4D International Journal of Management and Science
ISSN No: 2250-0669
@4D Crossconnect.com, Inc, 2012
www.4dinternationaljournal.com
Vol. 3, Issue2, July 2013

INVESTMENT PROCESS OF VENTURE CAPITAL FIRMS- A STUDY OF SELECTED FIRMS OF DELHI & NCR

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ABSTRACT

Venture Capital is intermediate financing for start-up between entrepreneur's own capital and angel investors. So it is necessary to understand the process of venture capital financing. This paper is the study of venture capital process of selected venture capital firms of Delhi and NCR. For this study only 41 firms were taken as sample and out of which author could collect information about 38 firms only. Most of the firms (65.3%) are pvt.ltd.VC firms. Out of which 28.9% firms are registered with SEBI and 42.1% are IVCA members. The preferred criteria to limit the investment are on the basis of industry preference. Maximum investment is done in India. Only 5-10% deals reaches to the stage of due diligence while they approach to the VC firms for funding. It seems that signing of non disclosure agreement is not mandatory for the VC firms. Most of the firms prefer to follow exit up-to 3-5 years and this exit is by issuing IPO's.

Key Words: Venture Capital, Venture Capital Process, Angels, etc

INTRODUCTION:

Venture Capital is intermediate financing for start-up between the entrepreneur's own capital and angel investors on one hand and an IPO or acquisition by a larger companies on other. Banks or financial institutions do not provide funds to companies with

- Unproved Products in untested markets
- Little or no collateral to secure loan
- No profit or no prospect of profits for years
- No ability to pay interest

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Venture capital is an investment, in the form of equity, quasi-equity and sometimes debt, in new or untried technology, or high-risk venture, promoted by a technically or professionally qualified entrepreneur, where the venture capitalist

- **a)** expects the enterprise to have a very high growth rate,
- **b)** provides management and business skills to the enterprise,
- **c)** expects medium to long term gains, and
- **d)** does not expect any collateral to cover the capital provided. (Pandey et al., 1995)

VENTURE CAPITAL INVESTMENT PROCESS

As per Tyebjee and Bruno venture capital activity is a five step process as follows:

1. Deal Organization
2. Screening
3. Evaluation or Due Diligence
4. Deal Structuring
5. Post Investment Activity and Exit

1. **DEAL ORGANISATION**: The processes by which deals enter into consideration as investment prospects. It means sourcing or locating venture capital proposals. In generating a deal flow, the VC investor creates a pipeline of deals or investment opportunities that he would consider for investing in. Deal can originate from different sources like being referred to venture capital funds by their parent or sister organizations, industry associations, consultants and past clients.

2. **SCREENING:** VCFs, before going for an in-depth analysis, carry out initial screening of all projects on the basis of some broad criteria. Instead of evaluating all the proposals received by the venture capitalists, which is a time consuming and costly preposition, the deals are first put through a screening process. Only proposals passing the screening test are considered for evaluation which saves the time and cost of venture capitalist. Each venture capitalist has its own criteria for such screening that limit the projects to selected areas in terms of industry sector, technology, product, stage of financing, size of venture/ investment, regional preferences etc. So, screening is a delineation of key policy variables which delimit investment prospects to a manageable few for in-depth evaluation.

3. **DEAL EVALUATION OR DUE DILIGENCE:** Due diligence is the assessment of perceived risk and expected return on the basis of a weighting of several characteristics of the prospective venture and the decision whether or not to invest as determined by the relative levels of perceived risk and expected return. The evaluation of ventures by VCFs in India includes;

Preliminary evaluation: The applicants are required to provide a brief profile of the proposed venture to establish prima facie eligibility.

Detailed evaluation: Once the preliminary evaluation is over, the proposal is evaluated in greater detail. VCFs in India expect the entrepreneur to have: - Integrity, long-term vision, urge to grow, managerial skills, commercial orientation.

VCFs in India also make the risk analysis of the proposed projects which includes: Product risk, Market risk, Technological risk and Entrepreneurial risk. The final decision is taken in terms of the expected risk-return trade-off.

4. **DEAL STRUCTURING:** It is the negotiation of the price of the deal, namely the equity relinquished to the investor, and the covenants which limit the risk of the investor.
5. **POST-INVESTMENT ACTIVITIES:** 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. 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. The assistance to the venture in the areas of recruiting key executives, strategic planning, looting expansion financing, and orchestrating a merger, acquisition or public offering.

The stages in the venture capital funding, assessment and monitoring process have been analyzed in a number of studies (e.g. Bygrave and Timmons, 1992; Fried and Hisrich, 1994; MacMillan, et al., 1985; Tyebjee and Bruno, 1994; and Sweeting, 1991b). These stages have been identified from direct analysis of the operation of venture capitalists' operations and have been based on approaches, which have sought to develop an understanding of what it is that venture capitalists do.

As identification of the above stages helps to highlight the inter-linkages between them, the same is briefly discussed below:

FUND RAISING BY VCs

The venture capital process starts with the establishment of the venture capital firm. Depending on the structure of the firm this can be done in many different ways. The most common structure is a private independent firm that sets up funds. The venture capital firms start their operations by raising a fund from which the investments are made (Gompers and Lerner, 1998). The fund is frequently collected from a variety of sources.

Venture capitalists follow an investment strategy, which is usually formulated by targeting a special set of investment opportunities: to invest in a certain geographical area or a certain industry. Other parameters of a funds strategy can be based on the stage in the development of a venture this comprise of pre-seed, seed, start-up and expansion. The selection of stages contributes to the risk and return profile of the venture capital fund. Early stages usually imply high risk and a high expected return. In order to minimize risk, venture capitalists take an active role in the development of their portfolio firms. As part of their active role, they also require board seats in the firm. Funds that place their investments in later stage tend to focus more on the long-term goals and less on daily routines in the firm. Another mechanism to control the risk of early stage investors is to stage the investments according to specific milestones (Gompers,

1995; Sahlman, 1990). Consequently, investors provide funding when specified milestones have been reached.

DEAL GENERATION

At the beginning of the venture capital process, it is crucial to obtain access to viable projects, which can be funded at early stage that will generate target rates of return. The difficulties faced by venture capitalists because of entrepreneurs' search and decision processes, and increases in competition between venture capitalists, attach significant importance to deal generation strategy.

Deal generation is closely linked at the strategic level to venture capitalists' preferences with respect to investment stages and deal size, as well as to the availability of information and the recruitment of venture capitalist executives with the specific skills to seek out transactions (Murray, 1995; and Bygrave and Timmons, 1992).

There are basically two different approaches to generate new venture opportunities for venture capital companies, a proactive and a reactive approach (Sweeting, 1991). In the proactive approach venture capitalists actively seek, potential entrepreneurial firms to invest in. This may include attending industry fairs and direct involvement in influential innovative environments. The reactive approach on the other hand implies that venture capitalists wait for the business plans to arrive. Studies show that the later approach is more widely prevalent than the former. In an analysis of venture capital firms in the mid-1980, Tyebjee and Bruno (1984) found that the behaviour of venture capitalists in seeking out deals was to wait passively for deal proposals to be put to them. It was also found that most deals were referred by third parties and that venture capitalists rarely tried to discover new investment opportunities proactively.

Many investors have a preference for including other investors when placing their investment - syndicated investments or co-investments. The reason for including more investors is primarily to spread risk, access more opportunities, and to create a broader knowledge base for investment decisions. McNally (1997) argues, "Co-investments with venture capitalists also called parallel investments are a potentially beneficial way of identifying investment opportunities and also accessing the investment expertise of the venture capitalist".

SCREENING

The investment evaluation phase is an important and very time-consuming activity. It includes a complete examination of the venture, which then receives funding based on very specific conditions. Venture capitalist spends almost fifty per cent of their time in screening and evaluating the proposals. (Tybjee and Bruno 1981). The problems in selecting new entrepreneurial firms are related to the difficulties in estimating their potential and the high risk of failure. Many of these projects entail only limited information about the products or services. The business may only consist of sketched out business plans and preferable intellectual property rights of the product or service. Besides, there might only be limited knowledge about the market and future costumers. Consequently, there is a high level of uncertainty about their success. Often there may be problem of the information asymmetry between entrepreneurs and the

venture capitalists (Amit et al. 1990).

In order to accommodate this incomplete distribution of knowledge investors make use of several methods, such as reliance on self-selection by the entrepreneur, environmental-selection, social networks for knowledge transfer, syndication of investment decisions, and use of checklists and selection criteria (MacMillan et. al, 1985).

A large number of studies especially by Wells (1974), Poindexter (1976) and Tyebjee &. Bruno (1984) has investigated the criteria used by venture capitalists in deciding to invest in entrepreneurial firms. It has been found that management related issues are key to their decision-making. (Figure 1) As Macmillan Et Al. (1985,) summarize their findings: "There is no question that irrespective of the horse (product), horse race (market), or odds (financial criteria), it is the jockey (entrepreneur) who fundamentally determines whether the venture capitalist will place a bet at all."

MacMillan et al. (1987) show that the most important criteria used by venture capitalists in screening investment proposals were entrepreneurial personality and experience, with lesser dependence being placed on market, product and strategy. In a similar study, Fried et al. (1993) explained that, venture capitalists were more concerned with market acceptance and less demanding of high potential rates of return and quick exit, which others see as a more realistic view of venture potential.

Fried and Hisrich (1994) found that venture capitalists use three generic criteria for screening investments — the viability and novelty of the project; the integrity, track record and leadership skills of management; and the possibility for high returns and an exit — before proceeding to detailed evaluation. Importantly, it may be difficult to find an investment opportunity that meets all the above criteria. Muzyka et al. (1995) therefore, emphasize that venture capitalists have to make trade-offs between various criteria in their screening of investments. According to them venture capitalists would prefer to select an opportunity, which offers good management team and reasonable financial and product market characteristics, even if the opportunity does not meet the overall fund and deal requirements.

The venture capitalists place considerable emphasis on the specific attributes of a potential investee company both in relation to assessment of its value and the rate of return to be expected from it. While accounting information is important in deal screening and in arriving at a valuation and a target rate of return, venture capitalists place most emphasis on very detailed scrutiny of all aspects of a business, typically including sensitivity analysis of financial information, discussions with personnel and accessing information of an unpublished and subjective kind.

VALUATION

The valuation process is an exercise aimed to determine the current value of the firm and to arrive at an acceptable price for the deal. Traditionally valuation involves a four step-process (Damodaran, 2002). These comprise of (a) Evaluating future revenue and profitability; (b) Forecasting likely future value of the firm based on experienced market capitalization or expected acquisition proceeds depending upon the anticipated exit from the investment; (c)

Targeting an ownership position in the investee firm to achieve desired appreciation on the proposed investment. The appreciation desired should yield a hurdle rate of return on Discounted Cash Flow basis and (d) Negotiating the valuation.

Manigart et al. (2000) examined the valuation methods used by venture capital investors in the United States, Great Britain, France, Belgium and Holland and investigated issues concerned the valuation of venture capitalists' investment decisions and the importance of accounting and financial information. The following Table illustrates valuation techniques used, in descending order from the most used (highest average over the five countries) to the least used.

DUE DILIGENCE

Due diligence emphasizes understanding and quantifying the risk of the proposed deal, rather than the upside. It involves a rigorous investigation and evaluation of the investee firm before committing funds. This investigation is conducted by the preparing a registration statement to form a basis for believing the statements contained therein are true and that no material facts are omitted. This process includes review of its management team, business conditions, projections, philosophy, and investment terms and conditions.

Due diligence verifies any business opportunities that survive the initial screening stage. For venture capital investments, no more than 10-15% of proposals make it past the initial screening stage to the full due-diligence process, and only 10% of those that reach the due diligence stage, receive funding. This verification process consists of checking the accuracy of business plans, audited accounts, and management accounts; getting replies to warranty and other standard questionnaires; patent searches; and technical studies. Unpublished accounting information and subjective information are equally important; these data are collected by calling customers, suppliers, lawyers, and bankers, and by checking trade journals. The aspects which are thoroughly probed in the due diligence process are summarised in the following table (Figure1)

Figure 1

Due Diligence Study Area

Management Quality: Chief Executive Officer; Number Two & Three in Management; Management as a Team; Organizational Structure & Decision-making; Management Characteristics; Corporate Ownership; Documentation; Management Reports; Strengths & Weaknesses
Human Resources and HR Policies: Corporate Organization; Employee Compensation; Profit-sharing Plan; Bonus Plan; Payroll Records; Training Program; Attitude and Morale; Record Maintenance; Reports; Motivation; Hiring Procedure; Consultants; Ratio Analysis
Contracts: In the Ordinary Course of Business (customer contracts; supplier contracts; agency/distribution agreements, etc); Not in the Ordinary Course of

Business (partnership agreements, joint venture agreements, confidentiality/trade secret agreements, etc)
Proprietary Rights: Intellectual Property Rights (IPR); Intellectual Property Agreements; Pending or Threatened Claims for Infringement or Other Violations; Suspected or Alleged Infringement by Third Parties; Arrangements for the Disclosure of Confidential Information; Agreements with Employees and Consultants; Arrangements Relating to Proprietary Rights of Employees
Marketing: Marketing People; Products; Customer Description; Customer Service; Competitive Analysis; Industry Analysis; Marketing Strategy; Product Distribution

Research Methodology:

The research design is a framework or blueprint for conducting the research. It describes the procedures necessary for obtaining the information needed to structure or solve the research problems. It lays the foundation for conducting the research. The VC industry in India is in nascent stage, with a view to promote innovation, enterprise, and conversion of scientific technology and knowledge-based ideas into commercial production, it has been important to promote VC activity in India. The present study attempted to demystify the VC financing and the issues involved in it.

There are 180 VC firms operating in India. These VC firms are located all over the country. The sample consists of 41 VC firms, based in Delhi & NCR. Out of which only 38 responses were collected.

Observations

	Universe	**Sample**	**%**
Total No. of VC Firms in India	**180**	**41**	**23**
No. of IVCA member VC Firms	**84**	**41**	**49**
No. of IVCA member VC Firms with HQ in NCR	**41**	**41**	**100**
No. of IVCA member VC Firms with HQ/ operations in NCR	**41**	**38**	**92.6**

Frequencies

Frequency	Percent	Valid Percent	Cumulative Percent
6	15.8	15.8	15.8
2	5.3	5.3	21.1
25	65.8	65.8	86.8
5	13.2	13.2	100.0
38	100.0	100.0	

Out of 38 VC firms located in Delhi &NCR ,65.8% firms are Pvt.Ltd Firms and15.8% are partnership firms. There are very few public ltd. Firms (13.2%).

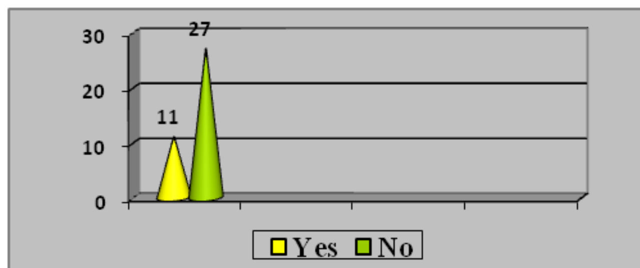
Registered with SEBI

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	11	28.9	28.9	28.9
No	27	71.1	71.1	100.0

Registered with SEBI

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	11	28.9	28.9	28.9
No	27	71.1	71.1	100.0
Total	38	100.0	100.0	

Firms registered with SEBI

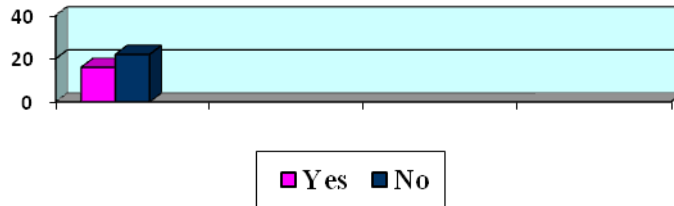


Only 28.9% of the total firms are registered with SEBI.

Member of Indian Venture Capital Association

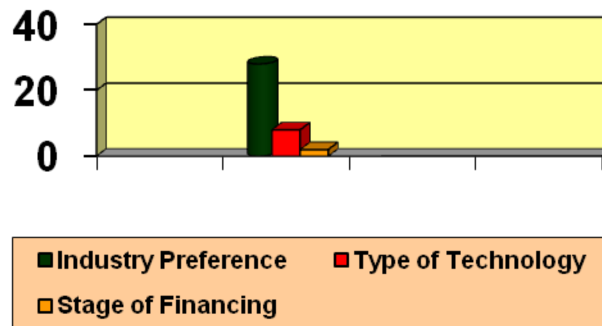
	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	16	42.1	42.1	42.1
No	22	57.9	57.9	100.0
Total	38	100.0	100.0	

Member of Indian Venture Capital Association



Frequency	Percent	Valid Percent	Cumulative Percent
28	73.7	73.7	73.7
8	21.1	21.1	94.7
2	5.3	5.3	100.0
38	100.0	100.0	

Preferred screening Criteria to Limit the Project

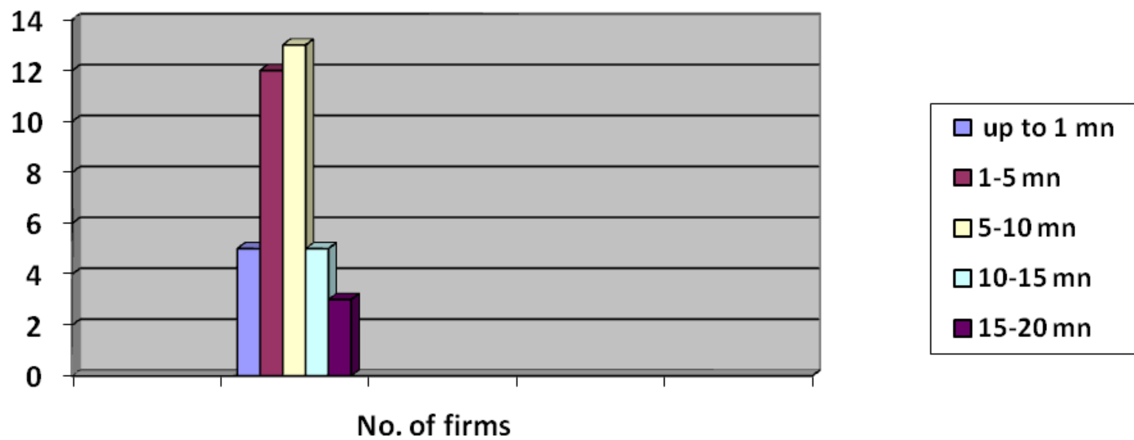


Most of the Venture Capital firm's screen the project on the basis of Industry preference (73.7%) than the type of technology and stage of financing.

Frequency	Percent	Valid Percent	Cumulative Percent
5	13.2	13.2	13.2
12	31.6	31.6	44.7

13	34.2	34.2	78.9
5	13.2	13.2	92.1
3	7.9	7.9	100.0
38	100.0	100.0	

preferred size of investment

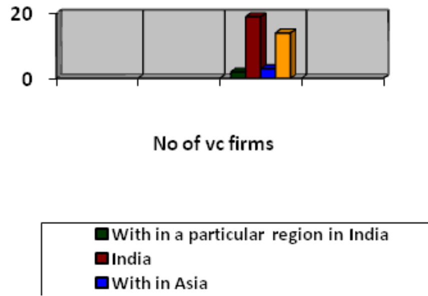


Maximum Venture capital Firms want to invest between 1-5 mn$ and 5-10mn $ i.e. between 31.6% and 34.2%.

Geographic Preference of Investment

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Within a particular region in India	2	5.3	5.3	5.3
	India	19	50.0	50.0	55.3
	Within Asia	3	7.9	7.9	63.2
	Global	14	36.8	36.8	100.0
	Total	38	100.0	100.0	

Geographic preference of investment

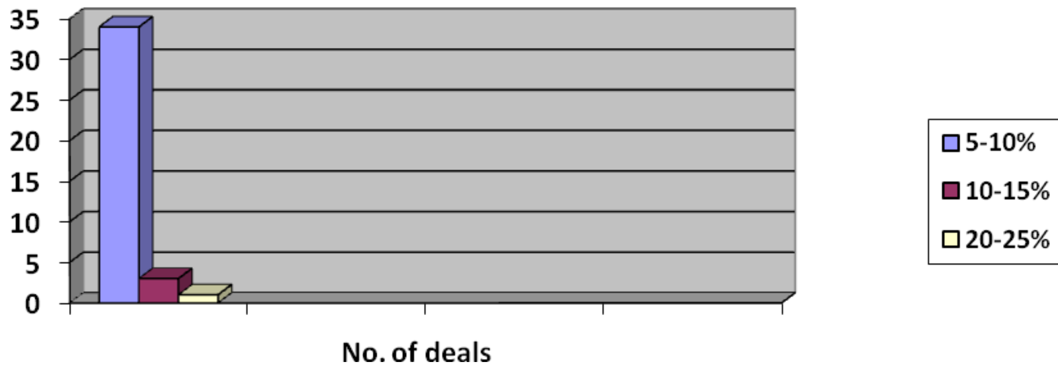


With reference to the geographic preference of investment 50% of the firms invest in India, 36.8% firms prefer to invest on global basis. 2% firms are there which like to invest within the particular region of India and 3% within Asia.

Deal reaches to the stage of due diligence

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	5 - 10%	34	89.5	89.5	89.5
	10 - 15%	3	7.9	7.9	97.4
	20 - 25%	1	2.6	2.6	100.0
	Total	38	100.0	100.0	

Deals reaches to the stage of due diligence



Only 5-10% of the deals reaches to the stage of due diligence.

Frequency	Percent	Valid Percent	Cumulative Percent
1	2.6	2.6	2.6
13	34.2	34.2	36.8
24	63.2	63.2	100.0
38	100.0	100.0	

Maximum time required between first contact by the entrepreneur and actual funding is between 16-20 weeks. Around 63% firms take the similar time.

Most preferred exit route

	Frequency	Percent	Valid Percent	Cumulative Percent
IPO	29	76.3	76.3	76.3
Merger & Acquisition	5	13.2	13.2	89.5
Sale to another VC	1	2.6	2.6	92.1
Sale through Stock Exchange	3	7.9	7.9	100.0
Total	38	100.0	100.0	

Most of the VC firms 76% prefer the exit by way of issuing IPO's.

Average time period of an investment before Exit

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	3 - 5 Years	28	73.7	73.7	73.7
	5 - 7 Years	8	21.1	21.1	94.7
	7 - 9 years	2	5.3	5.3	100.0

Average time period of an investment before Exit

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	3 - 5 Years	28	73.7	73.7	73.7
	5 - 7 Years	8	21.1	21.1	94.7
	7 - 9 years	2	5.3	5.3	100.0
	Total	38	100.0	100.0	

Average time period of investment before exit is between 3-5 years. Most of the firms takes this much of time.

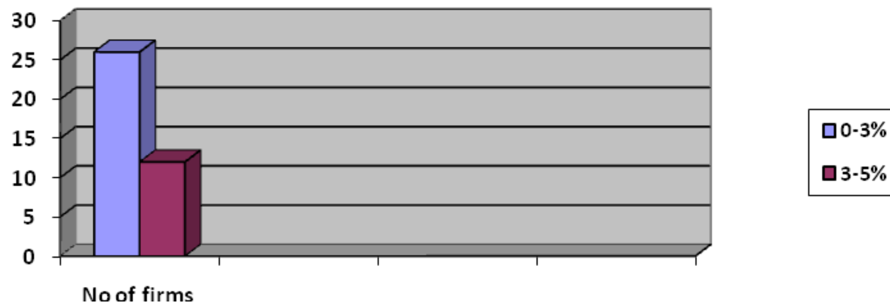
Sign Non-disclosing Agreement (NDA) prior to investment

	Frequency	Percent	Valid Percent	Cumulative Percent
Preferably	3	7.9	7.9	7.9
Does not matter	16	42.1	42.1	50.0
No	19	50.0	50.0	100.0
Total	38	100.0	100.0	

Most of the VC firms say that signing of NDA is not mandatory for them.

Proportion of accepted for funding out of the business plan/proposal received

	Frequency	Percent	Valid Percent	Cumulative Percent
0 - 3%	26	68.4	68.4	68.4
3 - 5%	12	31.6	31.6	100.0
Total	38	100.0	100.0	



Only 3% of the business plans which are received from the entrepreneurs are accepted by the VC firms for funding, if they seek potential returns out of that investment proposal.

Conclusion: Venture capital is intermediate financing for start-up between the entrepreneur's own capital and angel investors. Almost maximum no of VC firms follow the process given by Tybjee and Bruno. Most of the firms (65.3%) are pvt.ltd.VC firms. Out of which 28.9% firms are registered with SEBI and 42.1% are IVCA members. The preferred criteria to limit the investment are on the basis of industry preference. Maximum investment is done in India. Only 5-10% deals reaches to the stage of due diligence while they approach to the VC firms for funding. It seems that signing of non disclosure agreement is not mandatory for the VC firms. Most of the firms prefer to follow exit up-to 3-5 years and this exit is by issuing IPO's.

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