Presentation on

"Understanding The Venture Capital Process"

By

Ajay S. Hooda

Understanding the Potential of an Idea

Ideas fall into three categories, ones that:

Create New Business Models

- Such business models are generally technology based.
- The potential value creation from the VC point of view is the highest, while the risk too remains very high as the technology may not eventually deliver, the cost may be too high or the market not yet ready.

Create Better Efficiencies

- A generally safer option where experience or some new insight, into the way of doing things, improvements in technology creates new efficiencies among existing processes, i.e. 20% higher productivity, or 40% lower costs.
- The Indian IT and ITES story and a lot of Internet cum offline business models fall into this category.
- However here the potential value creation is lower and experienced management team is absolutely necessary.

New Niches in a Fast Growing Industry

- Basically "me too" of the previous category.
- Once the basic business model gets financed and the potential returns looks less rosy, VC's look for smaller fast growing niches that may be potentially more lucrative.
- The potential returns may be better as there may be lesser competition.

Leading Revolution" by "Gary Hamel"

"Competition within a broad domain, be it financial services, communications, entertainment, education, takes place not between products & companies, but between "Business Models". The goal of business concept innovation is to introduce more strategic variety into an industry or competitive domain. It changes the very basis for competition within the industry or domain, because it takes the entire business concept as the starting point, it is more comprehensive than innovation that focuses solely on products or technology.

What is not "different" is not "strategic", to the extent that strategy is the quest for above average profits; it is entirely about "variety" not just in one or two areas, but also in all "components" of the "business model". Business concept innovation usually falls short of this lofty goal, but that's the objective."

Investment Process With a VC

- **Business Plan Submission.**
- **The First Contact with a VC.**
- **A preliminary interest is indicated.**
- **Due Diligence Process.**

a. References of senior management members/back ground check.
b. Quarterly based milestone chart including anticipated revenues, cash expenses, funding requirements, headcount, and key hires etc.
c. Legal agreements & material contracts, audited financial statements,
d. Access to suppliers, customers, bankers.
e. Valuation, independent or in-house.

- **Investment Terms and Legal Work**

VC's Evaluation Criteria

"The process is both objective and subjective"

- **Business Concept Fit:** Whether the business concept fits with the VCs defined objectives, the business/technology space, stage of growth and synergy with portfolio companies.

- **Management:** VCs normally seeks to invest in businesses with strong management teams that display cohesive, aggressive and driven qualities or where there is a strong business concept having the scope to bring in strong management team along with the original entrepreneurs.

- **Market:** VC invests in companies with a focus on solving a real need within a very large and growing marketplace.

- **Barriers to Entry:** Necessary to maintain a competitive advantage. Typically, such barriers to entry include things like proprietary intellectual property, a unique understanding and experience within a market niche, or strong industry partnerships.

- **Profitability:** Businesses with a reasonable, verifiable path to profitability are favored.

- **Liquidity of Investment:** Critical to achieving a VCs investment objectives is planning an exit strategy that provides liquidity.

Valuation & Pricing a Deal

- Pricing venture capital deals involves the estimated future values of the entity being financed and is highly subjective. DCF, Earnings and Valuation comparison with peer group companies are most common methodologies.
- Venture capital investors expect an annual rate of return of 30 percent to 40 percent or more.
- The table below shows the percentage investment a venture capitalist would need to realize to support a 30 percent return on investment at various estimated market values. As shown, to realize a 30 percent return on an investment of $4 million, a venture capitalist would need to own 32 percent of a company with an estimated future market value of $60 million after six years.

Ownership Required by the VC to Support a 30% Return

***EFV of Co. in 6 Years**	**$20**	**$40**	**$60**	**$80**	**$100**
$ Invested in M					
2	48%	24%	16%	12%	10%
4	97%	48%	32%	24%	19%
6	**145%**	72%	48%	36%	29%
8	**193%**	97%	64%	48%	39%
10	**241%**	**121%**	80%	60%	48%

- **It‘s a numbers game.**

Since a VC has to process a very large number of new prospects, sometimes thousands each year, his highest priority is his own time management. This means that his work is mostly focused on eliminating 99% to 99.8% of the opportunities he is presented with as quickly as he can.

- **Risk/Reward profile**

Entrepreneurs believe that VCs like to take big risks in making their investments. Most VCs are actually very risk-averse, which makes sense when you perceive the environment to be full of uncertainty and unknown factors. At the VCs high altitude overview level, the major categories of risk are: people (management), technology (service/products), market opportunities (emerging or established), stage of growth (includes financing history), valuation and exit possibilities.

- **It‘s about the people.**

Most VCs today understand that they really invest in people, in the company management, directors, investors, customers, partners, etc. Their comfort level increases proportionately to their familiarity with the people, directly or indirectly, as by reputation.

- **The potential market opportunity must be huge.**

- The ideal proposed market for the products (or service) should be already identified, rapidly growing (more than 25% per year), and not dominated by any other companies, large or small.
- VCs want to back companies they believe can and will dominate fast growing market niches. Such a result is the most obvious, incontrovertible evidence of superior technology, superior management and superior strategy.
- Domination = winning the game, the game defined as being well positioned for a liquidity event " = IPO" or acquisition at an attractive valuation.

- **Listen for what is unsaid.**

Unfortunately, VCs, at least the smart ones, have learned to be nasty and suspicious of most people who come looking for funding. A more subtle VC approach is to listen for what is left unsaid, the implication being that what is unsaid may be more important, and potentially more damaging to the business proposal.

- **Everything is negotiable.**

- To some VCs, every interaction is like a move in a chess game, an element of strategy in a game of negotiation. In principle, an entrepreneur should not be afraid to negotiate, to "push back", especially on any negative comments offered by a VC, but must be done without being overtly aggressive.
- Treat the VC with respect, certainly, again, like a valued customer, but not to extent of being untrue to your-self. Self-respect is one of the keys to gaining respect from others.

- **VCs want to control their portfolio companies.**

VCs typically want minority ownership, between 10% and 40% of a company's stock, and often will request a seat on the board of directors if they are the lead investor or a large investor.

- **VCs assess a company's current valuation by their perception of future value at the next financing.**

While there are "financial calculations and rules of thumb" and comparisons can be made to competitive or similar companies, these numbers are just guidelines. The price of the stock is very much a negotiated quantity, what he VC will give and you are willing to take.

- **Not all VCs are created equal.**

A misfortune that may regrettably too often is a mismatch, a fundamental miscommunication about values, between a company and its venture investors.

How to Raise Money from Venture Firms

Briefly, the steps are:

- Find people to introduce your company to VC firms.
- Prepare the appropriate materials.
- Make initial contacts.
- Make the presentations " a dialogue, more than monologue".
- Suggest follow-up meetings.
- Follow-up with additional materials as requested.
- Use intermediaries to fill own gaps.
- Provide information at the pace VC can absorb.
- Maintaining direct contact.
- Track the Progress.
- Creating a good impression is being thoroughly prepared and alert.

Venture Capital Survey

How Do Venture Capitalists Value Companies?

1. Quality of management: 4.5 /5.0
2. Size of the market: 3.8/5.0
3. Product qualities:(uniqueness, brand strength, patent protection) 3.7/5.0
4. Rate of market growth: 3.5/5.0
5. Competition: 3.5/5.0
6. Barriers to entry: 3.4/5.0
7. Stage of development of the company: 3.2/5.0
8. Industry the company is in: 3.0/5.0

Quality of management was emphasized by the VCs to the extent that 7 out of 10 gave it a rating of "5", and nearly 9 out of 10 gave it at a 4 or 5

What's Quality Management?

VCs were asked what they considered the essential characteristics of a quality management team?

1. Successful experience or proven track record 9.5/10.
2. Integrity, honesty 3.0/10
3. Dedication, commitment, passion, energy 3.0/10
4. Vision and ability to articulate vision 2.3/10
5. Knowledge, skill level, intelligence 2.0/10
6. Leadership ability 1.0/10
7. Ability to build a team0 .75/10
8. Marketing focus 0.50/10
9. Made investment in company 0.50/10
10. Winning attitude 0.50/10
11. Industry contacts 0.50/10
12. Good references 0.25/10

Critical Mistakes in Your Business Plans

250 venture capital companies across the United States were asked how they evaluated the business plans presented to them. The survey participants were asked: **What is the worst mistake an entrepreneur can make when completing their company's business plan?**

Eight Critical Mistakes

- Most frequently occurring (17%) was that entrepreneurs were "not clear in explaining the opportunity".
- In second place was " unrealistic projections" (13%).
- Or "simplistic assumptions" (8%)
- The "analysis of competition" in business plans is an area that the venture capitalists believe is weak (10%).
- "Failure to describe a sustainable competitive advantage" was also noted. (8%)
- "Mistakes and errors" appear frequently in the plans they see. (10%)
- "Management strengths were overstated" in the plan. (8%)
- "Incompleteness" including leaving sections out of the plan or not including sufficient financial data. (8%).

Common Business Plan Mistakes

What are the most common mistakes entrepreneurs make when completing their business plan?

- "Company had no competition" or underestimating the strength of competitors (32%).
- "The failure to describe a sustainable competitive advantage" was also mentioned by 9%.
- "Not clearly explaining the opportunity" was the next most frequently mentioned mistake, by 27%.
- Following that was the related mistake of "having a disorganized, unfocused, or even poor presentation" (12%).
- "Miscalculation of market share and market size" (9%) was also regarded as frequently seen mistakes.
- Respondents also said they commonly see business plans that "do not address the risks of a venture, and contain no contingency plans for coping with the risks" (also 9%).

Other less frequently mentioned responses were:

- Not explaining how they are going to sell the product.
- They don't understand the venture capital process, and send the plan to the wrong audience.
- They overstate management's strengths.
- They make unrealistic projections.
- The information is incomplete; sections are missing; the financials are inadequate.
- They underestimate the amount of capital required and assume the business will develop easily.
- They refuse to cede control and insist on being CEO.
- The discussion of management is weak.
- They assume and IPO can be their exit strategy.
- They overestimate the value of their enterprise.

Making a good first impression.

- The business opportunity is presented in a clear, exciting manner.
- The entrepreneur understands that projections are at best, hopeful guesses and tries to base the projections on realistic assumptions.
- The entrepreneur makes as full disclosure as possible of the pitfalls of the business as well as its strengths.
- The plan is carefully proofread and edited until it does not contain any errors in grammar or math.
- The plan shows why the company and its products are different and significantly better than what is out there in the marketplace.
- The company has taken the time to study and understand its competitors and can address their strengths and possible weaknesses.
- The plan contains enough information to tell a complete story about the company, but is presented in a concise, tight writing style.
- The plan does not make exaggerated claims about the product or the management.
- The entrepreneur knows the plan by heart before making a presentation to the venture capitalist.