# CHAPTER 3

VENTURE CAPITAL FINANCING - PROCESS

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Chapter 3

VENTURE CAPITAL FINANCING - PROCESS

3.1 INTRODUCTION

Venture capitalists receive several proposals for investment. Many projects which find it difficult to raise funds from banks and other financial institutions approach venture capitalists for assistance. Venture capitalists assess several projects and invest only in a handful. They may receive as many as hundred proposals and may finance very few of them.

Venture capitalists conduct a preliminary project appraisal. This includes verification of whether the project is in the area of their investment and a review of the promoters of the business. The diagram below sets out the typical steps involved in a venture capital investment and disinvestment process.

Fig No. : 2

Source: Handbook on venture capital by Anjana Vivek
3.2 PROMOTERS WITH PROJECT

If the venture capitalists are interested in the project they offer a term sheet to the promoters. The term sheet is a summary of the proposed principal terms and conditions of a venture capital investment. It sets out the board terms and conditions of investment and is signed by both the venture capitalists and the proposed venture capital investee. Singing of a term sheet by both parties is a statement is good faith and is not an obligation until an agreement is signed by the parties. It is normally subject to satisfactory completion of due diligence review and singing of legal documents such as an equity subscription agreement. The role of the venture capitalist does not stop after the investment is made. The skills of the venture capitalists are most required after the investment as the venture capitalist gives advice and monitors the project continuously. (Anjana, 2008:24-25)

Exit from the investment is one of the most critical steps in venture capital investment. Exit varies, from investment to investment. There are several routes, IPO, buy back by promoters, sale to another venture capitalist or sale to another company in the case of a merger or acquisition. The method of exit and time of exit will be worked out based on what is most profitable and suitable to the venture capitalist, the promoters of the project and the project itself.

A venture Capitalist will look for a project that has potential for great returns. The project should be feasible and though it may be risky, there must be a definite chance that it can be successful. The venture capitalist would like to maximize the upside potential in any project, and would like to exit from a project at a time when he can get a maximum return on his investment in the project.

The venture capitalist will look at different aspects of the projects. Some of the important factors are the urge to grow and ability of the promoters and key management, the details of the project, the market potential and strategy for sale. Any reference made to market studies or survey reports will be studied carefully.

A professional venture capitalist would validate all data included in business plans. The word of the entrepreneur, is not enough, particularly when it comes to future projections. This does not mean that he does not trust the entrepreneur.
Most entrepreneurs are over optimistic about the possibilities of success. This is the very nature of entrepreneurs.

The fact that a venture capitalist is reviewing a project itself is an indication that he trusts the entrepreneur. If he did not trust the entrepreneur, he would not proceed with due diligence and would have rejected the project outright!

A venture capitalist is most concerned about the ability of the entrepreneurs to adapt to different circumstances, good and bad. The promoters must be committed and have a passion for their project. They must believe that they can do something different or differently. They must believe that they can succeed.

The venture capitalist backs the promoter first and then the project. In fact, sometimes, the project may be excellent, but if the venture capitalist feels that the promoters lack the required skills, the project may get rejected. This is not very surprising as venture investment is akin to a partnership, particularly in the initial stages of the project. If the partners in the project are not in agreement or have different ways of functioning, the entire project can be in jeopardy, despite having phenomenal potential.

The venture capitalist looks for a multidisciplinary term of persons. Venture capitalists are not generally in favour of financing projects which are single-man shows. The promoters should have the necessary domain skills. In some cases, if the venture capitalists feels that the project shows promise but the promoters lack the skills to successfully manage the business, they will bring in outside persons to work in the project. Not all promoters are happy with this. However some of them do not mind as the realize that their company’s value can increase substantially if managed well.

A venture Capitalist will also analysed the key aspects of the project in great depth. The project must have the potential to be commercially viable. Ultimately the investor wants a financial return, so it is important that the investment makes commercial sense. It must have the potential for commercial success. The project must be feasible, it must be marketable, i.e. it must meet an existing requirement or fill a gap in the market or it must have the potential to create a market. Further
the venture capitalist would like to have higher than normal returns as compared to other financial investors in a project. This is not surprising, since the venture capitalist does not expect all investments to do well, he would like the few that do well give above average returns.

Professional venture capitalists mentor projects they invest in. They are closely involved in the operations of the investee.

The venture capitalist often visits the project frequently. Some venture capitalists visit the projects every week, even spending half-a-day in each visit. This is one of the reasons why most of the venture capitalists do invest in some companies, each of the partners in the venture fund will monitor only a handful of projects closely. (Anjana, 2008: 27-30) In these cases, the number of projects which the fund can invest in will be limited by the number of persons managing the venture funds prefer to invest larger sums of money in smaller numbers of projects. Of course, some professional venture capitalists do invest in smaller projects. However these are limited in number. Generally these smaller projects which are invested in, have the potential to grow very fast.

Professional venture capital investor often provide what is referred to as ‘hands-on’ investment as the investors guide and mentor the projects they finance. These investors often have a good domain knowledge of the industry in which they invest. Sometimes they restrict their investments to industry in which they understand. This can lead them to invest in niche areas.

Venture capital would not like to invest in more than one project in the same or competing market. Unless they see some energy in the project.

A venture capitalist does not take any collateral or guarantee generally...If the project does well than the venture capitalist would get good returns...if it fails, entire investment is written off. A venture capital looks for great returns in say five years time..Typically cash flows are ploughed back in the business in the initial years.

Professional venture capitalists exit from the investment in the initial years generally three to five years..
3.3 SELECTION PROCESS

The selection process for identifying projects for investment is very critical and to be done with great care. The very survival of venture capitalists depend upon success of at least some fraction of the total companies invested in. They examine all the details of the project. Every projection made by the entrepreneur is clearly examined. The venture capitalist would study the trends in the industry and see if there is really any potential for such sales.

Summary:
Entrepreneurs are often surprised to find the venture capitalist examining in-depth the validity of all data. In their business plan, they have a perception that venture capitalist give away money for risky projects so they assume that they will get venture financing. So entrepreneurs must look and analyse everything properly before approaching Venture Capitalist.