



MeitY
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INCUBATION FUND MANAGEMENT

Investment Playbook

for

Startup Incubators

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**Authors' views are personal.*



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1. Background

Over the past two decades, India's startup landscape has transformed dramatically, from a dormant ecosystem to the third-largest startup hub in the world. Central and state governments have played a catalytic role in this transformation, particularly since the early 2000s. By establishing startup hubs and business incubators within academic institutions and knowledge centers, they laid the foundation for a vibrant entrepreneurial ecosystem.

Government support has grown consistently since the start of this century, with a particularly strong push over the past decade. Among the most significant initiatives has been the launch of schemes and programs to fund proof-of-concept development and provide seed capital to early-stage startups and innovators. The Technology Development Board (TDB) under the Department of Science and Technology (DST) and the Ministry of Electronics and Information Technology (MeitY) were among the first government bodies to introduce startup investment schemes, which were implemented through incubators. These efforts came at a time when India had very limited private investor participation in the startup space.

As India's startup investment environment matured, various government departments scaled up their funding efforts to make patient capital available to early-stage startups. However, government bodies typically do not invest directly in startups. They do so through incubators.

Technology business incubators play a pivotal role in nurturing nascent ideas into commercially viable businesses. The traditional model of incubation, primarily providing mentorship and workspace, has evolved into a more hands-on, investment-oriented approach. Today, many incubators actively participate in government startup funding schemes, using these grants to invest in startups through instruments such as equity, loans or convertible notes. In doing so, incubators become long-term stakeholders in the companies they support.

In this emerging model, funding has become a core value proposition of incubators. Consequently, incubators are now expected to develop fund management capabilities similar to commercial investors. While these grants are typically non-repayable and failure to recover investments carries no financial penalty, incubator managers must still adopt an investor's mindset when deploying public or corporate social responsibility (CSR) funds.

Since equity investments in startups are inherently long-term and dependent on follow-on rounds from angel or venture capital (VC) investors, incubators must assess whether the startups they support have the potential for exponential growth. Commercial investors typically back only such high-growth companies. In essence, incubators create a pipeline of investment-ready startups, de-risked through early-stage public funding and prepared for later-stage private capital.



To manage investment grants, referred to hereafter as the Incubation Fund, incubators must adopt clear investment guidelines distinct from their general operational policies. This includes defining an investment thesis, building networks and credible sources for high-quality deal flow, implementing structured processes for screening, valuation, due diligence, as well as developing capabilities for investment structuring, negotiation of terms, post-investment monitoring and value-addition, along with a plan for exits and self-sustenance. Crucially, incubators must also hire team members with relevant investment experience to manage the Incubation Fund effectively. Data driven approach and professional portfolio management minimise personal biases and conflicts in investment decisions, and also enhance the success of the Incubation Fund.

This document offers suggestive guidelines for early-stage incubators that have recently begun receiving seed grants from governments and other sources. While broadly relevant to all incubators managing an Incubation Fund, this guide would be most useful for incubators and incubation managers with limited prior experience in fund deployment and management.



PART - A
FORMATION OF INCUBATION FUND



2. Sources of Funds

For incubators, funding is now an important source of value addition for its incubated startups. Incubators must proactively raise and manage a pool of funds to support incubated startups in their initial stages. Some of the sources are:

- a) **Government schemes:** Various ministries in the central government and most state governments have startup support programs that channel funding through incubators. Governments also run schemes to support entrepreneurship via public sector enterprises. Incubators should actively monitor such programs and apply for relevant funding opportunities.
- b) **Corporate Social Responsibility:** Supporting innovation and entrepreneurship is a permitted area of spending under the Companies Act's Corporate Social Responsibility (CSR) provisions. Incubators must proactively reach out to corporations to make a case for the positive impact of innovation and entrepreneurship for society and industry.
- c) **Alumni network:** Incubators in academia can leverage their institution's alumni base, especially successful entrepreneurs and senior professionals who are keen to give back to their alma mater. Creating a structured alumni fund or investment platform can help mobilize contributions and deepen alumni engagement with the incubation ecosystem.
- d) **Regional network of businesses and High Net worth Individuals:** Incubators can also build relationships with local business communities and high net worth individuals (HNIs) who may be interested in supporting regional entrepreneurship. These stakeholders can play an important role not just as donors or investors, but also as mentors and connectors for startups.

By actively pursuing these funding avenues, incubators can strengthen their ability to support promising startups with early-stage capital, while positioning themselves as credible players in the broader investment ecosystem.

3. Mandate and Investment Thesis

The primary objective of the Incubation Fund is to support early-stage startups at a point where commercial investors are generally reluctant to invest. Typically, commercial investors shy away from investing in early-stage startups that still lack a minimum viable product (MVP), especially in the sectors that have long gestation periods to go from the concept or research stage to launching a product in the market. Similarly, startups in impact-oriented sectors, where exponential growth potential is perceived to be a challenge, often struggle to attract angel or VC



investment. For such startups, the Incubation Fund plays a crucial role in bridging the funding gap until they reach key milestones that signal investment-readiness or revenue stream.

Given that the Incubation Fund is usually limited in size, incubators must deploy it judiciously, ensuring it supports the most promising startups in achieving specific, high-impact milestones. These funds are most often sourced through government seed grant programs or CSR initiatives, each with their own terms, eligibility criteria and compliance conditions. Therefore, it is essential for incubators to adopt a clearly defined investment thesis that covers aspects such as target sectors, stage of the startup, team composition, market opportunity and the investment size per startup.

The key dimensions of an effective investment thesis are outlined below:

Dimension	Suggested Guidelines for Incubators
Stage	Incubation Fund should primarily target pre-seed stage startups. However, if more mature startups within the incubator require and deserve funding, the Investment Committee may allow it, striking a balance between the fund's core mandate and the potential for impact and return.
Deal size	Each seed grant source comes with its own limit on the amount that can be invested per startup. Incubators often face a dilemma: whether to fund a larger number of startups with smaller cheques or fewer startups with more meaningful support. The Investment Committee should ensure that the funding amount per startup is adequate to help them reach critical milestones, such as product validation, pilot deployment or customer acquisition, that enable them to raise the next round of funding. Typical deal sizes at this stage may range from ₹50 lakhs to ₹2 crores, depending on the startup's profile and the limits defined under the respective funding scheme.
Sectoral Focus	Incubators should align their investment strategy with their core strengths and the nature of their startup pipeline. Since incubators are expected to provide value beyond capital — through mentoring, network access, and strategic guidance — it is essential that they invest in sectors where they can meaningfully contribute. Investing outside their area of expertise may reduce their role to that of a passive financial investor, which is generally not desirable at the early stage.

Start-up Team	The quality and composition of the founding team is one of the most critical factors for the success of any startup. While incubators may accept single-founder startups for incubation, investment decisions should favour start-ups with 2–3 co-founders possessing complementary skills. These individuals should be capable of assuming CXO roles in the future as the start-ups grows.
Co-investment	Deep-tech or deep-science startups tend to require large capital outlays even at the early stages. A single incubator may not have sufficient funds to support such startups on its own. In such cases, incubators should consider co-investing with other institutional or individual investors. Depending on the grant guidelines, incubators should balance their role between acting as a lead investor and participating as a co-investor. Depending on cases, incubators should reach out to other early stage investors for co-investment.
Exit potential	While the primary aim of early-stage funding is to catalyse innovation, it is also important to consider exit potential. Incubators should ideally invest in startups that are scalable and have a reasonable prospect of exit within a reasonable horizon (5-7 years), either through follow-on funding, acquisition, initial public offering or other liquidity events.
Things to watch out for	Incubators must guard against the tendency to use the Incubation Fund merely as a tool to attract more startups for incubation. This can lead to the indiscriminate funding of every incubated startup, regardless of merit. A clear separation between incubation and investment decisions must be maintained. Funding should be based on rigorous evaluation and alignment with the fund’s objectives, not simply as an incentive for joining the incubator.

4. Incubation Fund Team

Managing an Incubation Fund requires more than selecting promising startups and investing funds. It demands the strategic and operational discipline of a professional early-stage investor. The team responsible for the fund plays a pivotal role in ensuring that investments are made judiciously, monitored effectively and aligned with both the incubator’s focus and the expectations of future co-investors.



Incubator managers must recognize that equity investments are not a one-time event. Appearing on a startup's cap table is just the beginning. Post-investment, incubators are expected to actively manage their equity positions, support portfolio companies, and protect the interests of the fund.

This involves developing core competencies in several areas, like:

- **Valuation:** Assessing startup valuations using appropriate methods suited for early-stage ventures
- **Term Sheet Negotiation:** Understanding and negotiating key clauses including investor rights, liquidation preferences, anti-dilution provisions, and exit terms
- **Shareholders' Agreements:** Structuring agreements to define governance, ownership, and future fundraising mechanisms
- **Equity and Exit Planning:** Ensuring that the terms allow for alignment with future investors and pave the way for credible exit opportunities
- **Monitoring and Support:** Regularly tracking portfolio company progress and intervening where needed with mentoring, strategic connects, or follow-on support
- **Stakeholder Alignment:** Balancing the interests of public or CSR-backed capital with those of private co-investors in subsequent rounds

Incubators managing an Incubation Fund should build a dedicated or trained team with a mindset similar to angel investors or early-stage VCs — one that understands startup risk, recognizes growth signals and is equipped to act not only as a grant manager but also as a strategic investor.



PART - B
PRE-INVESTMENT FUND MANAGEMENT



5. Deal Sourcing

A well-managed Incubation Fund is only as strong as the quality of its deal flow. Identifying high-potential startups that align with the fund's mandate requires more than passive intake. It demands a deliberate and strategic approach to sourcing. Deal sourcing is not just about filling a pipeline; it's about curating one that reflects the fund's investment thesis, sectoral strengths, and long-term goals. This involves a blend of inbound (startups coming to the incubator) and outbound (the incubator going to startups) efforts.

A. Inbound Sourcing

Inbound sourcing refers to the mechanisms by which startups discover and approach the incubator. To ensure a high-quality inbound funnel, the incubator must invest in building deep networks, maintaining institutional presence and enhancing brand recall in the startup ecosystem.

Key inbound strategies include:

- a) **Open Call Mechanisms:** Maintain a live application portal and run periodic cohort calls, each with defined themes (e.g., cleantech, artificial intelligence, women-led startups) aligned with the incubator's focus. This can be a dominant model of sourcing for incubators, but can generate a large number of low-quality leads which will have to be filtered out in the initial screening process.
- b) **Referral Networks:** Institutionalize referral pipelines through "friends of the incubator": mentors, portfolio founders, alumni, consultants, other incubators, accelerators and early-stage investors, among others. Deals sourced through warm introductions are usually of the highest quality and have a better fit with the mandate of the incubator. Personal networks of the incubation team, particularly senior members with a long-running presence in the startup ecosystem, can play an important role in inbound sourcing of high-quality deals.
- c) **Events and Competitions:** Organize awareness sessions, hackathons, pitch contests, demo days and sectoral challenges for the ecosystem. For some of the events, incubation and funding support can be offered to high-quality participants and winners.



- d) **Storytelling and Visibility:** Consistently share the incubator’s success stories, investments and startup journeys through social media, blogs, newsletters and mainstream media. A visible and active brand attracts applications.

- e) **Host-Institution Engagement:** For academic incubators, the campus is a natural wellspring of ideas. Run awareness sessions with students and faculty to develop relationships so that they feel comfortable to approach the incubator if and when they consider commercialization of their research by setting up a startup.

B. Outbound Sourcing

Outbound sourcing involves proactively identifying and reaching out to high-potential startups that may not have considered the incubator or are unaware of its funding opportunities.

Key outbound strategies include:

- a) **Startup Scouting and Direct Outreach:** Use startup databases, pitch event listings and platforms like GitHub and LinkedIn to identify promising startups and reach out to them personally. This approach typically generates a high volume of deals but many of them are of a low quality or do not align with the incubation fund’s mandate. This approach can be led by analysts in the incubation team who filter out inappropriate deals and only pass on high-quality leads to senior team members.
- b) **Participation in Ecosystem Events:** Send representatives to regional and national startup expos, demo days, thematic conferences and investor summits, among others. These events offer opportunities to discover new startups, evaluate them in real time and build relationships early.
- c) **Active outreach with “friends of the incubator”:** Build regular rhythms to reach out to various partners across the ecosystem to get information regarding trends in the ecosystem and leads for high-quality startups in spaces aligned with the mandate of the fund. For academic incubators, this could mean regular visits to academic campuses and R&D organizations outside their host institution to identify and curate potential startups for incubation and investment.



Also, building synergistic partnerships with other incubators, accelerators and corporate innovation programs can be fruitful for sourcing high-quality deals.

6. Screening and Initial Due Diligence

Incubators managing an Incubation Fund, especially for the first time, must avoid the common pitfall of investing in every startup that applies for funding. Instead, they should establish a rigorous and transparent screening process to filter applications and identify ventures that truly align with the incubator's objectives. Incubators can take a cue from the screening processes put in place by leading angel investor networks and venture capital funds.

A. Screening

Screening is the first evaluation step, conducted after receiving applications and before initiating due diligence or making investment decisions. The purpose of screening is to assess eligibility, strategic fit and potential. The idea is to ensure that only the most promising and suitable startups move forward in the evaluation process. Screening is largely done based on the documents submitted by the startup. In a cohort-based process, these documents include the application form, pitch deck and financial model.

1. Ensuring Eligibility and Alignment

Startups must meet the eligibility criteria defined by the funding agency or scheme. Most government-supported schemes allow investments only in companies which qualify as a "startup" as per the definition given by the Department for Promotion of Industry and Internal Trade (DPIIT). Startups are also expected to register on the Startup India portal.

It is equally important to ensure alignment with the mandate of the funding source. For instance, if the Incubation Fund is supported by the Department of Science and Technology (DST), it must be used only for Science & Technology (S&T) startups — not for ventures such as restaurants, salons or pet grooming services. If funding is provided by the Ministry of Electronics and Information Technology (MeitY), investments should be restricted to startups in electronics, information technology or digital technologies — not in unrelated sectors like chemical manufacturing. Ensuring this alignment at the screening stage prevents compliance issues later on.



2. Screening Process

Screening is typically carried out by the internal team managing the Incubation Fund. The process typically involves reviewing:

- Pitch decks, application forms and other documents submitted by startups
- One-on-one interactions (calls or meetings) to clarify key aspects of the proposal
- Consultations with domain experts, especially when evaluating complex technologies or unfamiliar sectors

The goal is to develop a basic understanding of the startup's viability, product/technology and growth potential without going into full due diligence at this stage.

3. Key Screening Criteria

The screening team should evaluate applications using a structured checklist or scoring matrix based on the following checkpoints:

- Alignment with the Incubation Fund's objective
- Eligibility as per funding scheme guidelines
- Strength of the product, technology or intellectual property (IP)
- Team composition, skills background and credibility
- Business model and scalability potential
- Initial traction or progress made
- Market potential and competitive landscape
- Basic financials and revenue model
- Funding amount requested and whether it is adequate for the next milestone
- Likelihood of future fundability (e.g., attracting follow-on investment)

4. Outcome of Screening

At the end of the screening process, the internal team must decide whether to reject the application (with or without feedback) or advance it to the next stage, i.e., initial due diligence. In some cases, the internal team might see promise in the startup but feel that it is premature for an investment given its current stage. The team can put such applications on hold till the startup achieves certain milestones, instead of rejecting the application. For shortlisted startups, the internal team starts preparing a brief evaluation note summarizing key observations and a risk-benefit analysis, which will keep getting more detailed during the initial due diligence process.



A. Initial Due Diligence

Once a startup passes the preliminary screening stage, the internal team may proceed with a more detailed evaluation during the initial due diligence process. This stage focuses on assessing a set of broad parameters, tailored to the startup's maturity, sector and product type (e.g., hardware vs software). The purpose is to prepare for Investment Committee (IC) discussions and anticipate potential questions. Some startups may be filtered out at this stage, especially when the number of shortlisted candidates exceeds the available funding capacity.

1. Technology and Product:

i) Stage of product development:

Assess whether the technology is still under development, lab-tested or validated in real-world environments. Evaluate the product's stage — concept, early prototype, production-ready prototype, piloted or deployed at a customer site — and the estimated time to completion or market launch. Technology Readiness Levels (TRLs) can serve as a benchmark. Startups with shorter go-to-market timelines are generally more attractive, but comparisons should account for domain-specific gestation periods.

ii) Intellectual property (IP):

Evaluate whether the core IP is proprietary, licensed or open-source. Check for ownership clarity, freedom to operate and any potential IP infringement risks. Assess the defensibility of the IP, its legal protection (e.g., patents, trademarks) and whether it offers sustainable competitive advantage. Review if the startup holds ownership or only a limited-term license (e.g., 2-year tech transfer from a university).

iii) Scalability:

Assess scalability potential of the technology and product, uniqueness and competitive positioning. Review the roadmap for future product development or expansion. Platform technologies that enable multiple product lines or evolving feature sets are preferred over single-product innovations, especially in hardware.

2. Legal:

i) Company Incorporation: Verify company registration documents and DPIIT (Startup India) recognition, if applicable.

Company incorporation documents, DPIIT Registration



ii) IP Ownership: Review documentary evidence for any claimed patents, copyrights, trademarks, design registrations or licensing agreements.

iii) Regulatory Approvals and Certifications: Check if any regulatory clearances or certifications are required for the product and whether they have been obtained or are pending.

3. Business:

An in-depth assessment may be conducted by the incubation team across the following dimensions:

- i. Problem-solution fit, product-market fit
- ii. Market size and growth potential
- iii. Target customer segments and traction
- iv. Competitive landscape and differentiators
- v. Business and revenue models

4. Team:

A comprehensive team evaluation by the incubator should cover:

- i. Competence: Founders' qualifications, experience and track record
- ii. Complementarity: Team structure and role clarity
- iii. Commitment: Full-time engagement, reflected in equity shareholding
- iv. Chemistry: Team dynamics and history of working together
- v. Common Vision: Alignment of long-term goals and values

5. Finance:

This involves stress-testing the startup's key assumptions, projections and overall financial model. The incubation team can connect with the founders to clarify assumptions, if needed, and ask for relevant information which might be missing. Some elements to look at:

- i) Burn rate and runway: How much runway will the proposed investment provide? Is it sufficient to reach the next major milestone?
- ii) Financial projections and underlying assumptions
- iii) Capital structure and shareholders: Ensure equity distribution reflects contributions and roles; key team members should have meaningful equity exposure (i.e., skin in the game)
- iv) Past funding/grants: Evaluate if past funds were utilized judiciously and whether previous milestones were achieved



6. Milestones in the context of funds sought:

- i. Clarity and Execution: Are the product, business and team milestones clearly defined and time-bound? Is there a detailed execution plan with designated responsibilities?
- ii. Use of Funds: Will the requested funding enable the startup to achieve these milestones? Are there red flags in proposed fund utilization (e.g., large proportion for founder salaries, unrelated expenses)?

If the startup successfully clears the initial due diligence process, it can be presented to the Investment Committee (IC) for final evaluation. The documents submitted by the startup (like application form and pitch deck) should include all the information required for the IC presentation and discussion.

7. Investment Committee

The Investment Committee (IC) is the final decision-making body for approving investments from the Incubation Fund. After startups pass the screening and initial due diligence, the IC assesses whether they are worthy of investment, based on a comprehensive and structured review. Given the importance of its role, the IC must be composed of members with investment expertise and sectoral knowledge to ensure high-quality decision-making.

The IC should primarily consist of independent experts, including experienced investors (angels, micro-VCs or other institutional investors), successful entrepreneurs and industry leaders, professors with expertise in startup financing and incubation, and domain or technology specialists relevant to the incubator's focus areas. One or two representatives from the incubator's management team and the host institution may serve on the IC. In some cases, government or CSR funding agencies may nominate a representative or observer to the IC. Maintaining a majority of independent experts ensures governance, objectivity and credibility in the investment process. Experts from fields outside incubation (like investors and academics) are able to complement the skills and expertise of the internal team by asking new questions and providing unforeseen insights which might lead to a change in the recommendation given after the initial due diligence process.

Startups invited to the IC stage make formal presentations covering their team, product, technology, business model, market opportunity and funding requirements, among other details. The IC also reviews the internal team's screening and initial due diligence report. Based on this comprehensive assessment, which considers market potential, technology readiness, intellectual

property, team credibility, financial projections and funding adequacy, the IC decides whether to approve, reject or defer the investment. For approved deals, the IC also sets the terms, including the investment amount, instrument (equity, convertible notes or debt), valuation, milestones, disbursement schedule and any special conditions for monitoring or follow-on funding.

Comparison between Screening and IC approval:

Particular	Screening	IC Approval
<i>Objective</i>	Initial filtering	Final investment decision
<i>Responsibility</i>	Internal team	Investment Committee
<i>Depth of Evaluation</i>	Basic eligibility, alignment, business model, product, technology, IP, risk analysis etc.	Comprehensive diligence for investability, milestones, investment amount, valuation and other terms of investment
<i>Outcome</i>	Rejection or shortlisting for the next stage	Approval, rejection or deferment for Investment

8. Investment Structuring and Negotiation

Once the Investment Committee approves a startup for funding, the process moves to the investment structuring and negotiation phase. The first step in this phase is the issuance of a term sheet, a document that outlines the key commercial terms of the investment like the startup's valuation, the type of financial instrument, proposed investment amount, rights and obligations of the parties and other standard clauses. While the term sheet reflects the mutual intent to proceed, it is non-binding in nature, except for two clauses that are typically binding: confidentiality and exclusivity (typically applicable only if the investment amount is significant). These ensure that discussions remain private and that the startup does not use the incubator's term sheet to seek more attractive terms from another incubator while the final due diligence is in process. This stage also involves detailed negotiations to align expectations between the



and the startup, ensure regulatory compliance and pave the way for a mutually beneficial long-term partnership.

Incubators must exercise caution when structuring early-stage investments — particularly around valuation and equity dilution. At this stage, startups typically lack a financial or operational track record, making it difficult to assign a precise valuation. As a result, rigid or aggressive valuation expectations can be counterproductive. Incubation Funds, often being the first institutional investors on the cap table, should be especially mindful not to demand excessive equity. Taking a large ownership stake too early can significantly reduce the founders' equity pool, making future fundraising rounds more difficult and disincentivizing the founding team over time. A balanced approach — prioritizing milestone-based growth over short-term equity gain — helps preserve founder motivation and ensures long-term fundability of the startup.

A. Valuation

Valuation is one of the most critical components of investment structuring, especially in the early stages where startups often lack significant revenue, customer traction or financial history. For Incubation Funds, selecting the right approach to valuation requires balancing the need for governance and financial discipline with the realities of early-stage uncertainty and founder sensitivity.

Incubators can adopt one of the following valuation strategies:

1. Fixed Valuation Approach

Under this model, the Incubation Fund sets a uniform valuation across all startups, as a matter of investment policy. For example, an incubator may define its investment thesis as offering ₹50 lakhs for a 5% equity stake in each startup — implying a post-money valuation of ₹10 crore. This standardization simplifies negotiations and sets clear expectations upfront.

Startups that do not agree with this valuation can self-select out of the process, saving time for both parties. While this approach is easy to implement, it may not reflect the diverse potential of startups and can sometimes deter high-potential applicants who expect higher valuations based on their progress or traction.

2. Deferred Valuation via Convertible Instruments

In cases where assigning a fair valuation at the time of investment is difficult, the Incubation



Fund may choose to invest using convertible instruments, such as Compulsorily Convertible Preference Shares (CCPS) or Optionally Convertible Debentures (OCDs).

This approach defers the actual valuation to a future round, where pricing is determined by external market investors (typically at the next priced equity round). The convertible instrument includes a clause that converts into equity based on the valuation of the future round, with or without a discount and/or valuation cap.

Among these, CCPS is generally preferred in early-stage investing because it behaves more like equity and provides clear shareholder rights. OCDs, being debt instruments until conversion, may pose regulatory challenges, especially in incubation setups backed by public or CSR funding, which often discourage debt-linked investment structures.

Deferred valuation allows startups and incubators to avoid difficult valuation negotiations at the outset, while still securing a stake in future upside. It is particularly useful for pre-revenue startups or those with long gestation technologies.

3. Co-Investment Valuation

When the Incubation Fund participates in a round alongside other institutional or angel investors, it can choose to align with the valuation agreed upon by the lead investor. This is a pragmatic approach that avoids duplication of diligence and negotiation and helps incubators ride on the pricing discipline of more experienced or market-driven investors. In such cases, the incubator can structure its investment either at the same terms or with minor variations (e.g., milestone-based disbursement or added governance rights if funding is from public sources).

B. Financial Instrument

Once the investment valuation is agreed upon, the next key decision is the choice of financial instrument through which the Incubation Fund will invest in the startup. The choice of instrument influences not only the legal structure of the investment but also the startup's cap table, future fundraising flexibility and the investor's rights.

Incubation Funds can consider the following instruments:

A. SAFE Note (Simple Agreement for Future Equity)

A SAFE note is a contractual agreement that allows an investor to invest money in a startup in exchange for the right to receive equity in a future priced funding round. It is neither equity nor debt, and does not accrue interest or have a maturity date.



SAFE notes are often used in the earliest stages of funding as they are simple, fast to execute, and postpone valuation negotiations until a later round. However, SAFE notes face restrictions in India due to the absence of direct legal recognition and the need to comply with existing Indian regulations. To navigate these limitations, startups use a derivative called iSAFE (Indian SAFE) notes, which are structured as CCPS. However, even iSAFE notes can lead to complications regarding dilution, regulatory compliance and the inherent hybrid nature of the instrument, which requires careful legal guidance to avoid pitfalls.

B. Equity Shares

Equity investments involve directly purchasing a defined percentage of ownership in the company at an agreed valuation. This is the most straightforward and legally recognized form of investment. However, for early-stage startups, direct equity investment comes with challenges. Valuations tend to be low in the initial phases, meaning that even small capital investments can lead to disproportionately high dilution for the founders. This can create long-term issues in future fundraising rounds, where new investors may be deterred by the limited founder equity remaining. For this reason, convertible instruments are often preferred at the incubation stage.

C. Compulsorily Convertible Preference Shares (CCPS)

CCPS are a widely used instrument in Indian early-stage investing. These are preference shares that carry preferential rights over ordinary equity shares in terms of dividends and capital return in case of liquidation. Importantly, CCPS must be converted into equity shares at a future date or upon the occurrence of a specified event (e.g., the next funding round) at a predetermined rate with the appropriate discount and/or valuation cap. One key advantage of CCPS is that they do not require a current valuation. The valuation and conversion terms are deferred to the next priced round, allowing early investors and founders to postpone difficult negotiations. This also protects founders from excessive early-stage dilution. Until conversion, CCPS form part of the startup's share capital and provide the investor certain shareholder rights, making them both flexible and legally secure. The discount and/or valuation cap are meant to reward early investors for taking higher risk by allowing them to convert their investment into equity at a more favourable valuation than later investors.

D. Compulsorily Convertible Debentures (CCD)

CCDs are debt instruments that are mandatorily converted into equity after a specified period or event. Until they are converted, CCDs remain classified as debt, offering the investor preferential



treatment over both equity and preference shareholders if the company shuts down. Like CCPS, CCDs do not require upfront valuation and thus help avoid early-stage dilution. Here too, conversion happens at a predetermined rate to ensure valuation benefits for early investors.

In addition to specifying the investment amount, valuation and financial instrument, a term sheet typically outlines a number of other important terms and conditions that define the rights, obligations and expectations of both the incubator and the startup. These terms may not be exhaustive or legally binding in most cases, but they serve as a foundation for drafting the final investment agreements. Incubators should ensure that their term sheets are clear, founder-friendly and aligned with best practices, especially when dealing with first-time entrepreneurs.

Incubators can also consider sharing the standard terms upfront by uploading on their website a standard term sheet.

9. Post-Investment Committee Due Diligence

Once the Investment Committee (IC) approves a startup for funding, the investment process does not immediately move to agreement signing. A critical step in between is post-IC due diligence — a detailed review of the startup’s legal, financial and contractual standing. While some elements of diligence (such as eligibility, sector alignment and broad team checks) are carried out earlier during screening and pre-IC evaluation, this stage involves a comprehensive, document-based assessment of the startup to confirm its investability and to safeguard the Incubation Fund from hidden risks.

The primary objectives of post-IC due diligence are to:

1. Verify the accuracy of claims made by founders.
2. Identify legal, financial or operational risks.
3. Ensure compliance with regulatory requirements.
4. Assess whether any red flags warrant renegotiation of terms or withdrawal from the investment.

It is advisable for incubators to engage external consultants (legal, financial and compliance experts) for certain specialised forms of diligence at this stage. A portion of the Incubation Fund’s administrative budget should be earmarked for such professional services, as they significantly reduce risk and add credibility to the investment process.



Key Areas of Post-IC Due Diligence

1. Financial

- Verification of historical financials, where available: revenue streams, expenses and cash flows
- Review of outstanding liabilities, loans or contingent obligations
- Scrutiny of fund utilization from previous grants or investments

2. Legal

- Examination of incorporation documents and company registration records
- Review of founders' agreements, shareholder agreements and previous investment documents, if any
- Verification of regulatory filings, statutory compliances, approvals and certifications
- Identification of ongoing or past litigation, regulatory notices or contingent liabilities

3. Contracts

- Review of contracts with customers, vendors, employees and service providers
- Assessment of exclusivity clauses, unusual obligations or terms that may limit viability and scalability
- Verification of ESOP schemes or employment agreements with key staff

Critical Red Flags

The due diligence process is as much about confirming strengths as it is about uncovering risks. Some of the most common red flags in early-stage startups include:

- Unclear IP ownership (e.g., IP still held by founders personally or by a host institution rather than the startup)
- IP infringement risks, such as reliance on borrowed code, patents or third-party rights without licenses
- Founder disputes, misalignment of vision or signs of weak commitment (e.g., part-time founders, unclear equity splits)
- Frequent changes in the founding team due to unresolved disagreements
- Conflicts with past investors, including disputed obligations or side agreements
- Exaggerated or unverifiable claims regarding technology readiness, product features, pilots or customer traction
- Hidden financial obligations, including undisclosed debt, personal guarantees or backdated commitments



- Serious regulatory breaches, non-compliance with company law or pending legal proceedings

Post-IC due diligence acts as the final safeguard before disbursing funds. While startups at the early stage may not always have extensive financials or mature processes, incubators must nevertheless apply rigor in reviewing legal, financial and contractual foundations. Engaging external professionals, maintaining a clear checklist and being willing to walk away in the presence of critical red flags are essential practices. This discipline not only protects the Incubation Fund but also ensures that funded startups are on a strong, compliant foundation for future growth and follow-on investment.

10. Investment Agreement:

After the term sheet is finalized, the incubator and the startup must enter into a formal, legally binding Investment Agreement or Shareholders' Agreement (SHA). This agreement expands on the term sheet and outlines detailed terms related to the investment, such as fund usage, equity ownership, founder obligations, milestones, governance and exit provisions. The agreement ensures legal clarity and protects the interests of both parties. It must be executed before the disbursement of funds, and any associated regulatory or compliance steps, such as board resolutions or filings, should be completed at this stage. Given the legal complexity, incubators should involve qualified counsel in drafting and reviewing the agreement. A clear, well-structured Investment Agreement provides a strong foundation for a transparent and accountable relationship with the startup.

Standard Terms in Term Sheet and/or Investment Agreement

Some of the common terms included in term sheet and/or investment agreement are:

a. Disbursal Schedule

This section specifies the total amount being invested and whether the investment will be disbursed in one go or in multiple tranches, often tied to predefined milestones (e.g., product launch, regulatory approval, hiring of key personnel).

b. Use of Funds

Term sheets often include a general understanding of how the funds will be used — for example, product development, hiring, market entry or IP protection. This helps ensure alignment on priorities and discourages misuse of funds for non-strategic purposes.



c. Conversion Terms (for Convertible Instruments)

If the investment is being made via convertible instruments, the term sheet should clearly mention the trigger event for conversion (e.g., next priced round), conversion ratio and valuation cap or discount, if applicable.

d. Rights of the Investor

The term sheet may specify key rights such as:

- Information rights (regular access to financial and operational updates)
- Board seat or observer rights on the board (without formal voting powers)
- Right to participate in future funding rounds (pro-rata rights are standard)
- Protection against future down-rounds (anti-dilution provisions)
- Exit rights including scenarios for voluntary and involuntary exits (e.g., M&A, IPO or company shutdown) like tag-along and drag-along rights

These rights should be tailored appropriately for early-stage incubation investments — focusing more on governance and less on control.

e. Founder Commitments and Restrictions

Founders are often expected to remain active in the company and not dilute their focus. Clauses may include:

- Minimum commitment period
- Restrictions on selling or transferring shares
- Non-compete and non-solicitation for a defined period

These provisions help de-risk the investment and ensure continuity in execution.

h. Liquidation Preference

In the case of preference shares, the term sheet may specify the liquidation preference i.e., the order and amount in which investors are repaid in the event of a company liquidation or exit. A 1x non-participating liquidation preference is standard in early-stage investments.



PART - C

POST-INVESTMENT FUND MANAGEMENT



11. Fund Disbursement

Once the investment agreement has been executed, the disbursement of funds to the startup is typically carried out in tranches, rather than as a single upfront payment. These tranches should be strategically linked to the achievement of predefined milestones, as outlined in the Shareholders' Agreement (SHA). This milestone-based approach ensures disciplined fund utilization, accountability, and progress tracking throughout the investment period.

In cases where the Incubation Fund is backed by government grants, disbursement must also adhere to the specific usage conditions and compliance protocols prescribed by the funding agency. These conditions are designed to ensure that funds are applied solely for legitimate business development activities.

Permissible Use of Funds

Government-supported grants generally permit fund usage for the following purposes:

- Product development and prototyping
- Hiring and manpower-related expenses
- Marketing and branding
- Professional and technical services
- Other justifiable operational and business development needs

Restricted or Prohibited Uses

Government grants typically do not allow the funds to be used for:

- Repayment of existing loans or dues owed by the promoters or their associates
- Payment of interest on such prior obligations
- Providing loans or financial assistance to promoters or related parties
- Making inter-corporate deposits (ICDs)
- Investing in or purchasing shares/securities of other companies
- Any expenditure that directly or indirectly benefits promoters or their associates for personal gain



Conditions for Tranche Release

Before releasing each tranche, the incubator must:

- Verify that the startup has achieved the agreed-upon milestones
- Ensure the founders and company have fulfilled their financial commitments, if any
- Collect utilisation certificates, as per the format prescribed by the funding agency
- Obtain progress reports or any additional documentation that demonstrates responsible fund usage and business advancement

Incubators bear the responsibility of ensuring compliance, both in terms of fund utilisation and reporting. A well-managed disbursement process not only supports startup growth but also strengthens the credibility and sustainability of the Incubation Fund itself.

12. Value Addition and Progress Monitoring

For incubators managing an investment fund, their role goes far beyond writing a cheque. Post-investment engagement is critical to ensure that startups not only use funds effectively but also receive the right support to achieve their next milestones. In this context, value addition and progress monitoring are two sides of the same coin — enabling strategic growth on one hand and ensuring accountability on the other.

A. Value Addition to Investee Startups

When incubators hold equity or convertible securities, there is an expectation to provide deeper and more focused support. While all incubated startups receive access to infrastructure and mentoring, the stakes are higher and expectations are sharper for startups in which the incubator is an equity investor.

Key areas where incubators can add value include:

- **Milestone Planning and Execution Support:** Helping startups break down long-term goals into achievable, fundable milestones — especially those linked to product development, pilot launches or market entry
- **Next Round Fundraising Readiness:** Coaching founders on pitch readiness, refining investor decks, preparing for due diligence and making warm introductions to angel networks and VCs



- **Governance and Compliance:** Guiding startups on establishing strong internal processes, governance frameworks and MIS systems. This includes helping with board formation, shareholder management, statutory filings and financial discipline
- **Strategic Connections:** Offering access to relevant networks — industry experts, prospective customers, channel partners, regulatory bodies and professional service providers — that are critical to scaling
- **Product and Business Model Feedback:** Providing structured feedback on product development, user validation, pricing models, go-to-market strategies and customer segmentation.

B. Progress Monitoring and Discipline

Continuous monitoring of progress — especially in relation to pre-agreed milestones — is essential for tracking the effectiveness of fund utilization and identifying red flags early. This includes:

- **Periodic Reviews:** Monthly or quarterly check-ins with startup founders to review key metrics, usage of funds and operational progress
- **Utilisation Tracking:** Ensuring that fund usage aligns with what was approved in the investment plan, especially when public or CSR funds are involved
- **Course Correction:** In cases where startups fall behind on milestones or misuse funds, incubators must step in with corrective guidance. Follow-on tranches of funding may be withheld until issues are resolved and necessary course corrections are made

This structured oversight builds a culture of accountability, protects the fund’s credibility and improves outcomes across the portfolio. Invested startups should not be seen as passive recipients of funds. Incubators must act as active strategic partners — monitoring progress, enforcing discipline and enabling growth through meaningful value addition. The more engaged and structured this post-investment support is, the more likely the startup is to scale successfully and attract future funding.

13. Exits and Self-Sustenance

Unlike conventional venture capital funds, Incubation Funds are typically grant-based and do not operate with a fixed fund lifecycle or a formal closure date. Since these funds are created from



public or CSR grants, there is usually no requirement to return capital to the original funding agency. However, most granting bodies do expect that any returns from investments be recycled or ploughed back into the fund, so that the capital can continue to support new startups over time.

To ensure long-term viability and relevance, incubators must proactively plan for exits and design a clear exit policy that balances the financial sustainability of the fund with the growth trajectories of the startups.

A. The Need for Exit Planning

Even though the original grant is non-repayable, achieving liquidity from investments is critical for two reasons:

1. It demonstrates impact and maturity in fund management to stakeholders, including government and corporate sponsors.
2. It helps build a self-sustaining fund corpus that can support future investments without relying solely on new grant inflows without timely exits, the capital remains locked in startups for long durations, limiting the incubator's ability to support the next generation of ventures.

B. Common Exit Strategies

Incubators can consider a variety of exit methods depending on the maturity of the startup and the funding environment:

- **Staggered Exit in Follow-on Rounds:**
The most common route is to exit partially or fully during subsequent equity funding rounds, by selling shares to incoming investors. This approach allows the incubator to exit at a higher valuation while ensuring continuity in the startup's growth journey.
- **Time-Bound Exit Strategy:**
The incubator may decide to exit after a pre-defined period (e.g., 4–5 years post-investment), irrespective of valuation, especially if there's limited upside or if the startup has stabilized but is not scaling further.
- **Milestone-Based Exit:**
Exit is triggered once a company achieves a significant milestone — such as break-even, a defined revenue threshold or international expansion.



- **Valuation-Linked Exit:**
The fund may plan a full or partial exit once the startup crosses a predetermined valuation benchmark (e.g., ₹50 crore or ₹100 crore), which reflects significant value creation.
- **Buyback by Founders:**
In some cases, founders may choose to buy back the incubator's equity stake over time, especially if they prefer to consolidate ownership.
- **Initial Public Offering or Strategic Sale Event:**
If the startup goes for an Initial Public Offering (IPO) or is acquired by a larger player, the incubator can liquidate its stake as part of the transaction.
- **Write-Off (in Case of Failure):**
If the startup is unable to progress and is shut down, the investment is written off. Proper documentation of the closure and fund utilization is essential in such cases, especially for grant audits.

C. Reinvesting Exit Proceeds for Self-Sustenance

All exit proceeds, whether partial or full, should ideally be ploughed back into the Incubation Fund. This enables the fund to become revolving in nature, allowing the incubator to continuously support new startups even after the original grant has been fully deployed.

Over time, this approach reduces dependency on external grant cycles and moves the Incubation Fund closer to a self-sustaining model. This also strengthens the incubator's credibility and bargaining power when seeking co-investment partnerships with angels, VCs or corporate investors.

D. Creating a Formal Exit Policy

To manage exits effectively and transparently, incubators should draft a formal exit policy that outlines exit scenarios and preferred methods, typical holding period expectations, plough-back requirements in line with the fund's governing rules, roles and responsibilities in tracking liquidity events, approval processes for partial or full divestments and a mechanism for monitoring fair



exit valuation. Such a policy helps manage stakeholder expectations, ensures regulatory compliance and establishes clarity on how investment returns will be handled.

E. Important aspects to ensure successful exits

Successful exits are the cornerstone of making an Incubation Fund self-sustaining, enabling successive cycles of investment and creating opportunities for incubators to earn healthy carry from each cycle. Achieving such outcomes requires a proactive approach: building a strong pipeline of startups, establishing a rigorous investment process supported by a capable Investment Committee, delivering consistent value addition to portfolio companies and maintaining close monitoring and review mechanisms to ensure steady progress.

Portfolio and Data Management

Prudent data driven practices in investment decisions and systematic oversight of investee-portfolio are core to the success of the Incubation Funds. A sound system for data collection for different elements - such as deal sourcing, due diligence, selection, business, financials, governance, regulatory and milestone tracking - create a repository of information crucial to decision making. This information enables timely identification of risks, performance, capital requirement, need for interventions, investment decision and planning exits across the portfolio of startups. Efficient data systems also facilitate effectiveness in portfolio management and continuous monitoring of investee's progress and strategic engagement. The combination of strong data management and active oversight ensures transparency, informed judgments and optimal use of public and philanthropic resources within the fund. Most importantly, this approach helps eliminate personal biases and conflicts while making investment and exit decisions.



PART - D
MISCELLANEOUS



14. Incubation Fund vs Incubation

Incubators managing both incubation and investment must clearly differentiate between these two decision-making processes. Incubators typically support startups at a very early stage, often at the idea or technology stage. In many cases, the founding team consists of a single technical founder. At this point, most startups are not investment-ready. The decision to incubate startups should be based on factors such as innovation, intellectual property, alignment with the incubator's mandate and the ability of the incubator to support the startup through infrastructure, experimental facilities, technical mentorship and business guidance. Incubation decisions tend to be more inclusive, with a focus on nurturing early-stage ideas and founders to build a robust pipeline for future investment.

In several cases, startups may not have high growth potential or may not become investible in the foreseeable future. However, their solutions may still offer strong societal impact or address strategic national priorities. Such ventures can be supported under the incubation program, even if they do not promise significant financial returns in the long run. Moreover, the decision to incubate usually does not involve extensive business or financial due diligence.

In contrast, investment decisions are financially driven and require a deeper analysis of the startup's business viability, market potential, scalability and risk-return profile. These decisions involve rigorous due diligence, milestone-based planning and clear return expectations. Furthermore, investment decisions are typically made by an independent Investment Committee to ensure objectivity and governance.

In essence, incubation is about enabling startups, while investment is about taking a financial risk on their growth potential with a clear expectation of generating financial returns. These two functions require different mindsets, evaluation criteria and levels of selectivity. Incubator managers must ensure that both decisions are taken through distinct yet complementary processes, with appropriate safeguards to prevent conflicts of interest and maintain transparency and fairness.

15. Incubation Fund vs Angel and VC Funds

Although the purpose of both types of funds is the same — supporting startups with investment and enabling them to achieve their growth potential — there are differences in their investment strategies.



Incubation Funds are primarily designed to support startups at a very early stage, often before they have reached significant milestones or validation. These startups may have long gestation periods (e.g., in healthcare, MedTech or hardware sectors) but possess strong technology and scalability potential. At this stage, commercial investors such as Angel Funds or Venture Capital (VC) Funds generally refrain from investing, as the risk and uncertainty are significantly higher. Incubation Funds take the initial risk by supporting these startups and helping them reach meaningful milestones. As a result, their investment decision-making process accounts for a higher level of uncertainty compared to Angel or VC Funds, which typically invest only after a startup has achieved a certain degree of product or market validation.

Another key difference is that startups supported by an Incubation Fund can also avail themselves of incubation benefits, such as access to technical expertise, product development support, laboratory and office infrastructure — benefits that are not typically offered by Angel or VC investors.

16. Co-investment with Other Incubators and Government Grants

Most Incubation Funds are created from grants received from various government departments and other agencies. Several government grant agencies place restrictions on co-investment in a company that has already received funding from another government grant source. While making investment decisions, due diligence should be carried out to identify any existing grant support received by the startups under consideration. Another restriction that needs attention is related to co-investment with other incubators in the same company. Incubators must carefully review such arrangements to ensure compliance with the terms of the respective grant programs.

17. Partnering with External Experts

Engaging external experts is essential to strengthen the investment process, especially in areas where the incubator's internal team may lack deep expertise. Legal experts play a critical role in ensuring that the investment process is compliant and risk-mitigated. They assist in drafting, reviewing and negotiating key legal documents such as the Term Sheet and Investment Agreement. They can ensure that all clauses related to fund usage, governance, exit and investor rights are enforceable and aligned with regulatory requirements. Beyond legal professionals, financial and technical experts are equally important during the due diligence phase. Financial advisors help assess whether the financial projections are accurate and achievable, while



domain-specific technical experts can evaluate the viability and innovation of a startup's product or technology. Additionally, professionals experienced in venture investing and early-stage fundraising bring valuable strategic insights into deal structuring and exit planning. For incubators, partnering with such external experts enhances the quality, credibility and long-term impact of investments, while also safeguarding the interests of both the fund and the startup.

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