Module 3: The Venture Capital Negotiation and Investment Process
The Venture Capital Investment Process

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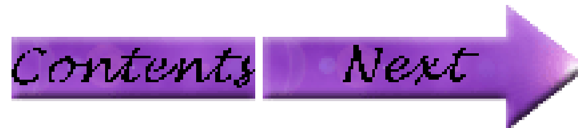

1.0 The Venture Capital Investment Process

Typical Stages in Life Cycle of Venture Capital Investment

Although each venture capital deal will have its own unique features, there will be a number of elements common to most. Following are some typical stages in the life cycle of a venture capital relationship:

1. Preparation and submission of business plan
2. Preliminary assessment of business plan
3. Meet the people
4. Light due diligence
5. Term sheet
6. Heavy due diligence
7. Investment memorandum
8. Commitment letter
9. Negotiation of shareholder's agreement
10. Grow the company
11. Exit

1.01 The Business Plan

The preparation of a convincing and credible business plan is a critical first step towards a successful venture capital business negotiation. A very high percentage of companies are rejected after a quick read of the business plan. The assigned readings in Module 2 of this course, **"How to Write a Winning Business Plan"** and **"Some Thoughts on Business Plans"** provide excellent advice on how to tailor a business plan to the interests and needs of venture capital investors.

In general, to qualify for venture capital your firm must have the following characteristics strongly evident in the business plan:

Extraordinary growth and profit potential. Sales growth rates will have to be double digit. Potential rates of return must be within the 35-80% target zone that venture capitalists use and there must be some probability that their target will be exceeded. Some investors will have a minimum sales and profit threshold, below which they will not consider a company. If the sales and profit projections in the business plan do meet the expectations of venture capital investors, the next challenge will be how the underlying assumptions upon which they are based stand up to due diligence examination.

Sustainable competitive advantage. Investors will want to focus on “what is the magic” of your business. How are you different and most important how will your advantage be protected? Do you have proprietary technology? Can it be patented? Will you be a market leader in innovation or will you be the low cost producer?

Excellent people. Once satisfied with the fundamentals of the business, venture capital investors will spend most of their time checking out the people behind the business. An excellent business plan is one thing. Executing it is another. This requires highly effective management and people skills.

Owners willing to accept the intervention of outsiders in their business. Some managers have difficulty accepting that they will have to give up a significant piece of ownership in their business in order to take it to the next level. Some managers have difficulty accepting that venture capitalists are not passive investors. They will have a significant say in and influence on the future direction of the business.

Ease of exit. Venture capitalists have a 4-7 year time horizon on their investment. Before they enter a deal they want to have some assurance that they will be able to exit within the 4-7 year time frame.

Another important role of the business plan is to determine the amount of venture capital investment that will needed to meet the business plan objectives. This will be reflected in the pro-forma financial statements. If subsequent rounds of financing are contemplated, this should be clearly spelled out in the business plan.

1.02 Preliminary Assessment of Business Plan

The first review of the business plan by the venture capitalist will focus primarily on the eligibility criteria presented above as well as any particular criteria that are emphasized by the venture capital firm in its portfolio investment strategy.

Many of the business plans that are rejected by venture capitalists are actually excellent business plans. The problem may be that they are not the kind of company that fits with the portfolio investment strategy of the venture capital firm. Before submitting a business plan it is essential that the firm be aware of typical eligibility criteria for venture capital financing. It is equally important that you become as familiar as you can with the firm from which you are seeking venture capital. For example, many firms will only invest in selected industries.

1.03 Meet the People

If the business plan passes the test of preliminary assessment, it is likely that the venture capitalist will want to have a face-to-face meeting with management of the business. The meeting will most likely take place at the premises of the business. The impressions gained in this meeting can be very influential in terms of whether the venture capitalist will proceed further. This is not a good time to have BMWs and Cadillacs in the parking lot! The venture capitalist is looking for a lean, committed management team.

1.04 Light Due Diligence

The next step will involve a more detailed assessment of the business plan. The industry, the positioning of the firm within the industry, competitors, the background and experience of the management team, etc will be examined to a degree that ensures the venture capitalist that there is a reasonable chance that a deal can be consummated. The “business model” of the firm (i.e. how will it make money) will be examined as well as the pro-formas as an input to the preparation of a term sheet.

1.05 Term Sheet

The term sheet is typically a very brief document that is essentially an offer of financing from the venture capitalist. The term sheet will outline, inter alia, the amount of money to be invested, the proposed deal structure, the proposed ownership percentage, any fees/expenses that the company is responsible for and any other special terms and conditions attached to the offer.

Some negotiation might take place between the parties before the term sheet is accepted by the investee and there is likely to be further negotiation as a result of issues that arise from due diligence. Once the term sheet is accepted and signed off by the investee, the due diligence process begins. It should be noted that the investee might be subject to financial penalties if they accept the term sheet, but later reject the deal even though it is the substantially the same as the term sheet. By signing the term sheet both parties are committing to do everything to consummate the deal, subject to the outcome of due diligence.

1.06 Heavy Due Diligence

It should be emphasized that both the investor and investee should conduct due diligence. The parties are about to enter into a 4-7 year relationship and it is important that both parties gain confidence that the relationship has the potential to be a positive one. Both sides should check the other out, especially in relation to their style of doing business. A bad "fit" in terms of chemistry between the parties can often be detected in the due diligence process.

It should also be noted that the costs of due diligence, especially if experts are retained by the venture capital firm to validate key components of the business plan, are usually passed on to the investee company. These costs can be significant and should be negotiated up front

The investor due diligence will typically focus on the following issues:

1. validation of the business plan assumptions and business model;
2. industry and competitor analysis;
3. investment risks and risk management strategies;
4. the strengths and weaknesses of management and the people behind the business.
   Reference checking is common;
5. commitment of the investee, financial and otherwise;
6. rate of return potential. What is the upside? What is the downside?
7. ensuring that any historical financial information provided is accurate;
8. ensuring that the company is in compliance with the law and regulations;
9. exit alternatives will be evaluated.

There are many casualties in the due diligence process. The most common reasons why deals are declined following due diligence are:

1. concerns about the people behind the business;
2. too little financial commitment from the owners;
3. too much dependence on one or two people for the success of the business;
4. unreasonable management compensation;
5. failure to agree on pricing and/or term and conditions of the shareholder's agreement;
6. investigation of the business plan assumptions raises doubts that the target rate of return can be achieved.

1.07 Investment Memorandum

It is common that the person who leads the negotiations and due diligence on behalf of the venture capital firm does not have the authority to approve an investment.

Typically the lead venture capitalist has to prepare a document (sometimes referred to as an investment memorandum) that summarizes the results of the due diligence process, justifies the proposed investment and recommends a particular deal structure and any special terms and conditions. Many venture capital firms have investment committees that meet to review and approve/reject the deals that are proposed by the lead negotiators.

1.08 Commitment Letter

Once the proposed offer of financing is approved by the venture capital firm, the final offer is presented in writing in what is often referred to as a commitment letter. This letter would set out any changes relative to the offer originally presented in the term sheet.

Again, the investee company might be subject to financial penalties if the deal is subsequently declined even though it is materially the same as outlined in the commitment letter.

1.09 Negotiation of Shareholder's Agreement

The shareholder's sets out the rights and obligations of both parties for the duration of their partnership. While there is opportunity to negotiate certain clauses, investee companies will discover that there are also many common elements to shareholder agreements negotiated by venture capital firms. Some of the clauses might seem unfair to the investee company but further investigation will reveal that they are not atypical. It would be prudent for any firm seeking venture capital to review a typical shareholder's agreement before accepting a term sheet.

Some of the specific contracting issues that arise in the negotiation of shareholder agreements will be presented in the next section of this module.

It should also be noted that the legal expenses for both parties are typically passed on to the investee company. Again, it would be prudent to negotiate this up front.

1.10 Grow the Company

This stage of the venture capital life cycle is obviously the most critical. The objective of both parties is to grow the value of the business.

As stated above, venture capitalists are not passive investors. While they will not be involved in day-to-day operations, they will be very involved in strategic decision-making.

The most important reality of this stage is that all venture capitalists want to “add value” to the firms they invest in. They want to participate directly in assisting the company to achieve its growth and profit objectives. They use their networks to facilitate strategic alliances and/or mergers/acquisitions. They connect the firm to excellent legal, strategic and financial advice. They contribute to critical financing, strategy and personnel decisions. If the company goes public, venture capital backed companies often achieve higher valuations.

In successful ventures, the participation of the venture capitalist is viewed as an opportunity as opposed to a nuisance.

1.11 Exit

The final stage in the life cycle of a venture capital investment is the exit of the venture capital firm from the investee company.

Exit alternatives are presented in module 4 of this course.