VENTURE CAPITAL

LECTURE - 2

TOPICS TO BE COVERED

- Venture Capital Funding Process
- Ways of exiting by venture capitalist

VENTURE CAPITAL FUNDING PROCESS

Venture Capital Funding Process-

Obtaining capital for a project through this route is very difficult. It involves many steps, which a prospective entrepreneur has to adopt when he approaches an investor. They are:

- Making a Deal (Deal Origination)
- Evaluation or Due Diligence
- Investment Valuation
- Deal Structuring
- Post-Investment Activities and Exit

VENTURE CAPITAL FUNDING PROCESS

1) Making a Deal (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 quit proactive in its approach to generating the dal flow by encouraging individuals to come up with their business plans.

   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.

VENTURE CAPITAL FUNDING PROCESS

2) 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.

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3) Investment Valuation: The investment valuation process is aimed at ascertaining an acceptable price for the deal. The valuation process goes through the following steps.

   i) Projections on future revenue and profitability.

   ii) Expected market capitalization.

   iii) Deciding on the ownership stake based on the return expected on the proposed investment.

   iv) The pricing thus calculated is rationalized after taking into consideration various economic scenarios, demand and supply of capital, founders/ management team's track record, innovation/unique Selling Propositions (USPs), the product/ Service size of the potential market, etc.

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4) 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 dal structuring. The agreement also includes the protective covenants and earn-out arrangements. Covenants include the venture capitalists' right to control the invest 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 and the right to replace management in case of consistent poor managerial performance.

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5) 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 involves in shaping of the direction of the venture. This may be done via a formal representation on the board of director, 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. Venture capitalists typically aim at making medium- to long- term capital gains. They generally want to cash-out their gains in five to ten years after the initial investment. They play a positive role in directing the company towards particular exit routes.

WAYS OF EXITING BY VENTURE CAPITALISTS

A venture capitalist can exit in four ways.

i. Initial Public Offerings (IPOs): When the company is making good profits and the market condition is conductive, the venture capitalists offer their shareholding to the public, the advantage of this exit rout is that the shares can be priced at premium in time with the market trend and will bring them good fortune. However, there are some disadvantages like high cost of issue, lower demand, etc.

ii. Acquisition by Another Company: Another strategy is to sell their holdings to another company who are interested to expand their business in this line. The advantage of this strategy is that they can negotiate the deal and results into transfer of controlling interest, the existing promoters may play defensive strategies for fear of loss of control. Sometimes the negative reputation of the acquiring company may bring down the business of the acquired company also.

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iii) Repurchase of the Venture Capitalist's Share by the Investee Company: If the promoters have enough cash at their disposal, thy can buy- back the shares from the venture capitalists so that they can retain their control over the company. However, if the company is enjoying good reputation in the market, the venture capitalists may demand a hefty amount as compensation for their exit.

iv) Purchase of VCs Share by a Third Party: Venture capitalists can sell their holdings through private placements to one or more third parties. Here also there is a chance of loss of control to the existing promoters, who may play some defensive strategies. However, compared to the public offer, this will be a cheaper route for exit.

THANK YOU

References:

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