How do venture capital funds evaluate an investment proposal?

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While we have earlier talked about the venture capital fund raising process from the entrepreneur's perspective, this article will provide a simplified version of the investment evaluation process from a VC's perspective.

This article has broken the VC's investment evaluation process into 4-steps. Entrepreneurs can use this to understand as to which step they are at vis-à-vis their fund-raising endeavors and how much work is left before they get a chance to see the money from the venture capital fund.

Step 1: Meeting with the promoters

If the venture capital investor likes the first teaser about the company, they set up a meeting with the promoters of the company. During this meeting, VC's objective is to meet the core team, understand the team's strengths and weaknesses, get a good understanding of business model, market potential, competitive landscape and exit options etc. This meeting is generally followed by a list of questions from the VCs and promoters answer to these questions with a lot of information.

Step 2: Validating the promoters "story"

After step 1, VCs do their own research to validate the promoters' story. They mostly do it in-house but in rare cases, they hire an outside agency to verify the promoters' claims about the business model, business potential, market size etc. They also talk to a few of company's vendors, partners and/or customers to get some feedback on company's background, market reputation of the promoters, product/service quality etc.

Step 3: Internal brainstorming and presentation to the investment committee

If the VC is satisfied with his findings in step 2, then the deal team inside the venture capital fund prepares the IM (Investment Memorandum) that captures investment rationale, valuation, exit scenarios, and key risk factors. VC presents this IM to his investment committee (IC).

Investment Committee is VCs internal group, which comprises of their limited and general partners and they provide their feedback on the investment opportunity. IC raises a number of issues about the investment and if after their discussion, venture capital fund is still positive about the investment then they call the promoters of the company for a presentation to some/all members of the investment committee.

The meeting with the partners is an important step in fund-raising process. The promoters should try to reach this step as quickly as possible by pushing their contact person in the VC fund. If the VC is being reluctant in setting up the meeting even after 10 weeks of first meeting, then promoters should realize that VC is not very interested in their proposal and it is most likely to result in a negative response.

Step 4: Detailed validation (due diligence) and shareholders' agreement

If everything goes well during the IC meeting, VCs generally issue a term sheet mentioning their key terms and conditions of investment. Once there is an agreement on all the terms and conditions mentioned in the term sheet, VCs perform a detailed due diligence on the company. Since there is hardly any financial information to verify in case of a start-up company, the due-diligence process for start-ups is restricted to VCs trying to get into details of fund requirements, detailed usage of funds, month-by-month milestones etc.

Generally, VCs end up adding a lot of additional terms and conditions after the due diligence process under the section "conditions precedent" in the shareholders' agreement. Once the promoters take care of all the issues identified during the due diligence process, VCs and promoters sign the shareholders' agreement and money is transferred to the company's account.

Source: http://wowfinance.wordpress.com

The venture capital investment process

http://www.indiamarkets.com

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The venture capital investment activity is a sequential process involving five steps; Deal origination; Screening; Evaluation or due diligence; Deal structuring, and Post-investment activities and exit

Deal origination

A continuous flow of deals is essential for the venture capital business. Deals may originate in various ways. Referral system is an important source of deals. Deals may be referred to the VCs through their parent organizations, trade partners, industry associations, friends etc. The venture capital industry in India has become quite proactive in its approach to generating the deal flow by encouraging individuals to come up with their business plans. Consultancy firms like Mckinsey and Arthur Anderson have come up with business plan competitions on an all India basis through the popular press as well as direct interaction with premier educational and research institutions to source new and innovative ideas. The short listed plans are provided with necessary expertise through people who have experience in the industry.

Screening

VCFs carry out initial screening of all projects on the basis of some broad criteria. For example the screening process may limit projects to areas in which the venture capitalist is familiar in terms of technology, or product, or market scope. The size of investment, geographical location and stage of financing could also be used as the broad screening criteria.

Evaluation or due diligence

Once a proposal has passed through initial screening, it is subjected to a detailed evaluation or due diligence process. Most ventures are new and the entrepreneurs may lack operating experience. Hence a sophisticated, formal evaluation is neither possible nor desirable. The VCs thus rely on a subjective but comprehensive, evaluation. VCFs evaluate the quality of the entrepreneur before appraising the characteristics of the product, market or technology. Most venture capitalists ask for a business plan to make an assessment of the possible risk and expected return on the venture.

Deal structuring

Once the venture has been evaluated as viable, the venture capitalist and the investment company negotiate the terms of the deal, i.e., the amount, form and price of the investment. This process is termed as dealstructuring. The agreement also includes the protective covenants and earn-out arrangements. Covenants include the venture capitalists right to control the investee company and to change its management if needed, buy back arrangements, acquisition, making initial public offerings (IPOs) etc, Earn-out arrangements specify the entrepreneur's equity share and the objectives to be achieved.

Venture capitalists generally negotiate deals to ensure protection of their interests. They would like a deal to provide for:

- A return commensurate with the risk
- Influence over the firm through board membership
- Minimizing taxes
- Assuring investment liquidity
- The right to replace management in case of consistent poor managerial performance.

The investee companies would like the deal to be structured in such a way that their interests are protected. They would like to earn reasonable return, minimize taxes, have enough liquidity to operate their business and remain in commanding position of their business.

Post-investment activities and exit

Once the deal has been structured and agreement finalized, the venture capitalist generally assumes the role of a partner and collaborator. He also gets involved in shaping of the direction of the venture. This may be done via a formal representation of the board of directors, or informal influence in improving the quality of marketing, finance and other managerial functions. The degree of the venture capitalists involvement depends on his policy. It may not, however, be desirable for a venture capitalist to get involved in the day-to-day operation of the venture. If a financial or managerial crisis occurs, the venture capitalist may intervene, and even install a new management team.