount of innovation generated by venture-backed start-ups.

Likewise, Lerner and Tag (2013) found that government policies that provide incentives for venture capital investment can increase the amount of venture capital investment and promote innovation in Europe, which can improve market conditions for start-ups. Further, Kerr and Nanda (2015) found that venture capital funding can help start-ups to overcome financing constraints during times of economic downturn, which can lead to higher levels of innovation. Moreover, Hellmann and Puri (2002) found that venture capital funding is positively associated with the adoption of professional management practices in start-ups, which can help these firms to navigate challenging market conditions. Based on it, this study develops the following hypothesis:

H_4: There is a positive relationship between market condition and innovation.

Founder

Founder refers to the individual or individuals who created and launched a new start-up company. The characteristics and qualities of the founder can have a significant impact on the level and type of innovation within the company (Chatterjee *et al.,* 2017).Research has shown that the founder's vision, passion, and experience can influence the innovative output of the company (Hsu *et al.,* 2017; Kim & Nofsinger, 2017). Additionally, the founder's ability to attract and retain talented employees can impact the company's ability to innovate (Thornhill *et al.,* 2019). Furthermore, the founder's risk-taking propensity and ability to manage uncertainty can impact the company's innovation strategy (Gupta et al., 2019). Founders who possess a strong entrepreneurial mind-set and are willing to take risks can drive innovation within their companies (Zhang *et al.,* 2016). Moreover, founders who have experience in the industry or sector in which they are launching their start-up can bring valuable knowledge and insights to the innovation process (Chatterjee *et al.,* 2017). Lerner and Schoar (2005) found that VC firms tend to prefer startups with founder-CEOs because they believe that founders are more committed to the success of their company and are more likely to make decisions that lead to innovation. Hellmann and Puri (2002) found that VC-backed firms with founder-CEOs tend to have lower innovation output compared to firms with non-founder CEOs. Kuppuswamy and Villalonga (2016) found that founder-CEOs have positive impact on innovation in VC-backed firms. The authors argue that founder-CEOs have a deep understanding of their technology and market, which allows them to make strategic decisions that lead to innovation. Based on it, this study develops the following hypothesis:

H_5: There is a positive relationship between founder and innovation.

3. Results and discussion

Correlation analysis

On analysis of data, correlation analysis has been undertaken first and for this purpose, Kendall's Tau correlation coefficients along with means and standard deviations have been computed, and the results are presented in Table 1

Table 1

Kendall's correlation coefficients matrix

This table presents Kendall's Tau coefficients between dependent and independent variables. The correlation coefficients are based on 125 observations. The dependent variable is I (Innovation). The independent variables are GP (Government policy), VC (Venture capital funding), IF (Industry focus of VC firms), MC (Market conditions), and F (Founder).

Variables	Mean	S.D.	I	GP	VC	IF	MC	F
I	2.79	0.62	1					
GP	2.33	0.54	0.376**	1				
VC	2.28	0.61	0.279**	0.487**	1			
IF	2.22	0.65	0.231**	0.453**	0.511**	1		
MC	2.20	0.71	0.172**	0.434**	0.546**	0.521**	1	
F	2.25	0.85	0.207**	0.408**	0.471**	0.423**	0.453**	1

Note: The asterisk signs (**) and (*) indicate that the results are significant at one percent and five percent levels respectively.

Table 1 shows that government policy related to VC is positively correlated to innovation. It indicates that supportive government policy leads to increase in innovation. Similarly, type of venture capital funding is positively correlated to innovation. It indicates that venture capital funding leads to increase in innovation. Likewise, industry focus of VC firms is positively correlated to innovation. It indicates that industry focus of VC firms leads to increase in innovation. Further, Market condition is also positively related to innovation. It indicates that good market condition leads to increase in innovation. In addition, founder is positively correlated to innovation. It indicates that good characteristics of founder drives to increase in innovation and attract more venture capital investment.

Regression analysis

Having indicated the Kendall's Tau correlation coefficients matrix, the regression analysis has been carried out and the results are presented in Table 2. More specifically, it shows the regression results of government policy, venture capital funding, industry focus of VC firms, market conditions and

founder on innovation.

Table 2

Estimated regression results of government policy, venture capital funding, industry focus of VC firms, market conditions and founder on innovation

The results are based on 123 observations using linear regression model. The model is UA = $\beta_0 + \beta_1$ GP+ β_2 VC+ β_3 IF+ β_4 MC+ β_5 F+e where the dependent variable is I (Innovation). The independent variables are GP (Government policy), VC (Venture capital funding), IF (Industry focus of VC firms), MC (Market conditions), and F (Founder).

Model	Intercept	Regression coefficients of					Adj. R_bar2	SEE	F-value
		GP	VC	IF	MC	F			
1	1.503 (7.368)**	0.267 (3.895)**					0.103	0.774	15.170
2	0.834 (4.827)**		0.607 (8.702)**				0.376	0.646	75.719
3	0.640 (3.442)**			0.707 (9.095)**			0.397	0.635	82.725
4	1.021 (5.630)**				0.554 (7.203)**		0.291	0.688	51.881
5	0.714 (3.953)**					0.697 (8.958)**	0.309	0.638	80.247
6	0.823 (4.231)**	0.008 (0.125)	0.602 (7.313)**				0.371	0.648	37.564
7	0.481 (2.462)*	0.047 (0.733)	0.365 (3.950)**	0.460 (4.552)**			0.458	0.601	35.997
8	0.436 (2.197)*	0.042 (0.660)	0.121 (1.241)	0.341 (3.617)**	0.382 (3.204)**		0.461	0.600	27.503
9	0.328 (1.656)	0.032 (0.519)	0.054 (0.544)	0.303 (3.255)**	0.297 (2.621)**	0.234 (1.807)	0.486	0.586	24.454

Notes:

i. *Figures in parenthesis are t-values.*
ii. *The asterisk signs (**) and (*) indicate that the results are significant at one percent and five percent level respectively.*
iii. *Innovation is dependent variable.*

The regression results show that the beta coefficients for government policy are positive with innovation. It indicates that government policy has a positive impact on innovation. This finding is consistent with the findings of Colombo & Grilli (2005). Similarly, the beta coefficients for venture capital funding are positive with innovation. It indicates that venture capital funding has a positive impact on innovation. This finding is consistent with the findings of Cumming and Johan (2013). Likewise, the beta coefficients for industry focus of VC firms are positive with innovation. It indicates that industry focus of VC firms have positive impact on innovation. This finding is consistent with the findings of Kortum and Lerner (2000). Further, the beta coefficients for market condition are positive with innovation. It indicates that market condition has a positive impact on innovation. This finding is consistent with the findings of Klotz *et al.* (2014). Moreover, the beta coefficients for founder are positive with innovation. It indicates that founder has a positive impact

on innovation. This finding is similar to the findings of Gimmon and Levie (2010).

4. Summary and conclusion

Venture capital is a form of private equity financing that is provided to early-stage companies with high growth potential, in exchange for an ownership stake. Venture capitalists invest in innovative startups and provide both funding and strategic guidance to help them scale and succeed. Venture capital remains an important source of funding for startups with high growth potential. It has played a key role in the growth of some of the world's most successful companies, including Google, Facebook, and Amazon.

This study attempts to examine the impact of venture capital on innovation and creation of new business in Kathmandu valley. The study is based on primary data with 125 observations.

The study showed that government policy, venture capital funding, industry focus of VC firms, market condition and founder have positive relationship with innovation. The study also concludes that industry focus of VC firms followed by founder are the most influencing factors that affect the impact of VC in innovation and creation of new business.

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