Tutorial Notes

Class: B.Com (Hons.) Semester VI (DSE3)

Subject: New Venture Planning

Topic: The Investment Evaluation Process from a VC's Perspective.

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The investment evaluation process from a VC's perspective.

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.

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