

A Handbook on Private Equity Funding



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INTRODUCTION

The private equity boom is breathtaking. It's not just making investors rich - the wave of deals is changing the mindset of corporate managers everywhere. The No. 1 reason private equity is on such a rise is the availability of capital. It opens up a universe of possibilities. The good news is that you don't have to wait for a Private Equity firm to swoop into your organization. By using private-equity strategies, any company can improve results and maybe even become as successful as the private equity funded companies.

In finance, private equity is an asset class consisting of equity securities in operating companies that are not publicly traded on a stock exchange. There are a wide array of types and styles of private equity and the term private equity has different connotations in different countries.

Private Equity is a part of the entire financial system of the Country, and therefore it becomes essential to first explain a little about the Financial system and the major sources of finance.

Finance

The term "finance" in our simple understanding it is perceived as equivalent to 'Money'. But finance exactly is not money, it is the source of providing funds for a particular activity. Thus public finance does not mean the money with the Government, but it refers to sources of raising revenue for the activities and functions of a Government.

Providing or securing finance by itself is a distinct activity or function, which results in Financial Management, Financial Services and Financial Institutions. Finance therefore represents the resources by way funds are needed for a particular activity. We thus speak of 'finance' only in relation to a proposed activity. Finance goes with commerce, business, banking etc. Finance is also referred to as "Funds" or "Capital", when referring to the financial needs of a corporate body.

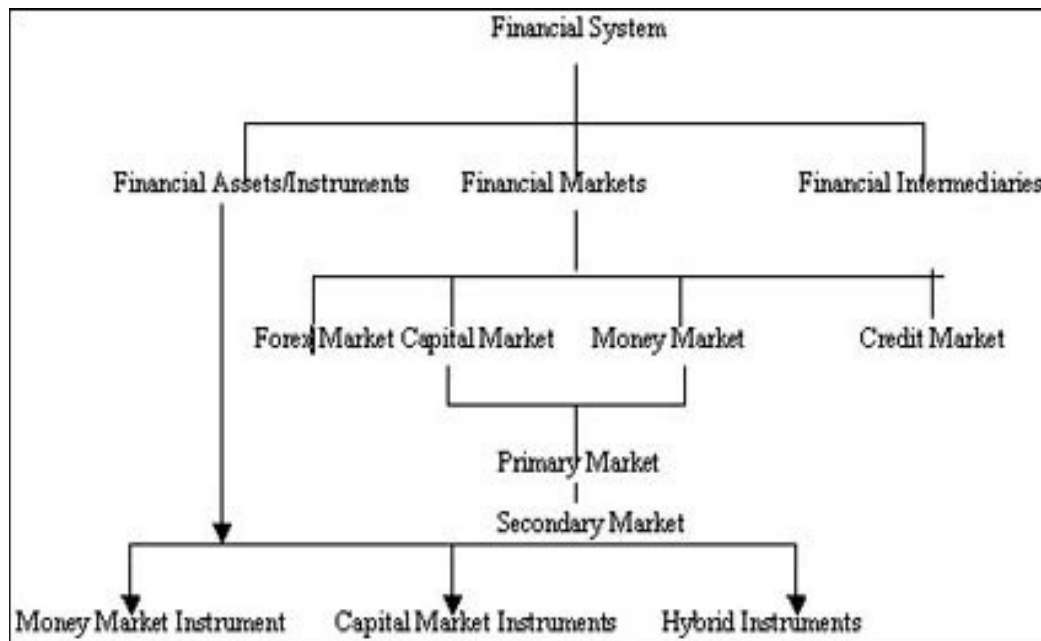
Financial System

A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. A Financial System is a composition of various institutions,

markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities.

The word "system", in the term "financial system", implies a set of complex and closely connected or interlined institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other.

Financial System of India (or any country) consists of financial markets, financial intermediation and financial instruments or financial products.



Finance Sectors

Total Finance sector in India can be divided into Formal and Informal Finance. The informal sector of finance may be said to refer to all economic activities that fall outside the formal sector that is regulated by economic and legal institutions. The Informal sector can be said to comprise of the money lenders, some channels of micro finance and the other not necessarily regulated sectors.

The Formal sector can be said to comprise of the Formal and necessarily regulated channels of financing like, finance provided by Banks, Financial Institutions, Non-Banking Financial Institutions, Micro finance institutions.

Sources of Finance

In the present days there exist several sources of finance. Keeping in view the type of requirement the finance sources are chosen. The sources of finance may be classified by four categories – Period; Type; Source; Mode of Acquisition.

I. Sources of Finance classified as per the Period for which Finance is required:

Organizations need 3 different types of finance as per the period i.e. long-term, medium term and short-term, but the combination in which these are used differ from one organisation to another.

Long term finance is generally needed for the purchase of fixed assets. On the other hand, medium term finance may be required to modernise machinery and to improve other facilities. Short-term finance is generally required for meeting expenses on day-to-day operations.

1) Long-term Sources of finance

The long-term sources of finances can be raised from the following sources:

- Share capital or Equity Share.
- Preference shares.
- Retained earnings.
- Debentures/Bonds of different types.
- Loans from financial institutions.
- Loan from State Financial Corporation.
- Loans from commercial banks.
- Venture capital funding.
- Asset securitisation.
- International Funds

2) Medium-term Sources of finance

The medium-term sources of finance can be raised from the following sources.

- Preference shares.
- Debentures/Bonds.
- Public deposits/fixed deposits for duration of three years.
- Commercial banks.
- Financial institutions.
- State financial corporations.
- Lease financing / Hire Purchase financing.
- External commercial borrowings.
- Euro-issues.
- Foreign Currency bonds.

3) Short term Sources of finance

- Trade credit.
- Commercial banks.
- Fixed deposits for a period of 1 year or less.
- Advances received from customers.
- Various other short-term provisions.

II. Sources of Finance classified as per the type of Finance which can be used:

Debt and equity financing are two different financial strategies: Taking on debt means borrowing money for your business, whereas gaining equity entails injecting your own or other stakeholders' cash into your company. Most businesses have a mix of debt and equity financing.

1. Debt Finance

Business owners may have some apprehension about borrowing from a financial institution, as it means relinquishing some cash profits. But it could be a good option so long as there is sufficient cash flow to pay back the loans, plus interest. The major benefit for debt financing, unlike with equity financing, is that full ownership of the business is retained. The interest on business loans is also tax-deductible.

Small businesses frequently take bank loans. They are usually easy to obtain. Loans may be secured or unsecured. Banks usually expect assets to back the loan. These assets could include property, personal investments, equipment or other tangible holdings that the bank could seize if there is default in repayment of the loan.

Commercial finance companies also lend money and are willing to fund riskier ventures that don't have solid financials. But this type of funding usually comes with high interest.

2. Equity Finance

Small business owners when weighing debt and equity financing options often opt for equity financing because they have concerns about either qualifying for a loan or having to channel too much of their profits into repaying the loan. Investors and partners can provide equity financing, and they generally expect to profit from their investments. However, if no profit materializes, you aren't obligated to pay back equity contributions.

The major drawback of equity financing is that you are no longer the full owner of a business once you have other financial contributors who expect a share. As such, you will be relinquishing not just financial control, but will no longer be the sole arbiter of the business's creative and strategic direction.

III. Sources of Finance classified as per the source from where Finance can be obtained:

Internal sources of finance are available to the firm, but these may be more limited in scope and for large projects, the firm may be forced to turn to External sources (banks or other institutions) to help them raise sufficient funding.

1. Internal sources

Internal sources are often preferable to a firm as they will usually be cheaper and perhaps easier to arrange at short notice. However, the

potential for arranging large amounts of finance may be low. The main internal sources available to a company may be:

a. Retained Profit - the company of course has to be profitable for this to be a source, and it must be available in cash. Often this is not viable as they may have paid the profit in dividend to the shareholders, or perhaps already tied the money up for other reasons.

b. Reduce working capital - the firm may be able to raise some money for investment if they can reduce their stock level (through improved stock control) or perhaps improve their credit control and ensure that they collect their debts more promptly and delay payment to creditors for as long as is possible.

c. Sale of assets or perhaps sale and leaseback - this will depend on the value of the assets, but the firm may either be able to sell surplus assets (if they have any) or perhaps sell existing assets that they use to a specialist leasing company and then lease them back. This will give them access to some capital, though they are then burdened with annual leasing costs.

2. External sources

a. Loans – Loans can be obtained from Banks, Financial Institutions, Non Banking Financial Institutions etc. The loan can be obtained for either short-term or long-term purposes, but the nature of the loan will tend to differ. The main types of loans are:

- Overdrafts - this is a short-term facility where you can spend money, to an agreed limit, as you want. The bank / Financial Institution will charge interest on any overdraft amount. They may only offer this as a short-term facility, but it can be very valuable for firms to fill short-term shortages of working capital or any possible brief cash flow problems.
- Long-term loans - long-term loans usually refer to lending over five years. The bank or Financial Institution lends you a sum of money for a set time at an agreed rate of interest. It is more expensive than an overdraft, but lasts longer. The bank may

well want some sort of guarantee for this type of loan to ensure that they get it back. It could perhaps be secured against an asset of the business.

- Debentures - a debenture is specialised form of loan. It is effectively a loan from people to the firm that will be repaid at a fixed date. Between the issue of the debenture and the maturity date, the firm will pay a set level of interest. They are a common way for businesses to raise money and are relatively low risk, though this will depend on the stability of the business.

b. Shareholders - limited companies or public limited companies can issue shares. These shares can be issued at a certain price though this price will depend on the profitability of the company and its prospects, so how successful the issue is will depend on how the markets view this.

c. Factoring debts - the firm may be able to sell their debts to a specialist debt-factoring company. This means that the firm sells their debts to the factoring company who pay them a proportion of the debts immediately. In this way the firm raises some immediate finance. The debt factoring company makes their money by collecting the whole debt when it is due (having only paid the original firm a proportion of the debt).

IV. Sources of Finance classified as per the mode of acquisition of the Finance:

Source of Finance classified as per the mode of acquisition may be of two types:

- a. Spontaneous;
- b. Non-Spontaneous (or Negotiated)

Spontaneous finance arises in the normal course of business. For example, if suppliers extend credit to the business, then purchasing on credit automatically generates finance in the form of accounts payable. Other examples of spontaneous finance are accrued expenses.

Non-spontaneous finance does not arise automatically in the course of trade. These sources of finance must be specifically negotiated by the business with a specific lender such as a bank. Bank loans and money

market instruments are typical non-spontaneous sources of short-term finance.

Raising Funds – Which is the best source of Finance

The Business has various options when raising funds. The choice of source of funds that a business makes will depend on a number of factors. These include:

1. Cost

This has to be one of the most important factor which determines which source of finance should be used. To use an overdraft for the medium to long-term may be an expensive way of raising money and so businesses need to look carefully at the cost of each of their loan options. This will mainly be the rate of interest charged, but there may be other costs as well (charges for debt factoring, leasing charges and so on).

2. Financial outlook

The financial strength of a business will also be a key determinant. If the business already has a very high gearing ratio, then they may want to look carefully to see if they can access internal sources of funds before borrowing even more. They may also find that banks and other lenders are going to be less willing to lend if they are not in a strong financial position.

3. Legal status

A sole trader will be unable to issue shares and may also face much higher rates of interest on loans as they may be considered a greater risk. The business status may therefore influence the routes that are available to them for raising money.

4. Time period

The company needs to plan ahead carefully to see how long they will need the funds for. The shorter the time period, the more they may be able to reduce the cost of the borrowing. If it is very long-term finance required then they may want to look at debentures or share issues. In the short-term, a simple overdraft may be the most flexible solution.

Private Equity – An alternative means of Finance

Private equity is often categorised under the umbrella of "alternative investments", comprising a variety of investment techniques, strategies and asset classes that are complimentary to the stock and bond portfolios traditionally used by investors.

To understand the characteristics of private equity investment and how best to approach the construction and implementation of a private equity portfolio it is useful to begin with an overview of the various methods used to finance business organizations.

Companies need funds to run their Business. Investment in relation to finance means the particular types of people and companies that regularly purchase equity or debt securities for financial gain in exchange for funding an expanding company. Less frequently, the term is applied to parties who purchase real estate, currency, commodity derivatives, personal property, or other assets.

Different ways of funding a Company can be as follows:

1) Grants

Grants are mainly provided by the government for specific projects/purposes, and are often needed to be matched by spending from the applicant. They are widely acknowledged to be 'the cheapest form of money' as it usually does not have to be repaid.

2) Debt

It is a low risk, low cost funding primarily provided by banks. Debt is simply a loan, which has to be repaid over a set term upon which interest is charged. Usually it is secured against other assets in a business. The different forms are described below:

1. Overdraft – repayable on demand, but flexible.
2. Term loan – debt with a specific repayment period, e.g. 5 years often secured against a specific asset. E.g. – A mortgage. It is often provided as a % of the value of the asset it is secured against.

3. Other Asset Finance - a term loan secured by specific assets
4. Factoring – Money is 'borrowed' against the debtor book of a customer. The factoring provider usually administers the debts and their collection. It is provided as a %age of the debts borrowed against. It is flexible, like an overdraft and is especially of use to businesses with growing sales, however it may cause difficulties for businesses that do not have growing sales or have large seasonal swings in sales. It is usually used for very small businesses who have limited administration support.
5. Invoice Discounting – Similar to factoring, however the business collects the debts from customers themselves.

3) Mezzanine

Mezzanine capital (or mezzanine debt) is a broad financial term that refers to unsecured, high-yield, subordinated debt or preferred stock that represents a claim on a company's assets that is senior only to that of a company's shareholders. Mezzanine comes from Italian and means half, in the middle or lower.

Mezzanine Financing is a hybrid of debt and equity financing that is typically used to finance the expansion of existing companies. Mezzanine financing is basically debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies. It is primarily used in special situations such as larger management buy-outs. It is a half way house between debt and equity funding which has a higher cost than bank funding, but is cheaper than equity finance.

Under mezzanine financing, the lender has a right of ownership of the borrower's shares in case the latter fails to pay back the fund in full and on time.

This type of financing is relatively a new concept in India.

4) Equity

It is a high risk funding with a high return and cost. This is used where firms cannot secure the funding they need through the lower cost options (e.g. debt) because they cannot provide any/enough security for a bank or where the project itself is inherently high risk (e.g. a start up business). The higher cost of equity compensates the provider for the increased risk of losing all their money. Equity is usually in the form of shares that mean the provider owns shares in the business and shares the risk.

Equity can come from a number of sources:

- Friends & family – However it is usually in smaller amounts from this source
- Business Angels / Angel Investors – These are wealthy individuals who often have a portfolio of investments. Angels typically invest their own funds and fill the gap in start-up financing between "friends and family" who provide seed funding, and venture capital.
- Venture Capital Funds – A venture capital fund is a pooled investment vehicle that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans.
- Private Equity - Private Equity is broadly defined as investing in a company through a negotiated process. Investments typically involve a transformational, value-added, active management strategy. Unlisted securities may be sold directly to investors by the company (called a private offering) or to a private equity fund, which pools contributions from smaller investors to create a capital pool.

Therefore, Private equity has arrived as a major component of the alternative investment universe and is now broadly accepted as an established asset class within many institutional portfolios.

HISTORY AND DEVELOPMENT OF PRIVATE EQUITY

As its name implies, private equity is an asset class consisting of equity securities in operating companies that are not publicly traded on a stock exchange. Therefore a private equity firm invests in assets not freely traded on public stock exchanges. There are a wide array of types and styles of private equity and the term private equity has different connotations in different countries.

Historical development of the Private Equity Industry

The phrase "private equity" only became widespread in the late 1980s following public interest in leveraged buyout ("LBO") fund activity, particularly in the US.

The private equity market dates back to the formation of groups in Europe such as Charterhouse Development Capital in 1934 and 3i in 1945 and, in the US, American Research and Development Corporation ("ARD") in 1946.

3i, 1945:

3i (originally named the Industrial and Commercial Finance Corporation) was founded by UK clearing banks and the Bank of England to meet the needs of smaller companies and address the shortage of long-term capital available to them for development.

American Research and Development Corporation (ARD), 1946:

American Research and Development Corporation (ARD) was formed to encourage private sector institutions to help provide funding for soldiers that were returning from World War II. While the ARD had difficulty stimulating any private interest in the enterprise and ended up disbanding, they are significant because this marked the first recognized time in financial history that an enterprise of this type had been formed. In addition, they had an operating philosophy that was to become significant in the development of both private equity and venture capital: they believed that by providing management with skills and funding, they could encourage companies to succeed and in doing so,

make a profit themselves. During the course of their unsuccessful journey, ARD did succeed in raising approximately \$7.4 million, and they did have one rousing success; they funded Digital Equipment Corporation (DEC).

Private equity in the 1970's:

By the 1970s such private participation had permeated into the private enterprise formation, but till in the late 1970s, the task was being largely carried out by investment arms of a few wealthy families, such as the Rockefellers and Whitneys.

The broader private equity market remained fragmented for some time, consisting largely of venture investment into early stage companies by private individuals (known as "business angels") and, to a lesser extent, foundations and university and government investment programmes.

Private Equity in the 1980's:

In the 1980s, the United Kingdom and the United States introduced several measures to salvage their respective corporate sectors from multiple crises, including, the first and second fuel crises of the 1970s, increasing pressure from workers for wage demands, and declining profitability.

Among measures such as deregulation, privatization, curb on wage demands, and major shift of resources from the public to the private sector, was the creation of Private Equity as a new instrument of boosting the declining fortunes of global private capital

The 1981 Companies Act in the UK had relaxed restrictions on company buy-outs. In the US, the creation in 1982 of the Unlisted Securities Market relaxed criteria for admission in the stock exchange thus facilitating listings for younger companies. But the most important innovation came in the UK in 2003. On the basis of a memorandum of understanding between industry and the tax authorities, profits of PEs were classified as "carried interest", and taxed as capital gains rather than as income.

In the US, in addition to lower taxes on capital gains, the rules which had

previously prevented investment of savings in high-risk ventures under the Employee Retirement Income Security Act (ERISA) were relaxed, as well as the reporting requirements for firms conducting private equity management

In the 1980's, FedEx and Apple were able to grow because of private equity or venture funding, as were Cisco, Genentech, Microsoft, Avis, Beatrice Foods, Dr. Pepper, Gibson Greetings, and McCall Patterns.

Private Equity in 1990's:

Subsequent structural and legal changes throughout Europe, for example to pension fund and insurance company regulation, have allowed for the liberalisation of investment choices available to institutions. In addition, tax reforms around Europe, made investments that return capital gains more attractive, have also been a catalyst. The movement of assets from fixed income investments into equities and other products was accelerated in the late 1990s by a low inflation environment. This environment has created a particular need for growth stocks and highlighted a core skill of successful private equity managers, namely creating conditions for growth in portfolio companies.

In the early 1990s the industry began a period of rapid international growth, culminating in over 200 billion being raised globally in 2000 by private equity funds.

Private Equity in recent years:

Private equity activity has accelerated noticeably. As per the research report by World Economic Forum, the total value of firms (both equity and debt) acquired in leveraged buyouts is estimated to be \$3.6 trillion from 1970 to 2007, of which \$2.7 trillion worth of transactions occurred between 2001 and 2007. In terms of global scope, a majority of private equity transactions now take place outside the United States.

As 2007 ended and 2008 began, it was clear that lending standards had tightened and the era of "mega-buyouts" had come to an end.

Since 2008 the global private equity sector has seen a significant downturn in activity as a result of the economic slowdown. The industry is however gradually recovering and remains an important source of funds for startup and young firms, firms in financial distress and those seeking buyout financing.

According to the Private Equity Report (August) 2011 by TheCityUK, global private equity investments grew 62% in 2010 to \$180 billion. Private equity funds under management totalled \$2.4 trillion at the end of 2010. Funds available for investments totalled 40% of overall assets under management or some \$1 trillion, a result of high fund raising volumes between 2006 and 2008.

Exit activity totalled \$232bn globally in 2010, a three year high. It continued to increase in 2011, to reach an all-time quarterly record of \$120bn in Q2 as fund managers took advantage of relatively robust financial markets to exit investments made in years preceding the credit crisis.

Development of Private Equity Market in India

The private equity market is an important source of funds for start-up firms, private middle-market firms, firms in financial distress, and public firms seeking buyout financing.

Over the past fifteen years it has been the fastest growing market for corporate finance, by an order of magnitude over other markets such as the public equity and bond markets and the market for private placement debt.

According to 'India Private Equity Report 2011' by Bain & Company supported by Indian Private Equity and Venture Capital Association (IVCA), PE and VC investments could potentially provide as much as between US\$40 billion and US\$50 billion in funding through 2014—four to five times their current levels by reaching 3 per cent of GDP, about the level that exists in the US.

The growth of the private equity industry in India can be considered in two phases:

The first phase began when the government recognized the need for venture capital as early as 1988. That was the year in which the Technical Development and Information Corporation of India (TDICI, now ICICI Venture Funds Management Company Limited) was set up. This was followed suit by multiple financial institutions that launched various funds, which essentially invested proprietary capital in small and medium enterprises during the next decade.

The second phase was heralded in by the SEBI (Security Exchange Board of India) Committee on the Venture Capital Industry. This committee chaired by Mr. K. B Chandrashekar laid down clear guidelines for VC funds which helped in opening up the industry.

In 1999 – 2000, there was a spurt of technology and internet companies in India, which attracted huge amount of capital. This period, while not necessarily the most lucrative for venture capitalists, was one of fostering the understanding of the concept of venture capital/private equity in India.

Today, the Indian venture capital/private equity industry has developed even further. From funding small start up ventures with emphasis only on new age companies, the industry has now matured to cover the entire spectrum of private equity products – seed funding, expansion capital, buy out financing, financing restructuring of companies and providing mezzanine capital across a variety of sectors. Deal sizes have also reached new heights, from sub USD 5 million in the early days to USD 50 million and more.

With India becoming a preferred investment destination, this heightened level of private equity activity is likely to continue for some time to come.

Performance of the Indian Private Equity Market:

Private Equity (PE) and Venture Capital (VC) firms usually raise capital from their Limited Partners (LPs) consisting of high net worth individuals and institutional investors such as insurance companies, investment banks, pension funds, and university endowment funds. These firms then invest this capital in yet-to-be-formed companies, in newly formed companies, in private companies not listed on stock exchanges, and in public companies that are listed on stock exchanges (wherein they make investments using “instruments” called PIPEs, i.e., Private Investment in Public Equity or by simply buying equity shares in the stock market).

The Indian Private Equity Market in the mid 90’s saw the advent of Foreign Venture Capital funds primarily focused on developmental capital without any sectoral focus, driven by opportunities. Post the success realized by these funds, there was an emergence of a number of India-centric foreign VC firms. Currently there are a number of large funds whose focus is buyouts and PIPEs. (Private Investment in Public Equity).

According to ‘India Private Equity Report 2011’ by Bain & Company supported by Indian Private Equity and Venture Capital Association (IVCA), India saw the largest increase in deal activity among the big Asia-Pacific markets in 2010. Although still far below the 2007 peak of US\$17 billion, the 2010 total deal value more than doubled from that of 2009 to US\$9.5 billion, including venture capital, infrastructure PE investments and real estate investments.

Some 120 PE funds seeking to raise approximately US\$34 billion in 2011 are currently on the road. The bulk of new capital will continue to come from offshore investors that face fewer restrictions investing across sectors and are freer from complex tax and legal burdens.

The year 2010 was a year of recovery for PE worldwide from the 2008 credit meltdown that followed the bursting of the US housing bubble and subsequent recessions that hobbled the world’s biggest economies. In line with its revival in developed markets in 2010, PE activity in

India, China and other leading emerging markets also recovered quickly. Including real estate, venture capital and PE investments in infrastructure, deal values in the Asia-Pacific markets rose to US\$51.4 billion in 2010, approximately 20 per cent of which was invested across 380 deals in India.

Major Private Equity Firms in India

Although PE firms like Baring Private Equity Partners, Warburg Pincus, CDC Capital, Draper International, HSBC Private Equity, Chrys Capital (formerly known as Chrysalis Capital), and Westbridge Capital (now a part of Sequoia Capital) were investing in India during 1996-2000, some of these firms, e.g., Westbridge Capital and Chrys Capital, changed their strategy between 2003 and 2006 and moved from only venture investing to both venture and private equity investing.

Today, many traditional Venture Capital firms based in the United States and Europe are investing millions in India, and hence the separation between VC and PE investment in India has become very blurred.

All the top international PE players today have a presence in India and are making investments in various sectors. They include the Blackstone Group, Kohlberg Kravis Roberts, W.L. Ross & Co, Warburg Pincus, Providence Equity Partners, Carlyle Group, Actis Capital, 3i Group Plc, Deutsche Bank, Temasek Holdings of Singapore etc.

Private equity deals in India

Private equity deals witnessed a 24% surge in value and volume terms in 2011, with 347 transactions valued at \$7.7 billion announced during the period, a 24% jump vis-a-vis the corresponding period last year. According to consultancy firm Grant Thornton, PE deals worth \$7.7 billion were announced in 2011 through 347 transactions compared to \$6.2 billion by way of 253 deals in 2010.

The Grant Thornton's Dealtracker report has taken into consideration deals up to December 9, 2011.

A sector wise analysis showed that real estate and infrastructure management witnessed the maximum deals worth \$1,656 million followed by automotive (\$1,006 million), power and energy was in the third position, ahead of banking and financial services with (\$816 mn) and IT and ITeS (\$783 mn).

The top five sectors contributed to 67% of PE deal values for the year, Grant Thornton said. Among the top 10 PE investments in first half of 2011 are Government of Singapore and Bain Capital pumping in \$850 million into Hero Investment Pvt Ltd. Other major transactions include Apollo Global Management investing \$350 million in Welspun Corp and Texas Pacific Group infusing \$257 million in Shriram Capital.

THE BASICS OF PRIVATE EQUITY

With its bright performance in 2010, Indian PE has re-emerged in good shape from the turbulent times of the global credit meltdown and subsequent economic retrenchment. Deal activity has rebounded more quickly than in other Asia-Pacific markets, the exit markets are healthier than ever and capital continues to pour into an expanding number of domestic and international PE funds.

Investment in P.E. firms adds value and managerial capacity in companies that are in need of rejuvenation and intend to compete in the global environment. Value addition is the main feature of investment.

What is Private Equity

In finance, private equity is an asset class consisting of equity investments in companies that are not traded on a public stock exchange. Investments typically involve a transformational, value-added, active management strategy.

Private equity is medium to long-term finance provided in return for an equity stake in potentially high growth unquoted companies.

Private equity provides long-term, committed share capital, to help unquoted companies grow and succeed.

Private equity is a broad term which commonly refers to any type of non-public Ownership Equity securities that are not listed on a public exchange

At the start of a business, owners put some funding into the business to finance assets. Businesses can be considered for accounting purposes to be sums of liabilities and assets (also known as the accounting equation). After liabilities have been accounted for, the positive remainder is deemed the owner's interest in the business. Thus, in accounting terms, ownership equity is the remaining interest in all assets after all liabilities are paid.

Obtaining private equity is very different from raising debt or a loan from a lender, such as a bank. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of the business.

Private equity is invested in exchange for a stake in the company which is being financed and, as shareholders, the investors' returns are dependent on the growth and profitability of the business.

Private equity is not secured on any assets although part of the non-equity funding package provided by the private equity firm may seek some security. The private equity firm, therefore, often faces the risk of failure just like the other shareholders. The private equity firm is an equity business partner and is rewarded by the company's success.

If a company is looking to start up, expand, buy into a business, buy out a division of its parent company, turnaround or revitalise a company, private equity could help it to do this.

Private Equity provides funds to the company irrespective of market conditions. It provides resources for:

- i. Expansion of business
- ii. Acquisition / change of control

- iii. Restructuring business
- iv. Increasing promoter stakes
- v. Privitisation

Private Equity investors are looking for bargains: businesses that are undervalued on the stock market or by their owners, companies that are in need, and firms in up-and-coming areas with real potential.

They usually pool in some money, and then rely on the bank to lend them the rest. They are looking for a quick, profitable sale, usually within three to seven years. And they do things in relative privacy, often de-listing their acquisitions if they were quoted on any stock market. Hence they are accountable only to small groups of private investors and lenders, rather than to stock market investors and company employees, and they do not have to release information to the press and media. There is apparent lack of accountability for Private Equity Investors.

The Components of Private Equity

The private equity asset class includes venture capital, buyouts, and mezzanine investment activity. Type of funding required is related to the size and maturity of the company. Classically:

- Venture funding for start-up / early stage
- Development capital for young, growing companies
- Buyout funding for large and/or mature businesses

Private equity investments can be divided into the following categories:

1. Venture capital: an investment to create a new company, or expand a smaller company that has undeveloped or developing revenues.

It is described as the "business of building businesses", means investing in companies that have undeveloped or developing products or revenue. Venture capital has a particular emphasis on entrepreneurial undertakings and less mature businesses. It is a type of private equity capital typically provided by professional, outside investors to new, growth businesses. Generally made as cash in exchange for shares in the

invested company, venture capital investments are usually high risk, but offer the potential for above-average returns. A venture capital fund is a pooled investment vehicle that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans.

Difference between Venture Capital and Private Equity

“Venture Capital” refers only to investments in early stage and “Private Equity” refers to investments in companies with an established track record and is also known as “Growth Capital”. In Europe, however, “Private Equity” is understood and used synonymously with “Venture Capital”.

Venture Capital funds provide seed capital to set-up greenfield projects and Private Equity funds provide additional capital to achieve the growth potential.

2. Buy-out: acquisition of a significant portion or a majority control in a more mature company. The acquisition normally entails a change of ownership. It can be of various types, some of them being:

a. Leveraged buyout

A leveraged buyout (LBO transaction) occurs when a financial sponsor gains control of a majority of a target company's equity through the use of borrowed money or debt.

A leveraged buyout is a strategy involving the acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired, in addition to the assets of the acquiring company, are used as collateral for the loans. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

The equity component of the purchase price is typically provided by a pool of private equity capital and, the loan capital is borrowed through a combination of pre payable bank facilities and/or public or privately placed bonds, which may be classified as high-yield debt, also called junk bonds.

Leveraged buyout firms specialize in helping entrepreneurs to finance the purchase of established companies. The approach of such firms is to provide a management team with enough equity to make a small down payment on the purchase of a business, and then to pay the rest of the purchase price with borrowed money. The assets of the company are used as collateral for the loans, and the cash flow of the company is used to pay off the debt. Because the acquired company itself is paying the freight for its own acquisition, these investments were originally known as "boot-strap" deals. Eventually they became known as leveraged buyouts, or management buyouts.

b. Management buyout

A management buyout (MBO) is a form of acquisition where a company's existing managers acquire a large part or all of the company. It is the purchase of controlling interest in a company by its existing management, usually in cooperation with outside financiers

Management buyouts are similar in all major legal aspects to any other acquisition of a company. The particular nature of the MBO lies in the position of the buyers as managers of the company, and the practical consequences that follow from that. In particular, the due diligence process is likely to be limited as the buyers already have full knowledge of the company available to them. The seller is also unlikely to give any but the most basic warranties to the management, on the basis that the management know more about the company than the sellers do and therefore the sellers should not have to warrant the state of the company.

c. Mergers and acquisitions

The phrase mergers and acquisitions refers to the aspect of corporate strategy, corporate finance and management dealing with the buying, selling and combining of different companies that can aid, finance, or help a growing company in a given industry grow rapidly without having to create another business entity.

3. Mezzanine Investment Activity: focuses on investing in mature companies. Intermediate or mezzanine financing provides a customised solution to financing requirements that cannot be fully met by conventional pure debt or equity products. It is mainly used in leveraged buyouts carried out by financial investment funds or industrial players (corporate acquisitions). It can however also be used to provide financing for internal or external growth, to strengthen shareholders' equity ahead of an IPO, or to restructure a company's capital in preparation for a change in the shareholder structure or a buyout.

Midway between debt and equity, mezzanine financing often has a quasi-equity status, particularly relative to other senior debt. This is why investors providing mezzanine financing see their investment as a medium/long-term partnership with the management and shareholders of the financed company, and derive part of their remuneration from the additional value created by their investment.

Type of Private Equity Funding

1. Financing at various stages of maturity of a company

Companies at various stages of development –be it start up, expansion or undergoing major change like buying into a business, buying out a division of their parent company, turnaround or revitalization can avail of private equity to finance their plans.

Stages of Maturity of a company may be listed as follows:

Seed -----à Start up -----à Expansion ----à Replacement Capital -
-----à Buyout

Private equity financing at the various stages of maturity of a company would be as follows:

1. Seed stage financing

Seed Stage Financing is provided to research, assess and develop an initial concept before a business has reached the start-up phase. It is generally a relatively small amount of capital provided to an inventor or entrepreneur to prove a concept and to qualify for start-up capital.

2. Start-up stage Financing

Start Up Financing is for product development and initial marketing. This stage implies that companies may be in the process of being set up or may have been in business for a short time, but have not sold their products commercially. This may involve product development and market research as well as building a management team and developing a business plan, if the initial steps are successful. Usually such firms will have made market studies, assembled the key management, developed a business plan and are ready to do business.

3. Expansion stage Financing

Expansion stage Financing is for growth and expansion of a company which is breaking even or trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital. This stage includes bridge financing and rescue or turnaround investments. Bridge financing is a method of financing, used to maintain liquidity while waiting for an anticipated and reasonably expected inflow of cash. Bridge financing is commonly used when the cash flow from a sale of an asset is expected after the cash outlay for the purchase of an asset.

4. Replacement Capital Financing

Replacement Capital Financing is for Purchase of shares from another investor or to reduce gearing via the refinancing of debt.

5. Buyout

Buyout financing means investing in more mature companies with established business plans to finance expansions, consolidations, turnarounds and sales, or spinouts of divisions or subsidiaries. A buyout fund typically targets the acquisition of a significant portion or majority control of businesses which normally entails a change of ownership. Financing expansion through multiple acquisitions is often referred to as a "buy and build" strategy.

Investment styles can vary widely, ranging from growth to value and early to late stage. Furthermore, buyout funds may take either an active or a passive management role.

2. Special Situation Private Equity Financing

Special situation financing includes distressed debt, equity-linked debt, mezzanine debt financing, project finance. It includes investments in a distressed company, or a company where value can be unlocked as a result of a one-time opportunity (Changing industry trends, government regulations etc.)

3. Private Investment in Public Equity - PIPE

PIPE would imply any privately negotiated equity or equity-linked investment in a public company. It is a private transaction between a limited group of investors and a public company. Unlike securities purchased from other investors in a public market, or trading exchange, a PIPE involves the purchase of securities in a primary market, where new securities are offered to the investors for the first time. A PIPE is used by a public company to raise capital.

4. Merchant banking: negotiated private equity investment by financial institutions in the unregistered securities of either privately or publicly held companies.

Rationale of Private Equity Form of Investment

Investing in private equity offers the investor the opportunity to generate higher absolute returns whilst improving portfolio diversification.

The rationale or advantages of making a private equity investment can be listed as follows:

1. High Returns

The private equity investors generally earn returns substantially higher than what can be earned in alternative markets. Though, private equity investments are regarded as substantially more risky and more illiquid than other assets, however there are high expected returns for investors.

Private equity firms generally receive a return on their investments through one of the three ways:

- i. An Initial Public Offering (IPO)
- ii. A Sale or Merger/Acquisition of the company the private equity fund controls
- iii. A Recapitalization

2. Long-term historical out-performance

The long-term returns of private equity represent a premium to the performance of public equities. This has been the case in the US for over 20 years and also in Europe, following an increase in the number of private equity funds, for over 10 years. In India, as well, research shows that the number of private equity funds are increasing rapidly as the money being raised through private equity investment is sky rocketing.

3. Portfolio Diversification improves risk and volatility

One of the core skills of successful private equity managers is to pick companies with growth potential and actively to create the conditions for growth in those companies. Since private equity funds own large, often controlling, stakes in companies, few, if any, other private equity managers will have access to the same companies.

4. Absolute returns and attractive alternative investment revenue

There is excessive volatility and poor investment performance experienced by quoted equity portfolios in most cases. Private equity managers seek absolute returns and their traditional incentivisation structure, is highly geared towards achieving net cash returns to investors.

5. Exposure to the smaller companies market

The private equity industry has brought corporate governance to smaller companies and provides an attractive manner of gaining exposure to the smaller companies market as a growth sector.

6. Access to legitimate inside information

A much greater depth of information on proposed company investments is available to private equity managers. This helps managers more accurately assess the viability of a company's proposed business plan and to project the post-investment strategy to be pursued and expected

future performance. This greater level of disclosure contributes significantly to reducing risk in private equity investment. Equivalent information in the public markets would be considered "insider information". Investors in public markets will know less about the companies in which they invest.

7. Ability to back entrepreneurs

The private equity asset class offers the ability to gain investment exposure to the most entrepreneurial sectors of the economy and thereby creating value in both traditional and hi-tech industries. This leads to rapid growth in technological innovation and substantial benefits for the whole economy.

8. Influence over management and active participation in a company's strategic direction

Private equity managers generally seek active participation in a company's strategic direction, from the development of a business plan to selection of senior executives, introduction of potential customers, M&A strategy and identification of eventual acquirers of the business. Furthermore, implementation of the desired strategy can normally be effected much more efficiently in the absence of public market scrutiny and regulation. This flexibility represents another feature whereby risk can be reduced in private equity investment.

Deterrents of Private Equity Form of Investment

Private equity fund investment is for those who can afford to have their capital locked in for long periods of time and who are able to risk losing significant amounts of money.

Some considerations for investing in private equity funds relative to other forms of investment include:

1. Long Term Investment Strategy

Private Equity Investment is a long term Investment Strategy. In general, holding periods between investment and realisation can be expected to average three to seven years.

2. Requirement of Substantial Investment

Most private equity funds require significant initial investment plus further investment for the first few years of the fund.

3. Liquidity Risk

"Liquidity risk" is one of the principal risk characteristics of the private equity asset class. Distributions are made only as investments are converted to cash; investors typically have no right to demand that sales be made. Although the investor may receive cash distributions during the fund's life, the timing of these is normally uncertain.

Because the underlying portfolio assets are less liquid, the structure of private equity funds is normally a closed-end structure, meaning that the investor has very limited or no ability to withdraw its investment during the fund's life.

4. "Blind pool" investing

When committing to a private equity fund, the commitment is typically to provide cash to the fund. Whilst launch documentation will outline the investment strategy and restrictions, investors give a very wide degree of discretion to the manager to select the companies that the investors will have a share in. There is usually no ability at the launch of a private equity fund to preview portfolio assets before committing, because they have not yet been identified. Likewise, there is generally no ability to be excused from a particular portfolio investment after the fund is established.

5. Risk of loss of Capital

If a private equity firm can't find suitable investment opportunities, it will not draw on an investor's commitment. Given the risks associated with private equity investments, an investor can lose all of its investment if the fund invests in failing companies.

The risk of loss of capital is typically higher in venture capital funds, which invest in companies during the earliest phases of their development, and lower in mezzanine capital funds, which provide interim investments to companies which have already proven their viability but have yet to raise money from public markets.

Also, India's economy is largely being built by closely-held family businesses, with minority private equity investors having less scope to hire and fire. Limited availability of secondary market data, high asset valuations and government restrictions are among the significant challenges for PE players in India.

PRIVATE EQUITY INVESTMENT

It's common knowledge that money does not grow on trees. The Good God knows that money has to be earned by the sweat of our brows. But, then again after earning it, how does one make it grow? The answer is simple: invest it.

Investment is a big word with even bigger risks attached to it. If you are lucky, you hit the jackpot. But one wrong move and you can end up losing your hard-earned cash. Be it an institution or a private equity investor, the risk factor holds good for both.

Private Equity Fundraising

Private equity fundraising refers to the action of private equity firms seeking capital from investors for their funds. The businesses that a private equity firm purchases with money from its funds are referred to as its "portfolio companies."

Typically an investor will invest in a specific fund managed by a firm, becoming a limited partner in the fund, rather than an investor in the firm itself. As a result, an investor will only benefit from investments made by a firm where the investment is made from the specific fund that they have invested in.

Firms typically set a target when they begin raising the fund and ultimately announce that the fund has closed at such-and-such amount.

This may mean that no additional capital will be accepted. But sometimes the firms will have multiple interim closings each time they have hit particular targets (first closings, second closings, etc.) and final closings. The term cap is the maximum amount of capital a firm will accept in its fund.

The amount of time that a private equity firm spends raising capital varies depending on the level of interest amongst investors for the fund, which is defined by current market conditions and also the track record of previous funds raised by the firm in question.

Firms can spend as little as one or two months raising capital where they are able to reach the target that they set for their funds relatively easily, often through gaining commitments from existing investors in their previous funds, or where strong past performance leads to strong levels of investor interest. Other managers may find fundraising taking considerably longer, with managers of less popular fund types finding the fundraising process more tough. It is not unheard of for funds to spend as long as two years on the road seeking capital, although the majority of fund managers will complete fundraising within nine months to fifteen months.

Once a fund has reached its fundraising target, it will have a final close. After this point it is not normally possible for a new investor to invest in the fund, unless they were to purchase an interest in the fund on the secondary market.

Investors in the Private Equity Market

On the funding side of the private equity business, a substantial portion of venture capital and private equity money in India has flowed from pension fund managers / investment institutions from the US, Far East, World Bank, other quasi governmental organizations, and multilateral development banks. However, there is a limited presence of domestic Indian investors.

Investors in private equity are those who accept the illiquid character of their investment. For this reason, it is often the case that the investors

who make the largest proportional allocations to private equity from their overall portfolios are those who are able to invest for the long term with no specific liabilities anticipated.

These include endowments, charities and foundations. Pension funds also are often large investors in the asset class.

The various types of Private Equity investors are:

- Venture Capital firms
- Private Equity firms- sector agnostic
- Sector dedicated Private Equity firms
- Angel Investors
- Country specific Private Equity firms
- Country and Sector specific PE firms
- Corporate Venturers
- MBO or LBO funds Distressed/ Stressed funds
- Mezzanine funds
- Offshore and On-shore funds

Making a private equity investment

The principal ways of making a private equity investment for an investor are:

- a) Investing in private equity funds which will invest in companies
- b) Outsourcing selection of private equity funds, (for example through a fund of funds), which in turn will invest in companies
- c) Direct investment in companies.

Direct Investment in Companies

While it is sometimes the ultimate objective of investors to be able to make direct investments into companies, compared with investing through funds it requires more capital (to achieve similar diversification and exposure), a different skill set, more resource and different evaluation techniques. Whilst this can be mitigated by co-investing with a fund and the rewards can be high, there is higher risk and the

potential for complete loss of invested capital. Therefore this strategy is used only by experienced private equity investors.

Investment through Private Equity Funds

For any number of reasons, investing directly in private equity funds can be difficult-particularly for individual investors and small institutional investors. Information about the performance of private equity managers is hard to come by. Gaining access to what are perceived to be the top-performing venture capital and buyout funds is problematic, since the fund managers often have more demand for their funds than they can accommodate. Finally, the relatively high investment minimums that fund managers generally require isn't uncommon for a large buyout fund-make it challenging for a small institutional or high-net-worth investor to gain sufficient diversification.

Therefore, for most investors the use of private equity funds is preferred, either selected by themselves or through outsourced selection.

Investors in a fund generally expect to gain broader exposure through a portfolio built during the commitment period by investment professionals who specialise in discovering, analysing, investing, managing and exiting from company investments. Being diversified amongst a number of different investments helps ensure that the risk of total loss of capital in the fund is relatively low compared to investing directly in unquoted companies. Compared to quoted equity funds, private equity funds often invest in relatively concentrated portfolios, for example there might be 10–15 companies in a typical buyout portfolio or 20–40 companies in a venture capital portfolio.

Outsourcing selection of Private Equity Funds

(i) Fund of Funds

It is a fund set up to distribute investments among a selection of private equity fund managers, who in turn invest the capital directly.

Fund of funds are specialist private equity investors and have existing relationships with firms. They may be able to provide investors with a route to investing in particular funds that would otherwise be closed to them.

Investing in fund of funds can also help spread the risk of investing in private equity because they invest the capital in a variety of funds.

A fund of funds is a pooled fund vehicle whose manager evaluates, selects and allocates capital amongst a number of private equity funds.

Many funds of funds are "blind" pools, meaning that exposure to particular underlying funds is not guaranteed. Rather the investor is relying on the record of the manager to identify and secure access to suitable funds.

The fund of fund manager co-mingles the investments of many small investors into a single pool, then uses it to assemble a portfolio of private equity funds.

The main drawback of investing in a fund of funds is the added layer of fees. Fund of fund managers generally charge an annual fee for their services. Many also take a small carried interest, or share of profits. This layer of fees is in addition to the management fees and carried interest charged by the underlying fund managers.

(ii) Consultants

Consultants will offer similar expertise to fund of fund managers, but may offer a choice of discretionary or advisory services. The latter will facilitate construction of a tailor-made portfolio, as opposed to committing to a blind pool alongside other investors. Consultants may also offer segregated rather than pooled accounts. Consultancy services are also offered by some fund of funds managers.

Private Equity Fund

A private equity fund is a collective investment scheme (fund) that invests in companies and/or entire business units with the intention of obtaining a controlling interest (usually by becoming a majority shareholder, sometimes by becoming the largest plurality shareholder) so as to be in the position to restructure the target company's reserve capital, management, and organizational infrastructure.

The majority of investment into private equity funds comes from three sources:

1. Institutional investors
2. Fund of funds (These are private equity funds that invest in other private equity funds in order to provide investors with a lower risk product)
3. Individuals with substantial net worth

In the past the performance of private equity funds has been relatively difficult to track, as private equity firms are under no obligation to publicly reveal the returns that they have achieved from their investments. In the majority of cases the only groups with knowledge of fund performance were investors in the funds, academic institutes and the firms themselves.

Following are the areas wherein PE funds have added value to their investee companies:

- Attracting talent: Through their relationships both in domestic and international market, PE firms have been able to attract talent for their investee companies.
- Business generation and development: Expansion into new geographies and helping investee companies win new customer contracts.
- Financial advisory support: While Indian corporates have excellent skill sets in financial accounting; they lack in M&A

planning and execution capabilities. These funds have also advised companies in acquisition financing.

- Corporate governance: PE helps in creating systems and procedures wherein board level controls could be exercised. Also, they help in recruiting independent directors on the board.
- Fund raising capabilities: This largely involves capital market expertise during the Initial Public Offer (IPO) process. With their relationships with Investment banking and Foreign Institutional Investors (FII), PE funds are best poised to run an effective IPO process for their investee companies. Many PE funds have also helped their companies to raise External Commercial Borrowings (ECBs) at competitive rates.
- Systems and risk management: Most entrepreneurial and high growth companies lack the requisite management expertise in choosing the right kind of systems and vendors for their MIS, ERP, forex risk management and supply chain. Funds through their experience in other investee companies have been able to identify appropriate vendors and negotiate better.
- Global presence: This is a critical factor, as global funds can add a lot of value in generating new business through their business relationships.

Essential Ingredients of a good Private Equity Fund

a) Credentials of Fund Manager

Evaluate each manager's credentials by investigating closely the fund's track record and reputation. Successful private equity managers will be able to demonstrate a number of key skills. Some of these are described below.

i. Focus on Business Plans - Business plans will be carefully built and analysed prior to any investment. Scrutinising a business plan and helping to create the conditions for its effective execution is one of the

major areas where private equity managers add value to their portfolio companies.

ii. Selectivity and Specialisation - Good private equity managers will see a large number of potential transactions each year, which permits them to be extremely selective, pursuing only those where they have the knowledge and capability to "add value." They should have a full technological and operating knowledge of these opportunities.

iii. Ability to Negotiate- Unlike the purchase of a public security, a private equity manager does not have to buy exclusively on the basis of price. The manager can negotiate a variety of protections including exclusion of liabilities, indemnities and retroactive price adjustments.

iv. Inside Information- Unlike the purchase of a public security, the private equity manager can legally employ inside information such as management projections in its investment process.

v. Strong Management - Strong management, both within the private equity manager and the company itself, is crucial to the success of an investment. The private equity manager should be able to depend heavily on the company's management in the day to day operations of the business.

vi. Value Added Focus- Ownership and management become aligned, which almost always occurs to a greater degree than is usual in public equity. In addition the private equity manager will become involved in the strategic direction of the company and the risk management of the business.

vii. Governance / Control -Unlike the governance structure of a public company, the private equity manager often has a degree of control or influence, allowing strategic and even operational intervention when necessary.

b) Investment strategy and market opportunity

A proposed fund's investment strategy should be clear and very similar to that on which the manager's track record is founded. The track record should demonstrate a disciplined approach and the ability to

adhere to the articulated strategy. The amount of money being raised should be clearly justified by the magnitude of the perceived investment opportunity and the extent of the manager's resources. The investment strategy should be attractive in the context of the wider economic landscape, which will impact the market opportunity.

c) Track record

Prospective investors need to examine return on their. Returns are often quoted on a "gross" and "net" basis. The gross return represents the fund's return on its investments and does not take into account the fees and expenses of the fund or the dilutive effect of holding uninvested cash. The net return represents the investor's return and is also referred to as the "cash on cash" return. Returns on realised investments are often also distinguished from returns on unrealised investments. Investors should look for a large proportion of realised investments in the portfolio. In respect of unrealised investments, investors will want to examine valuation policy. An analysis of the dispersion of returns on an investment by investment basis illustrates the volatility of returns and risk associated with the investment strategy. Investors should look for a level of volatility that is consistent with the strategy.

d) Investment team

An assessment should be done of the individuals comprising the management team, their incentives and the past and future continuity within the team. The most important aspect of each individual's background should be solid experience as a private equity manager. Additional attributes, such as relevant operational, sector or scientific experience, are helpful. It is important that the core members of the management team have already been working as a team for a significant period and departures from this core team over time have been minimal.

e) Deal origination and investment process, monitoring and exit strategy

Investors will generally look for a coordinated origination strategy and a disciplined procedure for evaluating investments. This should include evaluation of the business plan, the likely exit route and expected investment returns.

f) Number and variety of underlying investments

The greater the number of underlying investments, the greater is the diversification of risk. If the investments are very concentrated in number, or focused in one particular geography or field of operation, then the risk becomes more concentrated.

Given the importance of building a diversified portfolio an investor should ensure that the type of fund and its strategy fits into their broader private equity portfolio strategy without unnecessary duplication.

g) Quality of client servicing, reporting and administration

Transparency and regularity of reporting are a key area to enable investors to monitor the progress of their fund portfolios.

Private Equity Fund Structuring

Most private equity funds are structured as limited partnerships and are governed by the terms set forth in the limited partnership agreement.

When structuring a private equity fund, the main objectives should be:

a. Limited liability: Investors into a private equity fund are passive, and will not accept any liability beyond the amount that they are committing to the fund by way of an investment. Therefore, it is essential that the chosen structure delivers limited liability for investors. The most common international fund structure vehicle is the limited partnership.

b. Ease of administration: One consideration when structuring a fund will be to ensure that its operation is not unduly complicated. As the private equity industry has matured, it has become easier to structure funds that are offshore or which require certain procedures to be followed, because advisers and other service providers have become increasingly available and sophisticated.

c. No double tax: The fund must be exempt or transparent for tax purposes both as regards capital gains and (usually less importantly) as

regards dividends and interest. That is to ensure that the investors are in a similar position to the one they would be in if they had invested in the underlying portfolio company directly. They do not want to suffer tax at the fund level, and then again when they receive proceeds from the fund.

d. Tax efficient management fees and carried interest: Any “carried interest” structure incorporated within the fund in favour of its management should not be taxable as income, but rather should preserve its character as capital gain. Investors should not be charged to tax on income and capital gains arising within the fund to the extent that they are used for the payment of management charges. The management charge structure should be efficient from a Value Added Tax (VAT) point of view given the fact that either the fund or the fund manager or both may be unable to recover VAT.

e. Marketing: The structure should be capable, from a regulatory standpoint, of being marketed to all relevant investors.

Fund Structuring in India

A significant proportion of the foreign private equity investment in India is routed through Mauritius. There is no tax levied on capital gains made by an investment company located in Mauritius and other countries such as Cyprus and Singapore with similar double tax avoidance agreements with India.

Mauritius remains the preferred route for investments owing to the fact that it has over time become a well established route and has been tested by the Indian tax authorities although there have been indications recently that the Indo-Mauritius tax treaty may be renegotiated to restrict the usage of shell/conduit companies for claiming treaty benefits.

Another jurisdiction that has gained prominence in recent years as an alternative to Mauritius is Cyprus. One reason for this is the fact that the treaty with Cyprus offers lower withholding tax on interest payments.

In a typical overseas fund arrangement, there is an offshore fund manager who manages the assets of the fund and an investment advisor in India who identifies investment opportunities. The offshore manager would typically register as a Foreign Institutional Investor (FII) with the Securities Exchange Board of India (SEBI) and the fund vehicle, for example the Mauritius company, would be registered as a sub-account of the FII.

A foreign private equity firm can also choose to register with SEBI as a foreign venture capital investor (FVCI). An FVCI is permitted to invest only in venture capital undertakings (VCU) involving unlisted domestic companies that are not engaged in certain restricted sectors such as real estate business and non-banking financial services. As an FVCI, a foreign private equity firm can invest directly in unquoted companies in India or through a domestic venture capital fund, typically structured as a trust, alongside domestic investors.

Registration as an FVCI is not mandatory but it does offer certain advantages such as the freedom to remit monies into India for making investments in a VCU and the relaxation of entry and exit pricing restrictions.

Private Equity Firm

A private equity firm is an investment manager that makes investments in operating companies through a variety of loosely affiliated investment strategies generally called private equity.

Often described as a financial sponsor, each firm will raise funds that will be invested in accordance with one or more specific investment strategies (e.g., leveraged buyout, growth capital, venture capital, mezzanine capital).

Typically, a private equity firm will raise pools of capital, or private equity funds that supply the equity contributions for these transactions. Private equity firms will receive a periodic management fee as well as a share in the profits earned (carried interest) from each private equity fund managed.

Private equity firms, with their investors, will acquire a controlling or substantial minority position in a company and then look to maximize the value of that investment. Private equity firms generally receive a return on their investments through one of the following avenues:

- i. An Initial Public Offering (IPO)
- ii. A Sale or Merger/Acquisition of the company the private equity fund controls
- iii. A Recapitalization

An updated 2011 ranking created by industry magazine 'Private Equity International' (published by PEI Media - leading financial media group which was started in London in November 2001-), called the PEI 300, lists the largest private equity firms in the world. The ranking is based on the amount of private equity direct-investment capital raised by each firm over a five-year period. As ranked by the PEI 300, the 10 largest private equity firms in the world are:

- 1.TPG Capital
- 2.Goldman Sachs Principal Investment Area
- 3.The Carlyle Group
- 4.Kohlberg Kravis Roberts
- 5.The Blackstone Group
- 6.Apollo Global Management
- 7.Bain Capital
- 8.CVC Capital Partners
- 9.First Reserve Corporation
- 10.Hellman & Friedman

Fund or Investment Manager and Investment Advisor

Fund / Investment Manager:

The Fund Manager is the person(s) responsible for implementing a fund's investing strategy and managing its portfolio trading activities. A

fund can be managed by one person, by two people as co-managers and by a team of three or more people. Fund managers are paid a fee for their work, which is a percentage of the fund's average assets under management.

They are also known as an "investment manager".

The individuals involved in fund management must have a high level of educational and professional credentials and appropriate investment managerial experience to qualify for this position. Investors should look for long-term, consistent fund performance with a fund manager whose tenure with the fund matches its performance time period.

The whole point of investing in a fund is to leave the investment management function to the professionals. Therefore, the quality of the fund manager is one of the key factors to consider when analyzing the investment quality of any particular fund.

A private equity firm can also be an investment manager that makes investments in operating companies. For e.g ICICI Venture is one of the largest and most successful private equity firms in India with funds under management in excess of USD 2 billion.

Carried Interest

It is a fund manager's share of distributions from a private equity or hedge fund.

Typically, the fund manager's entitlement to distributions arises after the fund distributes to the investors amounts sufficient to return invested capital plus provide some return on invested capital.

This structure intends to provide incentive to the fund manager to achieve gains on fund investments, because the manager's economics from the fund is dependent on the fund's making distributions in excess of investments. This structure also permits the fund manager to receive an economic interest in fund profits greater than its proportionate capital contribution.

Investment Advisor

An investment advisor is an individual or firm that advises clients on investment matters on a professional basis.

They tend to fall into two distinct categories:

- a. investment advisors offering direct financial advice to individuals or businesses, or
- b. investment advisors offering asset management for (typically) corporate clients, hedge funds and/or mutual funds.

Depending on the nature of the relationship, investment advisors charge fees calculated as a percentage (e.g., 1%) of assets under management (see: fee-only financial advisor), on an annual basis, an hourly or on a "flat fee" basis.

The Private Equity Investment Process

Private equity investment is typically a transformational, value-added, active investment strategy. It involves investing in securities through a negotiated process which may consist of the following stages:

1. Approaching the private equity firm
2. Initial Enquiries and Negotiations
3. Business Valuation
4. Due Diligence
5. Structuring the Deal / Final Negotiation and Deal Completion
6. Monitoring and performance evaluation
7. Exit Strategy

APPROACHING THE PRIVATE EQUITY FIRM

India is home to scores of fast-growing small companies, and private equity firms are taking notice. These investment firms gather money from institutions and wealthy individuals and plow it into promising companies capable of outsized returns. It is a smart way to hook up with someone who can complement the company's business and provide a source of funding.

A large investment from a private equity firm can significantly speed up a company's growth. Private equity investors also can supply managerial know-how and strategic vision that entrepreneurs may lack. To tap into that money, business owners should make sure to have excellent accounting and record keeping systems in place several years before approaching a private equity firm, experts say. And it's usually smart to have an intermediary such as an accountant or attorney approach potential investors. That lends an air of credibility that may be absent when owners are hawking their own businesses.

Some private equity firms will manage a wide range of funds. You can determine what the firm's preferences for investments are by searching for their membership. Form a panel of advisors who can introduce you to their own contacts for private equity so that you can make the right choice when choosing a private equity firm. Always be sure to approach only those equity firms who match up with your own investment preferences. With careful targeting you won't be wasting your time or the private equity firm's time.

Before approaching any private equity firms, it is best to keep the following points in mind:

1. The team or person managing the business should be knowledgeable about the business and its value drivers, the team managing the business (or a team that could manage it), competition, segmentation, customer or consumer needs, technology requirements and capital-investment needs.

2. The private equity firm must be contacted with the current resume of the team members highlighting their experience, leadership roles and accomplishments. It also should showcase their exposure to acquisitions, such as planning, valuation, due diligence or post-acquisition integration.

3. Most importantly, there should be an attractive business opportunity or deal to propose. The company should be able to clearly and confidently discuss the business opportunity to secure the backing from a private-equity firm. Typically a detailed business plan is not required at the first meeting but gives an edge to have one ready.

Key Considerations in Selection of Private Equity Firm

The most effective way of raising private equity is to select just a few private equity firms to target with the business proposition. The key considerations should be to assess:

1. The stage of the company's development or the type of private equity investment required.
2. The industry sector in which the business operates.
3. The amount of finance the company needs.
4. The geographical location of the business operations.

Only those private equity firms whose investment preferences match these attributes should be selected. For the initial approach, it is worth considering sending only a copy of the Executive Summary to potential investors.

1. Stage/ Type of Investment

The terms that most private equity firms use to define the "stage" of a company's development are determined by the purpose for which the financing is required.

a. Seed

Seed Stage Finance is provided to research, assess and develop an initial concept before a business has reached the start-up phase.

Many seed financings are too small and require too much hands-on support from the private equity firm to make them economically viable as investments. There are, however, some specialists private equity firms which are worth approaching, subject to the company meeting their other investment preferences.

b. Start-Up

Start Up Finance is for product development and initial marketing. This stage implies that companies may be in the process of being set up or may have been in business for a short time, but have not sold their products commercially.

Other Early Stage Finance may be provided to initiate commercial manufacturing and sales in companies that have completed the product development stage, but may not yet be generating profits.

c. Expansion

Expansion stage Finance is for growth and expansion of a company which is breaking even or trading profitably. It is provided to grow and expand an established company. For example, to finance increased production capacity, product development, marketing and to provide additional working capital. Also known as “development” or “growth” capital.

d. Management buy-out (MBO)

Finance is required to enable the current operating management and investors to acquire or to purchase a significant shareholding in the product line or business they manage.

e. Management buy-in (MBI)

Finance is required by the company to enable a manager or group of managers from outside a company to buy into it.

f. Institutional Buy-Out

Finance is required to enable a private equity firm to acquire a company, following which the incumbent and/or incoming management will be given or acquire a stake in the business.

g. Secondary purchase

When a private equity firm acquires existing shares in a company from another private equity firm or from another shareholder or shareholders.

h. Replacement equity

Company needs finance to allow existing non-private equity investors to buy back or redeem part, or all, of another investor's shareholding.

i. Rescue/turnaround

To finance a company in difficulties or to rescue it from receivership.

j. Refinancing bank debt

To reduce a company's level of gearing.

k. Bridge financing

Short-term private equity funding provided to a company generally planning to float within a year.

2. Industry Sector

Most private equity firms will consider investing in a range of industry sectors. Some firms specialise in specific industry sectors, such as biotechnology, computer related and other technology areas. Others may actively avoid certain sectors.

3. Amount of Finance

The process for investment is similar, whether the amount of capital required is large or small, in terms of the amount of time and effort private equity firms have to spend in appraising the business proposal prior to investment. This makes the medium-sized to larger investments more attractive for private equity investment, as the total size of the return (rather than the percentage) is likely to be greater than for smaller investments, and should more easily cover the initial appraisal costs.

4. Geographical Locations

Several International private equity firms have offices in India. However, some regions are better served with more local private equity firms than others.

Business plan

A business plan represents an essential document for any company regardless of its stage of development. It is a crucial first step for an entrepreneur when moving from a business concept to the realization, funding and development of the venture.

Business Plan is a document whose main purpose when raising finance is to market the company's business proposal.

It should show potential investors that if they invest in the business, they would get a unique opportunity to participate in making an excellent return.

A business plan should be considered an essential document for owners and management to formally assess market needs and the competition; review the business' strengths and weaknesses; and to identify its critical success factors and what must be done to achieve profitable growth. It can be used to consider and reorganise internal financing and to agree and set targets for the company. It should be reviewed regularly.

A plan achieves multiple objectives. Most importantly, it requires management to carefully think through the company's purpose and goals and articulate how such objectives will be met. As the business develops, the plan can guide decision making on operational and financial issues.

In addition, a well thought-out, comprehensive and credible business plan is usually required in order to obtain funding from capital

providers such as banks, angel investors or venture capital firms. Entrepreneurs should therefore always assign the necessary time and resources to produce a thorough plan as evidence of their commitment and professionalism. .

Prior to writing the business plan, management needs a clear vision of the following core elements:

- the company's products or services,
- the target customer base,
- the firm's marketing strategy and competitive advantages, and
- how the venture will be financed. .

The business plan will identify the strengths and risks of the business, provide an overview of the market, set out financial projections, articulate long-term goals and define key targets to be achieved. Such goals and targets should be both realistic and quantifiable. The plan should serve as a reference document in the future for determining if the business is growing and evolving as anticipated.

There is no single template that is appropriate for all business plans, although companies should aim for a clear and concise document of 20-25 pages plus an Appendix, if required, that contains additional information or financial data. There is a range of business planning software packages available that will aid in defining relevant areas that should be addressed and will also provide templates to avoid drafting the document from scratch. The readability, length and appearance of the Plan are the three most important aspects to be kept in mind while writing the Business Plan.

Essential areas to cover in the business plan

Many businesses fail because their plans have not been properly thought out, written down and developed. A business plan should be prepared to a high standard and be verifiable. Although business plans have many common elements, the content will differ. A business plan covering the following areas should be prepared before a private equity firm is approached:

1. Executive Summary
2. Market and Competition
3. Details of the Product or Service
4. The Management Team
5. Business Operations
6. Financial Projections
7. Funding Requirements
8. Exit Opportunities for the Investor

1. Executive Summary:

This is the most important section and is often best written last. It summarizes the business plan. It is vital to give this summary significant thought and time, as it may well determine the amount of consideration the private equity investor will give to the detailed proposal. It should convince the reader of the company's growth and profit potential and management's prior relevant experience. It needs to clearly encapsulate the company's USP (i.e. its unique selling point – why people should buy its product or service as distinct from the competitors). The summary should be limited to no more than two to three pages (i.e. around 1,000 to 1,500 words)

The executive Summary should include information on the following key elements:

1. The market
2. The product or service
3. The management team
4. Business operations
5. Financial projections
6. Amount and use of finance required and exit opportunities

Other aspects that should be included in the Executive Summary are the company's "mission statement" – a few sentences encapsulating what the business does for what type of clients, the management's aims for the company and what gives it its competitive edge. It should also explain the current legal status of the business. It should include an overall "SWOT" (strengths, weaknesses, opportunities and threats) analysis.

2. Market and Competition:

The private equity firm needs to be convinced that there is a real commercial opportunity for the business and its products and services. This requires a careful analysis of the market potential for products or services and how the company plans to develop and penetrate the market.

A market analysis should be made and it should be as specific as possible, focusing on believable, verifiable data. A thorough analysis of the company's industry and potential customers, details on the number of potential customers, the purchase rate per customer, and a profile of the typical decision-maker, the size of the market, growth rates, recent technical advances, Government regulations and trends should be included in the market analysis.

Finally, a comment on the percentage of the target market the company plans to capture, with justification should be made. The primary purpose of this section of the business plan is to convince the private equity firm that the market can be developed and penetrated. The Market Plan of the company specifying its pricing, distribution channels and promotion techniques should be prepared.

A discussion of the competition is an essential part of the business plan. The business plan should analyse the competition and attempt to anticipate likely competitive responses to the product.

3. Details of the product or service

Explain the company's product or service in plain English. If the product or service is technically orientated this is essential, as it has to be readily understood by non-specialists.

Emphasise the product or service's competitive edge or USP. For example, is it?

- A new product?
- Available at a lower price?

- Of higher quality?
- Of greater durability?
- Faster to operate?
- Smaller in size?
- Easier to maintain?
- Offering additional support products or services?

With technology companies where the product or service is new, there has to be a clear “world class” opportunity to balance the higher risks involved. Address whether it is vulnerable to technological advances made elsewhere.

4. The management team

Private equity firms invest in people – people who have run or who are likely to run successful operations. Potential investors will look closely at the members of the management team.

This section of the plan should introduce the management team and what they will bring to the business. Include their experience, and success, in running businesses before and how they have learned from not so successful businesses. There is a need to demonstrate that the company has the quality of management to be able to turn the business plan into reality.

The senior management team ideally should be experienced in complementary areas, such as management strategy, finance and marketing and their roles should be specified. The special abilities each member brings to the venture should be explained.

Concise curriculum vitae should be included for each team member, highlighting their previous track records in running, or being involved with successful businesses.

Other points to be included are:

- Identify the current and potential skills’ gaps and explain how they will be filled.

- Explain what controls and performance measures exist for management, employees and others.
- List the auditors and other advisers.
- The appointment of a non-executive director should be considered as they add significant value to the companies with which they are involved.

Many private equity firms at the time of their investment will wish to appoint one of their own executives or an independent expert to the board. Most private equity executives have previously worked in industry or in finance and all will have a wide experience of companies going through a rapid period of growth and development.

5. Business operations

This section of the business plan should explain how the business operates, including the making of the products or providing of the service. It may also outline the company's approach to research and development. It should include location and size of the facilities; availability of labour; accessibility of materials; research and development programme; proximity to distribution channels, and the availability of Government grants and tax incentives.

Describe the equipment used or planned. If more equipment is required in response to production demands, include plans for financing. If work will be outsourced to subcontractors – eliminating the need to expand facilities – state that too. The investor will be looking to see if there are inconsistencies in the business plan. If a prototype has not been developed or there is other uncertainty concerning production, include a budget and timetable for product development.

6. Financial projections

Developing a detailed set of financial projections will help to demonstrate to the investor that the financial implications of the company's growth plans have been meticulously thought out. It should also include notes to explain the major assumptions used to develop the revenue and expense items and explain the logic behind these assumptions.

The projections should include:

- Assessment of sales, costs (both fixed and variable), cash flow and working capital.
- Assessment of the value attributed to the company's net tangible assets.
- State the level of gearing (i.e. debt to shareholders' funds ratio).
- Include all costs associated with the business.
- Provide budgets for each area of the company's activities.
- Present different scenarios for the financial projections of sales, costs and cash flow for both the short and long term.
- If it is envisioned that more than one round of financing will be required, identify the likely timing and any associated "milestones" which need to be achieved.

The company may consider using an external accountant to review the financial projections.

Investors will expect to see a full set of cohesive financial statements – including a balance sheet, income statement and cash-flow statement, for a period of three to five years. It is usual to show monthly income and cash flow statements until the breakeven point is reached followed by yearly data for the remaining time frame.

7. Funding Requirements

How much finance is required by the business and from what sources (i.e. management, private equity firm, banks and others) and for what it will be used should be explained. For this an implementation schedule, including capital expenditure, orders and production timetables should be prepared.

8. Exit Opportunities for Investor

It is important that the exit options are considered and discussed with the investors. Consider how the private equity investors will make a return, i.e. realise their investment.

ENQUIRIES AND NEGOTIATIONS

If a private equity firm is interested in proceeding further, the company will need to ensure that the key members of the management team are able to present the business plan convincingly and demonstrate a thorough knowledge and understanding of all aspects of the business, its market, operation and prospects.

The company's team should be prepared for a series of interviews that will focus on the background, strengths and weaknesses, knowledge of industry and players in the industry -- and the business opportunity. The private equity firm will be looking to see how flexible and efficient the facility plans are.

Negotiating Points

The private equity investor or firm evaluates the investment opportunities based on individual merit and the potential to add strategic diversification to client portfolios.

They undertake an examination of the following criteria:

- Track record reflecting attractive portfolio development and strong returns
- Experience and continuity of the team working together to invest institutional capital
- Demonstrated expertise consistent with well-defined strategies
- Disciplined investment approach that creates long-term value
- Ability to realize profits
- Company's access to suppliers who can provide the materials required
- Availability of work force with requisite skill

The Private Equity Firms will consider several principal aspects:

- Is the product or service commercially viable?
- Does the company have potential for sustained growth?
- Does management have the ability to exploit this potential and control the company through the growth phases?
- Does the possible reward justify the risk?
- Does the potential financial return on the investment meet their investment criteria?

A deal acceptable to both management and the private equity firm can usually be negotiated.

Other negotiating points are often:

- a. Whether the private equity firm requires a seat on the company's board of directors or wishes to appoint an independent director.
- b. What will be the forms of finance
- c. What happens if agreed targets are not met and payments are not made by the company?
- d. How many votes are to be ascribed to the private equity firm's shares?
- e. The level of warranties and indemnities provided by the directors.

Term Sheet / Offer Letter and Conditions Precedent

At this point, the private equity firm will send the Company an Offer Letter, which sets out the general terms of the proposal, subject to the outcome of the due diligence process and other enquiries and the conclusion of the negotiations. The Offer Letter, without being legally binding on either party, demonstrates the investor's commitment to management's business plan and shows that serious consideration is being given to making an investment.

A Term Sheet is then prepared. Negotiating deals with terms that are

satisfactory to both sides and ensuring that stakeholders' interests are properly aligned is crucial. This process begins with a term sheet.

A Term Sheet is a document which outlines the key financial and other terms of a proposed investment. It is a brief preliminary document designed to facilitate and provide a framework for negotiations between investors and entrepreneurs. Provisions are not usually intended to be legally binding.

A term sheet is a bullet-point document outlining the material terms and conditions of a business agreement. After a Term Sheet has been executed, it guides the legal counsel in the preparation of a proposed final agreement. It then guides, but is not necessarily binding, as the signatories negotiate, usually with legal counsel, the final terms of their agreement.

It generally focuses on a given enterprise's valuation and the conditions under which investors agree to provide financing. Investors use a Term Sheet as a basis for drafting the investment documents.

Excepting clauses dealing with confidentiality, exclusivity and sometimes costs– provisions of a Term Sheet are not usually intended to be legally binding.

Conditions Precedent

Condition precedent refers to an event or state of affairs that is required before something else will occur. Condition precedent is a provision of a contract that suspends the coming into effect of a contract or a term of the contract unless or until a certain event takes place.

A condition subsequent brings a duty to an end whereas a condition precedent initiates a duty.

A Term Sheet will usually contain certain conditions which need to be met before the investment is completed and these are known as conditions precedent.

Ingredients of a Term Sheet:

- Type of share
- Valuation and milestones
- Dividend rights
- Liquidation preference and deemed liquidation
- Redemption
- Conversion rights
- Automatic conversion of share class/series
- Anti-dilution (or price protection)
- Founder shares
- Pre-emption rights on new share issues
- Right of first refusal, co-sale and tag along rights
- Drag along or bring along
- Representations and warranties
- Voting rights
- Protective provisions and consent rights (class rights)
- Board of Directors/Board Observer
- Information rights
- Exit
- Registration rights
- Confidentiality, Intellectual Property, Assignment and Management
- Non-compete Agreements
- Employee share option plan
- Transaction and monitoring fees
- Confidentiality
- Exclusivity
- Enforceability
- Conditions precedent

Negotiating a Term Sheet

A very important part of the private equity financing process is negotiating the term sheet. Although they're only 2-3 pages long, term

sheets contain summaries of all the critical aspects of a financing, and once they're signed, the remainder of the financing process is significantly more "automatic."

A few points which a portfolio company must keep in mind while negotiating a Term Sheet are:

1. Need for Experienced Professionals:

It is very important to have experienced professionals like lawyers, chartered accountants etc. to assist in the negotiating stage. They should be not only efficient but should have dealt with private equity so as to know private equity financings like the back of his or her hand. No matter how many deals the portfolio company may have worked on, an experienced private equity professional would have definitely worked on more of them.

2. Focus on terms that matter:

A typical VC term sheet will have at least 20 terms spelled out in it. There are only a few that really matter in the end, although the portfolio company should at least make sure that the other terms are reasonable and somewhat standard. Time should be spent on valuation, the type of security, the option pool, Board composition, compensation and rights. Price/valuation may not be the most important thing to maximize in a deal. The structure of the security can be much more important in the long run.

3. Pay up for high quality investors:

There is a world of difference between good private equity financiers and bad private equity financiers that will ultimately have a lot to do with how successful the portfolio company can become. It is important to "pay" for quality in the form of slightly weaker terms (whether valuation or type of security).

4. Ask for references:

It doesn't pay to be shy. Prospective private equity financiers are checking up on their investment, so the portfolio company has every right to do the same with them. The private equity financiers should be asked for references of CEOs they've worked with. The good financiers will give the full roster of everyone they've ever funded and advice to

call anyone. The bad ones will give maybe just two names and ask for time to prepare them ahead of time.

5. Explanation is important:

A private equity financier should not be allowed to get away with negotiating a point by saying “we always do it this way.” The financiers may have a preferred way of doing deals or handling a specific term, but every deal they do is different, and if there’s a compelling reason for them to insist on a particular term, the portfolio company can have the right to hear it.

6. Handle the term sheet negotiation carefully:

Whether it’s an initial round or a follow-on round, how the portfolio company handles the negotiation sets the tone for the next stage of the relationship with the private equity financier. The financing is the line of demarcation between the portfolio company and the private equity fund courting each other, and the private equity fund joining the portfolio company’s Board and effectively becoming the boss.

7. Don’t forget to say thank you at the end of the process:

Whether by send a formal email, a handwritten note, or a token gift, the portfolio company should be sure to thank the private equity fund after a financing. They’re investing in the company and they’re making it possible for it to pursue the future course of action. That deserves a thoughtful thanks.

Assuming a satisfactory outcome of the meeting and further enquiries, the private equity firm will commence discussions regarding the terms of the deal with the Company. The first step will be to establish the value of the business.

BUSINESS VALUATION

The dictionary meaning of "Valuation" is "The act or process of assessing value or price;" Business valuation is the act or process of assessing value or price of financial asset or liability.

By their very nature, valuation of private equity investments (which lack market valuations provided by public equity markets) is often difficult, being highly sensitive to assumptions and methodology. For the initial investment as well on periodic basis valuations of venture capital and private equity investments needs to be done. But ascribing a value to illiquid companies is not a trivial matter.

There is no right or wrong way of valuing a business. There are several ways in which it can be done.

If we adopt "fair value" as the starting point – a strategy that has been adopted by the standards issued by the European Private Equity and Venture Capital Association (EVCA) and the French and British national associations in their guideline, - It assumes that investments will be valued based on the amount for which they could be sold, assuming knowledgeable, willing parties in an arm's length transaction. The concept of fair value has gained importance in international accounting practice.

This raises some difficult questions about valuation methodology, and the guidelines issued by EVCA are mainly concerned with identifying and describing various ways to identify "fair value". These include the cost of investment, earnings multiples, net assets and (with some caution) discounted cash flow (of either the underlying business or the investment). In all cases, however, subjective judgements have to be made, and in some cases an estimate of fair value would be unreliable. In those cases, unless there is evidence of impairment, the investment should be reported at its previous carrying value.

Concept of fair value

Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arms length transaction. The objective of estimation of fair value is to assess the exchange price at which market participants would agree to transact. Since in private equity largely, there is an absence of active market, the valuer has to estimate the fair value utilising one of the valuation methodologies. The valuer has to apply a methodology, which is appropriate in light of nature, facts and circumstances of investment and its materiality in the context of the investment portfolio and should use reasonable data and market inputs, assumptions and estimates.

Valuation Methodology

One favourable point about private equity is that the value is crystallised through sale or flotation of the entire business and not a portion of it, so the value of the business as a whole can be used as a base for estimating the fair value of an investment in that business.

Because of the uncertainties involved in valuation of private equity investments, a degree of caution (though not excessive caution) should be applied in exercising judgment and making the necessary estimates. One thing has to be remembered that private equity investment is made with the objective of effecting substantial changes in the underlying business, be it strategy, operations, management or any other area of business. It may also involve refinancing or turnaround of a business.

A number of valuation methodologies may be considered for estimating value of the investments. These methodologies should be amended as necessary to incorporate case specific factors, which affect the value. Say for example presence of surplus assets or cash should be reflected in the methodology. The valuer should select the method, which is most appropriate, and use information and experience to make valuation adjustments. The factors which need to be considered are:

- Applicability of methodology given the nature of industry and market conditions
- Quality, reliability of data used.
- Stage of development of enterprise
- Comparability of enterprises data to parameters.
- Other factors unique to the enterprise.

Whatever the methodology selected, the valuer should be predisposed towards market based measures of risk and return as they usually prove to be more reliable than those based on assumptions.

Research and data gathering

The following are some of the areas that should be considered in a valuation

- The nature of the business
- The history of the business
- The economic outlook and the conditions of the specific industry
- Market Prospects and Technical Feasibility
- Management Information System
- Assumptions for Financial Projections
- Latest Financial position
- Market price of comparable publicly traded companies
- Assessment of ownership of assets and realizable value of inventories and debtors and Contingent Liabilities
- Bank Facilities and Charge on the assets of the Company
- Leased Assets
- Tax benefits
- Employee contracts, PF and pension plans
- Dependency of company's value on current management
- Availability, Ability and Commitment of Key Management Personnel

Information required for valuation includes financial & corporate documents and other information like:

- Financial statements

- Corporate documents for the company (Certificate of Incorporation, Memorandum & Articles of Association, Resolution of Directors, etc.)
- Governance body minutes
- Organization chart
- Tax returns
- Accounts receivable, accounts payable and inventory detail
- Contracts/leases
- Budgets/forecasts
- Marketing material/price lists
- List of Liabilities, Loans and Mortgages including taxes, insurance policies, etc.
- Valuation of intangible assets, goodwill, trademarks, etc

Other Information required may include:

- List of Services/Products
- Present Marketing and Advertising Information
- Major competitors and market position
- Customer lists
- Financing terms
- Financing for possible expansion and projections for financial statements (if applicable)
- Other inducements, present employees, managers, etc.

External Resources are required which can be broadly classified under the following heads:

Business valuation publications

- General Business Valuation
- Transaction Data
- Industry-Specific Valuation
- Cost of Capital
- Professional Practice Valuation
- Partnership Valuation
- ESOP Valuation
- Mergers & Acquisitions Valuation
- Intangible Assets Valuation

- Sample Valuation Reports
- Financial Reporting Valuation
- Valuation Software Technology Valuation
- Real Estate Valuation etc.

Industry information

- industry overview
- issues
- Trends & outlook
- financial ratios and benchmarking
- compensation and salary structure

Economic data

- bond yields and interest rates
- inflation and cost living data
- economic forecast resources

Market transaction data

- cost of equity capital,
- equity risk premiums

Business valuation multiples (derived from company merger and acquisition transaction data)

Legal and tax resources

- Tax regulations
- Case laws

Valuation Methods

The organization and the consultant have to decide on business valuation method to be used based on the nature and requirements of the engagement. This will also involve analysing the company information in conjunction with the industry and other comparable company data.

1. Discounted Cash Flow (DCF) Method

The Discounted Cash Flow (DCF) methodology expresses the present value of a business as a function of its future cash earnings capacity. This methodology works on the premise that the value of a business is

measured in terms of future cash flow streams, discounted to the present time at an appropriate discount rate.

This method is used to determine the present value of a business on a going concern assumption. It recognizes that money has a time value by discounting future cash flows at an appropriate discount factor. The DCF methodology depends on the projection of the future cash flows and the selection of an appropriate discount factor.

When valuing a business on a DCF basis, the objective is to determine a net present value of the cash flows ("CF") arising from the business over a future period of time (say 5 years), which period is called the explicit forecast period. Free cash flows are defined to include all inflows and outflows associated with the project prior to debt service, such as taxes, amount invested in working capital and capital expenditure. Under the DCF methodology, value must be placed both on the explicit cash flows as stated above, and the ongoing cash flows a company will generate after the explicit forecast period. The latter value, also known as terminal value, is also to be estimated.

The further the cash flows can be projected, the less sensitive the valuation is to inaccuracies in the assumed terminal value. Therefore, the longer the period covered by the projection, the less reliable the projections are likely to be. For this reason, the approach is used to value businesses, where the future cash flows can be projected with a reasonable degree of reliability. For example, in a fast changing market like telecom or even automobile, the explicit period typically cannot be more than at least 5 years. Any projection beyond that would be mostly speculation.

The discount rate applied to estimate the present value of explicit forecast period free cash flows as also continuing value, is taken at the "Weighted Average Cost of Capital" (WACC). One of the advantages of the DCF approach is that it permits the various elements that make up the discount factor to be considered separately, and thus, the effect of the variations in the assumptions can be modeled more easily. The principal elements of WACC are cost of equity (which is the desired rate

of return for an equity investor given the risk profile of the company and associated cash flows), the post-tax cost of debt and the target capital structure of the company (a function of debt to equity ratio). In turn, cost of equity is derived, on the basis of capital asset pricing model (CAPM), as a function of risk-free rate, Beta (an estimate of risk profile of the company relative to equity market) and equity risk premium assigned to the subject equity market.

2. Balance Sheet Method or the Net Asset Value Method

The Balance sheet or the Net Asset Value (NAV) methodology values a business on the basis of the value of its underlying assets. This is relevant where the value of the business is fairly represented by its underlying assets. The NAV method is normally used to determine the minimum price a seller would be willing to accept and, thus serves to establish the floor for the value of the business. This method is pertinent where:

- The value of intangibles is not significant;
- The business has been recently set up.

This method takes into account the net value of the assets of a business or the capital employed as represented in the financial statements.

Hence, this method takes into account the amount that is historically spent and earned from the business. This method does not, however, consider the earnings potential of the assets and is, therefore, seldom used for valuing a going concern. The above method is not considered appropriate, particularly in the following cases:

- When the financial statement sheets do not reflect the true value of assets, being either too high on account of possible losses not reflected in the balance sheet or too low because of initial losses which may not continue in future;
- Where intangibles such as brand, goodwill, marketing infrastructure, and product development capabilities, etc., form a major part of the value of the company;
- Where due to the changes in industry, market or business environment, the assets of the company have become redundant and their ability to create net positive cash flows in future is limited.

3. Market Multiple Method

This method takes into account the traded or transaction value of comparable companies in the industry and benchmarks it against certain parameters, like earnings, sales, etc. Two of such commonly used parameters are:

- Earnings before Interest, Taxes, Depreciation & Amortizations (EBITDA).
- Sales

Although the Market Multiples method captures most value elements of a business, it is based on the past/current transaction or traded values and does not reflect the possible changes in future of the trend of cash flows being generated by a business, neither takes into account the time value of money adequately. At the same time it is a reflection of the current view of the market and hence is considered as a useful rule of thumb, providing reasonableness checks to valuations arrived at from other approaches. Accordingly, one may have to review a series of comparable transactions to determine a range of appropriate capitalization factors to value a company as per this methodology.

4. Asset Valuation Method

The asset valuation methodology essentially estimates the cost of replacing the tangible assets of the business. The replacement cost takes into account the market value of various assets or the expenditure required to create the infrastructure exactly similar to that of a company being valued. Since the replacement methodology assumes the value of business as if a new business is set, this methodology may not be relevant in a going concern. Instead it will be more realistic if asset valuation is done on the basis of the new book value of the assets. The asset valuation is a good indicator of the entry barrier that exists in a business. Alternatively, this methodology can also assume the amount which can be realized by liquidating the business by selling off all the tangible assets of a company and paying off the liabilities.

The asset valuation methodology is useful in case of liquidation/closure of the business.

5. Liquidation Value

Liquidation value uses the value of the assets at liquidation. Liabilities are deducted from the liquidation value of the assets to determine the liquidation value of the business. Liquidation value can be used to determine the bare bottom benchmark value

6. Capitalization methods:

This method calculates a business's value by discounting the future business profits or dividends flowing to the entity's owners, which is derived from future commercial profits (statement of earnings). There are two methods:

a. INCOME CAPITALIZATION VALUATION METHOD: First determine the capitalization rate - a rate of return required to take on the risk of operating the business (the riskier the business, the higher the required return). Earnings are then divided by that capitalization rate. The earnings figure to be capitalized should be one that reflects the true nature of the business, such as the last three years average, current year or projected year. When determining a capitalization rate, compare with rates available to similarly risky investments

b. DIVIDEND CAPITALIZATION: Since most closely held companies do not pay dividends, when using dividend capitalization consultants first determine dividend paying capacity of a business. Dividend paying capacity depends on net income and on cash flow of the business. To determine dividend paying capacity, near future capital requirements, expansion plans, debt repayment, operation cushion, contractual requirements, past dividend paying history of a business should be studied. After analyzing these factors, percent of average net income and of average cash flow that can be used for the payment of dividends can be estimated. The dividend yield can be also determined by analyzing comparable companies. .

The Company has to calculate a value for the company that will give the private equity firms their required rate of return over the period they anticipate being shareholders.

Private equity firms usually think in terms of a target overall return from their investments. Generally “return” refers to the annual internal rate of return (IRR), and is calculated over the life of the investment. The overall return takes into account capital redemptions, possible capital gains (through a total “exit” or sale of shares), and income through fees and dividends. The returns required will depend on the perceived risk of the investment – the higher the risk, the higher the return that will be sought – and it will vary considerably according to the sector and stage of the business.

DUE DILIGENCE

Due diligence is a term used for a number of concepts involving either the performance of an investigation of a business or person, or the performance of an act with a certain standard of care. It can be a legal obligation, but the term will more commonly apply to voluntary investigations. A common example of due diligence in various industries is the process through which a potential acquirer evaluates a target company or its assets for acquisition. Due Diligence has to be properly planned and professionally managed.

What is Due Diligence

Due diligence refers to an examination of a potential investment to conform all material facts of the prospective business opportunity. It involves review of financial and non-financial records as deemed relevant and material. It aims to take the care that a reasonable person should take before entering into an agreement or a transaction with another party.

In business transactions, the due diligence process varies for different

types of companies. The relevant areas of concern may include the financial, legal, labor, tax, environment and market/commercial situation of the company. Other areas include intellectual property, real and personal property, insurance and liability coverage, debt instrument review, employee benefits and labor matters, immigration, and international transactions.

Due Diligence in Private Equity

Due diligence in the private equity industry implies the process through which a potential acquirer evaluates a target company or its assets for acquisition.

Due diligence is used to study, investigate and evaluate a business opportunity. It implies a general duty to exercise care in any transaction. It is a process of investigation, performed by investors, into the details of a potential investment such as an examination of operations and management and the verification of material facts. It entails conducting inquiries for the purposes of timely, sufficient and accurate disclosure of all material statements/information or documents, which may influence the outcome of the transaction.

Investing successfully in private equity at a fund or company level, involves thorough investigation. As a long-term investment, it is essential to review and analyse all aspects of the deal before signing. Capabilities of the management team, performance record, deal flow, investment strategy and legal, are examples of areas that are fully examined during the due diligence process.

For private equity investors, the due diligence process is a means of identifying and becoming comfortable with the risks to which the capital would be exposed.

It involves an assessment of both the microeconomic and macroeconomic factors that can affect the earnings growth of the target company.

a. Microeconomic analysis

These are the factors within management's control and include a careful assessment of the management team, the business model, the value proposition, the distribution strategy, the intellectual property, the financial strategy and capital requirements, and the legal structure and records of the company.

b. Macroeconomic analysis

These factors are generally outside of management's direct control and include a review of such areas as market size and expected growth potential, the perception of the company and its products by its suppliers and customers, the competitive situation and product differentiation, and government and regulatory influences.

Additionally, a detailed due diligence process usually results in a more informed investor who can help management in the value-creation process from inception rather than spending time following the initial investment trying to understand the business and the challenges faced by the management team.

Therefore, Due Diligence requires:

- (a) Examination of documentation and litigation issues, preliminary and in the review of the financial books, operations and technology to assess the way business is run, possibility of cost savings in operations and means to improve the working capital structure.
- (b) Due diligence also involves background checks on people and it is usually based on bad experiences in the past.
- (c) Due diligence entails the buyer's core competency in judging the business targeted and critically important is judging the management.
- (d) Due diligence endeavor to find out "what else?"

Requirement of Due Diligence

1. From Buyer's Viewpoint

Due Diligence is the process when the investor will be able to access the target company's books and records to verify that all of the information that one has been told thus far is true and accurate. Most often, people

unwisely believe that due diligence is simply the exercise to verify the financial position of the company. While this is true to some extent, a proper and effective due diligence goes past the financials.

When a business opportunity first arises and continues throughout the talks, initial data collection and evaluation commence. Thorough detailed due diligence is typically conducted after the parties involved in a proposed transaction have agreed in principle that a deal should be pursued and after a preliminary understanding has been reached, but prior to the signing of a binding contract. There are many reasons for carrying out due diligence for the investor, which are:

- Confirmation that the business is what it appears to be;
- Identify potential 'deal killer' defects in the target and avoid a bad business transaction;
- Gain information that will be useful for valuing assets, defining representations and warranties, and / or negotiating price concessions; and
- Verification that the transaction complies with investment or acquisition criteria

The essence of the due diligence process is to provide an investigation into answering the four basic questions for the private equity investor:

1. What are we really buying?
2. What is the target's stand-alone value?
3. Where are the synergies—and the skeletons?
4. What's our walk-away price?

2. From Seller's Viewpoint

Apart from due diligence from the buyer's side, there is a requirement of similar exercise from the seller's side. This aspect covers three main items as discussed below.

1. Gauge the seriousness of the potential buyer

This Involves:

a. Evaluate the financial ability of the seller to acquire and run the business –

- Does the buyer have cash to make a cash deal?
- Does the buyer already carry a large debt burden or has the ability to finance the deal?
- In case of a public limited company is it feasible to consummate a stock deal?
- Does the buyer have a clear and realistic plan on how the deal will be structured and financed?

b. Evaluate the means of initial contact –

- Was it through a senior executive or board member or through a person with less authority?
- If it is through an intermediary, how credible is the intermediary and is it formally representing the buyer?

2. Staging the flow of information

Stage the flow of confidential information based on the overall progress of the transaction is one of the best means of protection. In other words, less sensitive information should be shared initially, and as the potential buyer progresses and shows seriousness; more sensitive information could be shared. It forces the potential buyer to earn the more sensitive information and limits the number of parties who see the most highly confidential records.

The phasing of information flow could follow the pattern mentioned below:

- The first phase consists of information that are already in public domain
- The next phase consists of information that is typically heavier on current and historical matters than on forward-looking projections. Quite a bit of confidential company information is

disclosed at this stage, but very little that is competitively sensitive

- The third phase involves the most sensitive company information, including projections, customer information and any other information requested by the buyer deemed too sensitive to share earlier in the process
- Finally, the accounting and legal due diligence is usually at the end of the process. This phase is last more for reasons of larger number of people involved and cost than for confidentiality reasons.

3. Look out for Warning Signs

Throughout the process, it is key to continually evaluate the potential buyer in a number of areas as outlined hereunder –

- Action of a serious buyer is reflected in – how large is the due diligence team, how much time is the team spending, and are professionals such as investment bankers, lawyers and accountants deployed for the exercise
- Is it that the buyer's team fishing for information that is not critical to the deal but could be important to a competitor?
- Which groups of people are involved from the potential buyer's side? Typically, there is mostly corporate level involvement in the early process and more operational people and specialists come later.

Although a well run due diligence programme cannot guarantee that a business transaction will be successful, it can definitely improve the odds.

However, it must be remembered that too much due diligence can offend a target company to the point where it could walk away from a deal. It can also result in “analysis paralysis” that prevents from completing a transaction or provides time for a better competing offer to emerge. Accordingly, it is important that due diligence be prioritised

and executed expeditiously. A sensible level of trust concerning lesser issues must balance appropriate investigation and verification into the most important issues.

Time and Cost

Time allocated for completion can vary widely with each situation. Many preliminary agreements define the timeframes in which due diligence would be conducted. Though time schedules through the closing of a transaction are typically tight, parties should ensure that adequate time is allocated to due diligence.

Every target company will try to negotiate the shortest due diligence period possible. It is impossible to truly get a feel for a business in a short time. The investor needs at least 30 days (20 working days) for even the smallest of companies. Since a proper investigation reaches farther than just financials the investor must allow oneself adequate time to accumulate the information.

Every transaction should be given different due diligence priorities. For example, if the main reason for acquiring a company is to get access to a new product it is developing to accelerate buyer's own time to market, then the highest priority task is to ensure that the product is near completion, that there are no major obstacles to completion, and that the end product would meet the buyer's business objectives. In another transaction, the highest priority might be to ensure that a major lawsuit is going to be resolved to the buyer's satisfaction.

Confidentiality

Certain activities conducted during due diligence could breach confidentiality that a transaction is being contemplated. For example, contacting a customer to assess the satisfaction with the target company's products might result in a rumor spreading that the company is up for sale. Accordingly, to maintain confidentiality, often customers may be contacted under the guise of being a prospective customer, journalist, or industry analyst.

Staffing

The Private Equity Investors generally use professionals (specifically Chartered Accountants and Lawyers) to carry out the Due Diligence Process.

Due Diligence Check List

Once an investor decides to seriously consider a business opportunity, a checklist of information and documents that eventually may be required is generally compiled.

This checklist should contain all essential data yet avoid the superfluous. Such a large quantity of information on so many subjects is needed that an effort must be made to circumvent matters of little importance or those that are irrelevant.

Due Diligence is the process to assess the Technical and financial feasibility of the Business proposition with particular focus on certain areas.

It is impossible to learn everything about a business but it is important to learn enough such that could lower the risks to the appropriate level and make good, informed business decisions. The objective of due diligence, is to obtain sufficient information to make an informed business decision. There is no precise definition as to what is 'sufficient', but generally examination of the following aspects can be considered:

1. Corporate Books & Records

- Charter and By-Laws
- Minutes of Meetings
- Recent Records of Officers and Directors
- List of Shareholders
- Company Registrations
- Reports to Shareholders

2. Financial Information

- Financial Statements
- Taxation Matters
- Indebtedness
- Contingent Liabilities

3. Employee Matters

- Availability, Ability and Commitment of Key Management Personnel
- Organisational Information
- Agreements
- Benefit Plans

4. Legal Matters

- Regulatory Compliance
- Litigation

5. Contracts, Agreements and Other Arrangements

6. Proprietary Rights

- Licenses
- Royalty Arrangement
- Infringements, if any, on these rights

7. Assessment of ownership of assets and realizable value of inventories and debtors and Contingent Liabilities

- Plant, Property & Equipment
- Real Property/Assets
- Encumbrances, if any

- Description of Facilities
- Bank Facilities and Charge on the assets of the Company
- Leased Assets

8. Insurance

- Assets
- Employees
- Directors
- Loss of Profit
- Transit Goods

9. Sales & Marketing

- Description of Market and Share
- Customer Identification and Profile
- Sales Policy
- Market Prospects and Technical Feasibility

10. Others

- Company's Management Information System
- Future Business Plan
- Press Releases

Types of Due Diligence

In business transactions, the due diligence process varies for different types of companies. The relevant types of due diligence may include:

1. Financial
2. Operational
3. Market Prospects and commercial situation
4. Technical Feasibility
5. Strategic
6. Human Capital
7. Legal
8. Environmental
9. Systems
10. Taxation Matters
11. Intellectual property
12. Real and personal property
13. Insurance and liability coverage
14. Debt instrument review
15. Employee benefits and labor matters
16. International transactions

Know Your Customer (KYC) Due Diligence

Know your customer (KYC) is the due diligence and bank regulation that financial institutions and other regulated companies perform to identify their clients and ascertain relevant information pertinent to doing financial business with them. Typically, KYC is a policy implemented to conform to a customer identification program mandated under the laws of a country.

Know your customer policies have becoming increasingly important globally to prevent identity theft fraud, money laundering and terrorist financing.

In a simple form these rules may equate to answering twelve questions, but this is the tip of the iceberg and regulators now expect much more. KYC should not be thought of as a form to be filled - it is a process to be undergone from the start of a customer relationship to the end.

Beyond name matching, a key aspect of KYC controls is to monitor transactions of a customer against their recorded profile, history on the customers account(s) and with peers.

Due Diligence Report

A due diligence study of a business can be conducted by an accountant or an attorney if the attorney is experienced in the industry of the business and has a background in accounting and finance. The company's financial condition is a big part of the report.

The due diligence report starts with an executive summary that contains the name of the person who conducted the study and the name and position of the person who asked for the study. The executive summary will outline the steps taken to conduct the study. The executive summary will also list the documents and other items reviewed during the study. Finally, the executive summary will present an overview of the findings of the study.

The due diligence study contains the biography and credentials of the person who conducted the study. The report will outline the steps taken during the study, and the report will describe the specific areas of the business that were part of the study. For example, the report will discuss the company's history and the company's management. Other factors considered are the company's background, the culture and goals, the business strategy, any business awards, media attention, and indications of growth.

In considering the company's culture, the report will state the mission statement and a description of the business model. In considering the company's growth, the report will list gross revenue, industry rankings (if available), number of offices and locations, and any other relevant financial information. The report will address the last 3-5 years of the company's operations.

If there are key indicators of the company's growth such as new offices opened or new technology installed, the report will give that information. If the company had media recognition, the report will give that information also. If the company has been involved in litigation, the report will describe each lawsuit and the outcome. This is usually the concluding portion of the due diligence report.

DEAL STRUCTURING AND FINAL NEGOTIATIONS

Once the due diligence is complete, the terms of the deal can be finally negotiated and, once agreed by all parties, the lawyers will draw up Heads of Agreement or Agreement in Principle and then the legally binding completion documents. Management should ensure that they both take legal advice and have a firm grasp themselves of all the legalities within the documents.

Deal Structuring

Deal structuring is deciding the following in relation to the private equity investment - From where, through what vehicle, at what time, what amount, in which company, through what instruments, investment is made in most tax efficient manner, so that entry and exit are very easy & flexible.

The Deal should be structured in a manner which is ideal for both the private equity Investor and the Company securing the finance.

It will involve various technicalities like deciding upon the capital structure to be used for financing the companies, control level to be exercised by both parties, warranties and indemnities etc. which are discussed below in detail.

Financial Modeling and capital structure

The Company must be prepared to give up a realistic portion of the equity in its business if it wants to secure the financing. However the

day-to-day operations should remain the responsibility of the Company and its management team.

The level of a private equity firm's involvement with the company depends on the general style of the firm and on what agreements have been made with them.

There are various ways in which the deal can be financed and these are open to negotiation. The private equity firm will put forward a proposed structure for consideration and that will be tailored to meet the company's needs. The private equity firm may also offer to provide more finance than just pure equity capital, such as debt or mezzanine finance. In any case, should additional capital be required, with private equity on board other forms of finance are often easier to raise.

The following types of classes of capital may be used by private equity firms to finance companies:

1. Share capital

The structure of share capital that will be developed involves the establishment of certain rights. The private equity firm through these rights will try to balance the risks they are taking with the rewards they are seeking. They will also be aiming to put together a package that best suits the company for future growth.

a. Equity shares

These are shares that are entitled to all income and capital after the rights of all other classes of capital and creditors have been satisfied. Equity shares have votes. In a private equity deal these are the shares typically held by the management and family shareholders rather than the private equity firm.

b. Preference shares

These are non-equity shares. They rank ahead of all classes of ordinary shares for both income and capital. Their income rights are defined and they are usually entitled to a fixed dividend. The shares may be redeemable on fixed dates or they may be irredeemable.

2. Loan capital

Loan capital ranks ahead of share capital for both income and capital. Loans typically are entitled to interest and are usually, though not

necessarily, repayable. Loans may be secured on the company's assets or may be unsecured. A secured loan will rank ahead of unsecured loans and certain other creditors of the company. A loan may be convertible into equity shares. Alternatively, it may have a warrant attached that gives the loan holder the option to subscribe for new equity shares on terms fixed in the warrant. They typically carry a higher rate of interest than bank term loans and rank behind the bank for payment of interest and repayment of capital.

Legal Issues involved in Deal Structuring

1. Share Capital

When deciding upon the types of shares to be used in the proposed capital structure, the following points should be looked into:

a. Preference Share Capital

- Applicability of the following sections of Companies Act, 1956:
Section 80 (Power to issue redeemable preference shares)
Section 80A (Redemption of Irredeemable Preference Shares etc.)
Section 85 (Two kinds of share capital)
- preferential right to fixed amount or rate
- preferential right on repayment on winding up
- redeemable / irredeemable
- convertible / non-convertible
- cumulative / non-cumulative

2. Voting Rights

(Applicability of Section 87 (Voting Rights) of the Companies Act, 1956)

a. Equity Shareholder - has right to vote on every resolution placed before the company

b. Preference Shareholder - has right to vote only on resolutions which directly affect their rights. In the case of cumulative / non cumulative preference shares, they can vote on all resolutions if dividend is in arrear for not less than two years.

3. Dividend Rights

Private Equity financier would generally ask for preference shares with cumulative dividend rights with usually fixed at a %age of the

subscription price. The company may also be prevented from paying dividend to any other equity shareholder till dividend is paid to preferred shareholder [Private Equity Financier]

4. Board Representation

PE / VC may require its representation on Board for monitoring and control.

5. Anti-Dilution of Shareholding of Private Equity Financier

Excepting a few exceptions to the contrary, any new equity entering the company dilutes the interest of the existing equity holders. Private Equity sources will attempt to protect themselves with anti-dilution provisions that allow them to preserve their relative position.

Anti dilution provisions vary significantly from 'pre-emptive' rights, (i.e Rights given to shareholders which entitle them to buy additional shares in a new issue before it is offered to the general public) and 'ratchet clause'. A 'ratchet clause' is a provision under which the contract-associated rights of the involved parties are adjusted according to an agreed upon formula upon completion of a part or stage of the contract. A full ratchet clause protects the existing equity holder but is viewed negatively by new capital sources.

Points to be kept in mind in this regard include:

- [Applicability of Section 81 (Further issue of Capital) of the Companies Act, 1956]
- Provision may have to be made to protect the value of Private Equity Financier's stake if new shares are issued at lower price
- New shares may have to be issued to PE financier at no or nominal cost to offset the dilative effect of issue of cheaper shares
- Issue of additional shares to PE to maintain its ownership at same level

If a company seeks to raise private equity, principal documents needed for the final negotiations round are generally a Disclosure Letter or Subscription Agreement, a Shareholders' or Investors' Rights Agreement (frequently these are combined into a single agreement) and the Company's Memorandum and Articles of Association.

Warranties and Indemnities

A Warranty is an undertaking given by the company receiving the investment to the private equity firm or its financiers, that certain facts in relation to the business or the company are true. If there is a breach of warranty, the private equity financier can claim compensation against the company.

In the case of an Indemnity, the private equity financier is entitled to full recompense from the company for any loss on the occurrence of a certain event, without the need to prove the loss. Indemnities are promises by the Company to make good losses of the Private Equity Firm, if specific events occur.

Warranties and Indemnities, provided by the Key founders, management and the company usually cover the following areas:

- Legal existence of the company
- The authority and capacity of the company to sell the shares
- Warranty as to the accuracy of the Financial statements, latest audited accounts, stock values and the level of provision for bad debts
- Warranty that the company is not subject to any unforeseen tax liability in the future, as a consequence of its operations upto the date of the private equity investment process
- Warranty as to the ownership of the property and other assets used by the company
- Warranty as to the future relationship with the private equity financier

Company has to reimburse the Private Equity financier for diminution in the share value attributable to the Representations, Warranties and Indemnities given by it, being inaccurate

Disclosure Letter

In response to the warranties, the Private Equity Firm carries out a disclosure exercise, which results in the preparation of a disclosure letter.

The disclosure letter goes hand in hand with warranties. It is a letter from the company setting out aspects of non-compliance with the warranties. These are cross-referenced against, and qualify, the warranties.

The Disclosure Letter or Subscription Agreement will usually contain details of the financial modeling, capital structure and modes of financing to be used, including number and class of shares subscribed for, payment terms and representations and warranties about the condition of the company. These representations and warranties will be qualified by a disclosure letter and supporting documents that specifically set out any issues that the company believes the investors should know prior to the completion of the investment.

The disclosure letter has 2 purposes in a private equity process:-

- a. it acts as a collection point for information disclosed to the private equity firm about the business or company being financed; and
- b. it records exceptions or qualifications to the warranties contained in the agreement.

The warranties are usually drafted in wide, general terms and disclosure is the mechanism by which exceptions or qualifications to them can be documented and agreed. As each disclosure in the disclosure letter lessens the private equity firm's rights under the warranties (by excluding the matter disclosed from the scope of the general warranty) it effectively increases the the firm's risk and for this reason the firm may not accept all disclosures which the company would like to make to it in the disclosure letter.

Memorandum and Articles of Association

The Memorandum and Articles of Association will include among other things information about the objects and capital clauses of the company, the rights attached to the various share classes, the procedures for the issue and transfer of shares and the holding of shareholder and board meetings.

Some of the protective provisions in the Shareholders' Agreement may instead be contained or repeated in the Articles of Association. The decision to include terms in one or both of these documents may be jurisdiction-specific, based primarily on company law restrictions, enforceability concerns and confidentiality concerns. Articles of Association must be filed as a public document with The Registrar of Companies while the other investment documents can often be kept confidential.

Shareholders Agreement

The shareholders' agreement - together with the company's articles of association - regulates the affairs of the company and gives investors their main contractual protections

The Shareholder's Agreement details the terms of the investment, including continuing obligations of management required by the private equity firm, the warranties and indemnities given by the existing shareholders, penalty clauses and shareholder rights.

A Shareholders' or Investors' Rights Agreement will usually contain investor protections, including consent rights, rights to board representation and non-compete restrictions. Many business agreements are oriented towards the present. Shareholder agreements, in contrast, are focused primarily on anticipating future circumstances. Existing shareholder agreements are unlikely to be suitable to deal with new private equity investors. Private equity investors must negotiate appropriate control and liquidity provisions into the shareholder agreement, especially in light of the fact that most private equity

investors do not intend to remain invested in the company for the long term.

The main contents of a shareholders' agreement are:

1. Board appointment rights

It is common for the shareholders' agreement to establish the relative rights of representation that the shareholders will have on the company's board of directors of the company. A minority shareholder may seek to have one director on the board in order to be kept informed of matters discussed at board level. A larger shareholder may seek to appoint a large number of directors to reflect its proportionate holding of shares at board level.

2. Veto rights

A list of material things that cannot be done without the investors' prior consent. These normally range from fundamental matters, such as issuing further shares or charging assets, to more day-to-day matters, such as capital expenditure and so on.

3. Adoption and amendment of business plans and budgets

The agreement may provide a process for adopting and amending business plans and budgets, to ensure that individual shareholder or their appointed directors are properly represented in that process.

4. Scope of business

It is common, in particular in a joint venture or a start-up, for the shareholders' agreement to specify the scope of the business that the company will conduct, and provide that consent is required from the shareholders before the company can change the nature of its business.

5. Intellectual property rights

Where shareholder parties are contributing know-how or proprietary information to a venture, the shareholders' agreement may provide for the ownership and licence of intellectual property rights, preserving certain such rights for the parties themselves and others to the company. Such provisions are particularly common in joint venture agreements.

6. A right to information

PE financier may demand information rights, which is mainly promise from entrepreneur to provide unaudited quarterly financial statements & audited annual statements.

It is extremely important for the investors to monitor performance closely, particularly to give them an early warning if things are starting to go wrong. Accordingly, they will expect a contractual right to receive regular reports, management accounts, cash flow forecasts and so on, together with statutory accounts. The investor will also often seek the right to have its own director appointed to the board. He will expect board meetings to be held regularly and all material decisions to be made by the board.

7. Warranties from the management team

In general terms, these are a series of statements about the company that the investors would expect to be true and accurate. At a first-stage capital raising, it is unlikely that these statements will be little more than confirmations: that the team stands behind its business plan; that the company is clean; and that the team knows of nothing that has been withheld from investors. However, at subsequent funding rounds, once the company has a track record, the warranties will extend to the company's general trading affairs.

8. Restrictions on transfers of shares

The investors will be keen to ensure that the management team they are backing, holds on to their shares. In certain circumstances, managers will be permitted to transfer shares to family or to trusts.

9. Restrictive covenants in Service Contracts

PE financier may require Restrictive Agreement with Key Persons of the Company. It may require key person or persons with technical knowledge to enter into non-compete Agreement with the Company. These will make it clear that, while members of the management are employed and for a period of time afterwards, they cannot compete with the company or solicit customers or employees.

However Under Section 27 of the Indian Contract Act,1872, Agreement in restraint of trade is void. Every agreement by which any one is

restrained from exercising a lawful profession, trade or business of any kind, is to that extent void. Only partial restriction is allowed.

10. Financial Covenants (FC)

FC may be part of the agreement between the Private Equity Financier and the Company securing the finance.

FC are the promises by the company to adhere to certain limits, for example, not to allow certain balance sheet items or ratios to fall below or go over an agreed upon limit.

Examples of FC – Debt Equity Ratio, Interest Cover, Debt Service Cover Ratio.

PE financier generally does not want to get involved in day to financial activities of the company, one reason being to avoid any liability. FC protects PE, by acting as an early warning system before something goes wrong. This allows PE to step in before default occurs and take corrective measures, and therefore PE financier will want FC in the agreement.

11. Strategic investor rights.

Where a shareholder is looking for more than a return on its investment, the shareholders' agreement provides an opportunity to negotiate terms covering ancillary commercial arrangements, such as giving a shareholder or its group first rights of refusal on certain type of business or contract with the company, or the right to be informed of and to co-invest in investments to be made by the company.

12. Drag Along Clause

The Drag along Clause implies that when PE financier decides to sell its stake to third party, the entrepreneur is dragged along / forced to sell his stake. The clause may not be stated upfront, but may be worded in the document. This provision might create obligation on all shareholders of the company to sell their shares to a potential purchaser, if certain %age of the shareholders vote to sell to the purchaser.

13. Dispute Resolution

The following has to be decided upon in advance:

- In case of disputes, will the PE financier and the Company resort to Litigation or Arbitration.
- Where will the jurisdiction lie- In India or abroad? Outside India may be costly and inconvenient to entrepreneur / Company
- Governing laws & procedure related to the private equity process

14. Exit provisions

A shareholders' agreement will very often include provisions that are intended to encourage or facilitate a realisation by the shareholders of their investments.

There are, of course, many other detailed provisions in an average shareholders' agreement. It is normally a sophisticated legal document. No private equity firm will invest a substantial amount in any company without protecting itself with contractual rights in a shareholders' agreement.

MONITORING AND MEASURING PERFORMANCE OF THE PRIVATE EQUITY INVESTMENT AND EXIT STRATEGY

The performance of private equity funds and their investments has recently gained wide attention of investors (mainly institutional) in private equity as a vehicle for diversification and return enhancement. Aspects of measuring performance include the risk return relationship of private equity (PE), its performance relative to public markets (PM) and the attractiveness of the investment opportunities.

In comparison to public equity there are two major characteristics of private equity: No liquid secondary markets and very restrictive disclosure politics of market players.

Investments are in practice frequently appraised in reference to the return of a chosen benchmark investment rather than via maximizing individual utility functions. Objective and unbiased returns of public

market investment often serve as reference points for performance appraisal purposes. If the relation between public market returns and the investment's return is unclear, selecting adequate benchmarks and drawing unambiguous conclusions is difficult.

Understanding Private Equity Performance

Earning Acceptable Returns Takes Time. In the early years, private equity funds will show low or negative returns. The investment gains usually come in the later years as the companies mature and increase in value. The effect of this timing on the fund's interim returns is known as the J-Curve Effect.

In the initial years, investment returns are negative due to management fees, which are drawn from committed capital, and under-performing investments that are identified early and written down (reduction in the value of an investment). It can take several years for the portfolio valuations to reflect the efforts of the Investment Managers. Over time, progress is made by investee companies and justifies a value for the business that is higher than its original cost, resulting in unrealized gains. In the final years of the fund, the higher valuations of the businesses are confirmed by the partial or complete sale of companies, resulting in cash flows to the partners. In practice, a private equity portfolio involves a series of J-Curves because funds are invested in at different times. However, not all funds will be profitable given the inherent risks of investing in private equity, including macroeconomic factors and the performance of underlying companies.

J-Curve Effect

The J-curve is the curve realized by plotting the returns generated by a private equity fund against time (from inception to termination). The common practice of paying the management fee and start-up costs out of the first draw-down does not produce an equivalent book value. As a result, a private equity fund will initially show a negative return. When the first realizations are made, the fund returns start to rise quite steeply. After about three to five years, the interim IRR will give a

reasonable indication of the definitive IRR. This period is generally shorter for buyout funds than for early-stage and expansion funds.



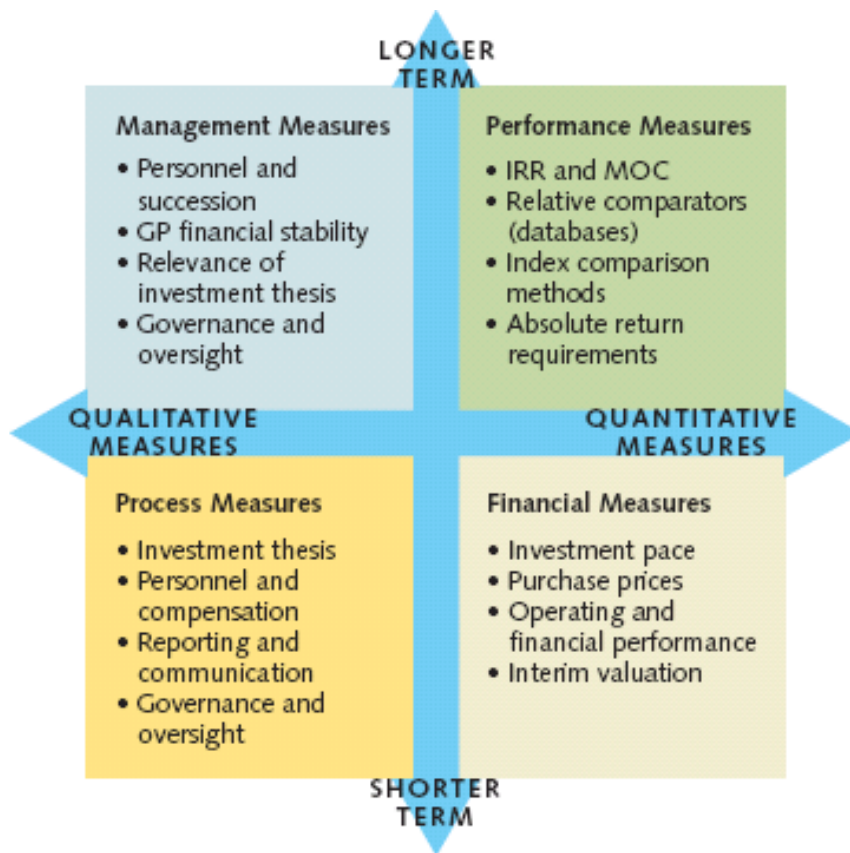
Measuring Performance

There are no current industry standards for valuations, reporting, and performance benchmarking.

In the first year of a private equity fund, investments are carried at cost. In subsequent years, the sale of portfolio companies or public offerings of their shares results in cash and/or stock distributions to the Partners. Over time, increasing proportions of a fund's performance reflects actual cash distributions received, rather than valuation estimates. The most widely used measure of performance is the internal rate of return (IRR). The calculation of the IRR takes into consideration the timing of cash contributions and distributions to and from the partnership and the length of time an investment has been held. Another widely accepted measure of performance is using an investment multiple. This measures the proceeds received from a fund plus the valuation of the remaining investments divided by the capital contributed to the fund.

Over the life of a private equity program, different measures of performance are intended to measure different things, so it is important to understand what should be measured, when, and why. A balanced approach, including qualitative as well as quantitative measures, is the

best way to assess private equity performance, particularly in the early years.



What to measure and When

Several useful things can be measured over the life of a fund. The obvious ones are the performance of the private equity portfolio relative to a chosen rate of return or index and its peer group; the performance of the Managers relative to its stated investment objectives; and the performance of the underlying portfolio companies.

‘Softer’, more qualitative measures apply particularly in the earlier part of a fund’s life, while ‘harder’ quantitative measures can be used only later.

This is when portfolio companies’ numbers begin to reflect the value added by the Managers, and cash returns from exits start to be distributed.

Monitoring in the early stages

During the first five years of a private equity program, many of the 'soft' monitoring criteria are similar to those that typically apply to managers of traditional assets. Plan fiduciaries will want to be sure that the Manager is not drifting away from its stated investment thesis or area of competence, but at the same time is responding appropriately to changing economic and market conditions.

The pace of investment

Is the amount invested each year consistent with stated goals, and with the opportunity set available? If not, why not? (Market conditions may have steered the fund off course, for instance.) Are the number, size and quality of companies in the portfolio consistent with expectations?

The purchase price of investments

What is the purchase price of investments and how does this compare with comparable company valuations? What does the purchase price imply about the exit price that will be required to achieve expected returns?

Later stage performance measurement

In the later stages of the investment cycle (between five and 15 years), quantitative performance measures can be used alongside qualitative ones. The quantitative aspects of data collection and comparison are attracting a lot of attention as the industry grows in importance.

Performance Measures – Asian Development Bank

ADB is an international development finance institution whose mission is to help its developing member countries reduce poverty and improve the quality of life of their people.

Headquartered in Manila, and established in 1966, ADB is owned and financed by its 67 members. India became a member of ADB in 1966.

Private Sector Operations (PSO) has been a core activity for the Asian Development Bank (ADB) since its inception.

PSO Department and the Operations Evaluation Department (OED) are formulating guidelines for implementing the Good Practice Standards (GPS) for Evaluation of Private Sector Investment Operations, which were prepared by the Evaluation Cooperation Group of the multilateral development banks.

The Evaluation Cooperation Group was formed by the multilateral development banks to design common evaluation standards for private sector operations. The group's work is ongoing and some aspects of the present evaluation framework might change to correspond to best practices.

These GPS cover the roles of the independent evaluation department and the private sector department itself, the evaluation dimensions for private sector operations, the nature of annual reporting, and dissemination of reports and lessons.

According to the GPS, the three principal dimensions for private sector evaluation are development outcome, investment profitability for the institution, and operational effectiveness.

The performance measures are grouped into three key areas:

(i) Business performance. The extent to which the Fund has reached its objectives in terms of the overall profitability and commercial viability of the Fund and subprojects.

(ii) Economic sustainability. The effects of the Fund and subprojects on the Developing Member Country's (DMC's) economy, and the associated benefits and costs. On the one hand, these measures assess the extent to which the Fund improved the allocation of resources and provision of financial services to viable private enterprises. On the other hand, these measures evaluate whether the subprojects directly generated positive effects on the local economy.

(iii) Private sector development. The impact of the Fund on private sector development beyond the Fund itself and its immediate stakeholders, e.g., the Fund's contribution to the growth of viable financial institutions and financial markets development.

Quantitative and qualitative measures of performance in this regard are:

(i) Business performance (Fund)

Overall profitability of the Fund: gross and net IRR.

(ii) Economic sustainability (subprojects)

(a) Efficient allocation of finance and provision of financial services to economically viable enterprises.

(i) Sub-project economic performance: annual net profits and revenues of subprojects.

(ii) Stronger local entrepreneurship: (a) number of entrepreneurial projects receiving finance from the Fund, and (b) number of returning entrepreneurs and skilled workers from industrialized countries receiving finance and transferring skills.

(iii) Contribution to widening the access to finance of SMEs: additional debt raised by subprojects as a result of the equity investments.

(iv) Provision of value-added services enhancing the viability of SMEs: (a) number of enterprises advised, and (b) quality of advice in financial planning, expansion strategies, human resource development, accounting standards, corporate governance, and management training.

(b) Direct contribution of subprojects to the local economy and living standards.

(i) Contribution to government revenues: increased amount of taxes paid by subprojects.

(ii) Employment generated: (a) number of jobs created by subprojects, and (b) quality of jobs created by subprojects (e.g., technical jobs).

(iii) Adoption of new technologies and production processes: (a) increased investment in new technologies or improved production processes by subprojects, and (b) number of subprojects implementing successful new technologies.

(iii) Private sector development (impact beyond the Fund and subprojects)

- (i) New technology, development of management skills, and employee training in domestic financial sector: (a) number of local investment professionals in SME private equity trained by the Fund, and (b) number of the Fund's investment professionals raising a subsequent fund in a DMC.
- (ii) Resource mobilization through private equity: (a) domestic finance for investments in SMEs mobilized by the Fund, and (b) international finance for investments in SMEs mobilized by the Fund.
- (iii) Positive effect on the legal and regulatory framework and its administration: (a) quality and volume of the Fund's feedback to ADB on improvements in the regulatory environment, and (b) evidence of lobbying by the Fund for improvements in the regulatory framework.
- (iv) Growth in financial services in the domestic financial markets: (a) growth in the private equity market in the domestic financial sector, and (b) increased access to long-term finance.

Exit Strategy

Many business owners and shareholder management teams are looking at some point to sell their investment or seek a stock market listing in order to realise a capital gain.

Private equity firms usually also require an exit route in order to realise a return on their investments.

The time frame from investment to exit can be as little as two years or as much as ten or more years. At the time of exit, the private equity firm may not sell all the shares it holds.

In the case of a flotation, private equity firms are likely to continue to hold the newly quoted shares for a year or more.

Exit options

The five main exit options in Private Equity Deals are:

1. Trade sale

The sale of the company's shares to another company, perhaps in the same industry sector. The majority of exits are achieved through a trade

sale. This often brings a higher valuation to the company being sold than a full stock market quotation, because the acquirer actually needs the company to supplement its own business area, unlike a public shareholder.

2. Repurchase

To repurchase shares the Company will need to consult the Companies Act, which governs the conditions of this exit option. Advance clearance from the Regulatory Government Authorities is required.

3. Refinancing

This type of exit may be most suitable for a company that is not yet willing or ready for flotation or trade sale, but whose private equity investors may need an exit.

4. Flotation

To obtain a quotation or Initial Public Offering (IPO) on a stock exchange. A stock market quotation has various advantages and disadvantages for the entrepreneur.

5. Involuntary exit

Where the company goes into liquidation

THE REGULATORY ENVIRONMENT FOR THE PRIVATE EQUITY INDUSTRY

The Securities and Exchange Board of India (SEBI) issued its Regulations for Venture Capital in 1996, thus establishing the agency's authority over the funds, the limits on their activities, and incentives for them to finance and rescue troubled companies.

There are no legal or regulatory differences between venture capital and private equity firms. The Government first permitted financial institutions (Industrial Development Bank of India, ICICI, and IFCI),

commercial banks (including foreign banks), and subsidiaries of commercial banks to establish venture capital companies under guidelines issued in 1988.

In addition, under Central Bank regulations, banks' investments in mutual funds catering to venture capital funding are considered to be outside the ceilings applicable to banks' investments in corporate equity and debt.

Foreign venture capital funds have been permitted to operate in India since 1995. They may either hold the shares of unlisted Indian companies directly (or route their investments through domestic venture capital funds and companies. Before guidelines were issued in September 2000, direct exposure by offshore private equity funds in shares of unlisted companies was treated as a foreign direct investment and had to be approved in line with the Government's general policy on foreign investments. Indoceen Venture Fund (now Indoceen Chase), originally set up by George Soros and Chemical Bank in October 1994, was the first such overseas private equity fund.

The regulatory environment for the private equity industry was simplified in 1995–2000. Foreign institutional investors participated in the growth of the private equity industry through the foreign direct investment regulations of the Government and the simplified tax administration procedures under the Indo-Mauritius Double Taxation Avoidance Treaty. While the foreign direct investment route offered minimum investment restrictions for private equity funds, exit pricing and repatriation of capital were regulated by the Reserve Bank of India (RBI). To bring these capital flows under the regulation of the venture capital industry, new SEBI regulations were issued with simplified exit pricing and repatriation procedures for foreign investors.

SEBI was also made the sole regulatory authority, and private equity funds must submit quarterly reports to it. In September 2000 SEBI announced the guidelines that now govern foreign venture capital investment.

These regulations have significantly improved the regulatory environment for private equity funds operating in India. In addition, they reflect the strong commitment of the Indian Government to support the provision of long-term equity finance to domestic entrepreneurial companies.

Legislations having a bearing on Private Equity

The Legislations, which will have a bearing on the Private Equity Deal, are:

1. Capital Market Regulations

- Securities and Exchange Board of India Act, 1992
- SEBI (Issue of capital & Disclosure requirements) regulations 2009
 - Chapter XIII- Guidelines for Preferential Issues
 - Chapter XIIIA- Guidelines for Qualified Institutions Placement
- SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997
- SEBI (Prohibition of Insider Trading) Regulations 1992
- SEBI (Foreign Institutional Investors) Regulations 1995
- SEBI (Venture Capital Funds) Regulations 1996
- SEBI (Foreign Venture Capital Investors) Regulations 2000
- SEBI (Mutual Funds) Regulations 1996
- Securities Contracts (Regulation) Act, 1956

2. Reserve Bank of India (RBI)

- Foreign Exchange Management Act, 1999
- Foreign Exchange Management Regulations (Transfer or Issue of Security by a Person Resident Outside India Regulations 2000)

3. Foreign Investment Promotion Board (FIPB)

- Foreign Direct Investment Policy
- Investment Approvals
- Press Notes

4. Income Tax Laws

- Income Tax Act, 1961
- Double Taxation Avoidance Agreements
- DTAA (Comprehensive agreements With respect to taxes on income) -
- DTAA (Limited agreements – With respect to income of airlines/merchant shipping) –

5. Indian and International Accounting Standards

- IAS 32- Financial Statements Presentation
- IAS 39- Financial Instruments- Recognition and Measurement
- IFRS 7 – Financial Instruments Disclosures

6. Other Laws:

- Companies Act, 1956
 - Indian Trust Act, 1882
 - Indian Contract Act, 1872
 - Foreign Contribution (Regulation) Act, 2010
 - Limited Liability Partnership Act 2008
 - Listing agreement Clause 40A and 40B for Listed Companies
 - Section 81 and 81A of the Companies Act 1956 - A public company will have to comply with these sections
 - Unlisted Public Companies (Preferential Allotment) Rules, 2003.
 - Private Limited Company and Unlisted Public Limited Company (Buy Back of Securities) Rules 1999
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Mr. Adukia is a rank holder from Bombay University and did his graduation from Sydenham College of Commerce & Economics. He received a Gold Medal for highest marks in Accountancy & Auditing in the Examination. He passed the Chartered Accountancy with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy

Course in 1983. He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional expansion. His level of knowledge, source of information, professional expertise spread across a wide range of subjects' right from the simplest to the most complex, has made him a strong and sought after professional in every form of professional assignment.

In addition to being a Chartered Accountant, Company Secretary and a Cost Accountant, MBA, Dip IFR (UK), Mr. Adukia also holds a degree in law and Diploma in Labour Laws. He has been involved in the activities of the Institute since 1984 as a convenor of Kalbadevi CPE study circle. He was the Chairman of the Western Region of Institute of Chartered Accountants of India in 1997 and has been actively involved in various committees of ICAI. He became a member of the Central Council in 1998 and ever since he has worked tirelessly towards knowledge sharing, professional development and enhancing professional opportunities for members.

He has been coordinating with various professional institutions, associations' universities, University Grants Commission and other educational institutions. Besides he has actively participated with accountability and standards-setting organizations in India and at the international level. He was a member of J.J. Irani committee which drafted Companies Bill 2008. He is also member of Secretarial Standards Board of ICSI. Currently he represents ASSOCHAM as member of Cost Accounting Standards Board of ICWAI . He is a member of working group of Competition Commission Of India, National Housing Bank, NABARD, RBI, CBI etc.

He has served on the Board of Directors in the capacity of independent director at BOI Asset management Co. Ltd, Bharat Sanchar Nigam Limited and SBI Mutual Funds Management Pvt Ltd. He is also a member of the London Fraud Investigation Team

Mr. Rajkumar Adukia specializes in IFRS, Enterprise Risk Management, Internal Audit, Business Advisory and Planning, Commercial Law Compliance, Labour Laws, Project Work, Carbon Credit, Taxation and Trusts. His clientele include large corporations, owner-managed

companies, small manufacturers, service businesses, property management and construction, exporters and importers, and professionals. He has undertaken specific assignments on fraud investigation and reporting in the corporate sector and has developed background material on the same.

Based on his rich experience, he has written numerous articles on most aspects of finance-accounting, auditing, taxation, valuation, public finance. His authoritative articles appear regularly in financial papers like Business India, Financial Express, Economic Times and other professional / business magazines. He has authored several accounting and auditing manuals. He has authored books on vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, etc. His books are known for their practicality and for their proactive approaches to meeting practice needs.

Mr. Rajkumar is a frequent speaker on trade and finance at seminars and conferences organized by the Institute of Chartered Accountants of India, various Chambers of Commerce, Income Tax Offices and other Professional Associations. He has also lectured at the S.P. Jain Institute of Management, Intensive Coaching Classes for Inter & Final CA students and Direct Taxes Regional Training Institute of CBDT. He also develops and delivers short courses, seminars and workshops on changes and opportunities in trade and finance. He has extensive experience as a speaker, moderator and panelist at workshops and conferences held for both students and professionals across the country and abroad. Mr. Adukia has delivered lectures abroad at forums of International Federation of Accountants and traveled very extensively abroad for professional work.

Professional Association: Mr. Rajkumar S Adukia with his well chartered approach towards professional assignments has explored every possible opportunity in the fields of business and profession. Interested professionals are welcome to share their thoughts in this regard.

Some of the notable publications authored by Mr. Rajkumar S Adukia

1. Encyclopedia on IFRS
2. The Handbook on IFRS
3. Professional Opportunities for Chartered Accountants
4. A Manual on Internal Audit
5. Manual on SEZ,FT & WZ-Developers and Units(including other export oriented units such as 100% EOU.STP,EHTP,BTP AND AEZ)
6. Guide to Stock Audit in Banks
7. A Manual on Statutory Bank Branch Audit
8. A Manual on Companies (Auditor's Report) Order 2003
9. Money Laundering and Its Prevention- An Overview of Counter Measures (Including Notifications, International Initiatives & Compliance Programs)
10. Encyclopedia for Real Estate Builders, Developers, Brokers and Investors
11. LABOUR LAWS OF INDUSTRY one should know (for employers& employees)
12. Manual on Anti -Dumping & Countervailing Duty including Safeguard measures For Importers, Exporters, traders & Producers
13. A Guide to MAHARASHTRA VAT AUDIT WITH GUIDANCE NOTE
14. A Comprehensive Guide on Company Deposits (Including all allied provisions like chit funds, Nidhi Companies, Miscellaneous Companies, NHB ,RBI guidelines, state money lending provisions)
15. Encyclopedia on Not for Profit Organisations (includes charitable Trust, Societies, Non Trading Corporations, Section 25 Companies under Companies Act 1956, Foreign Contribution (Regulation) Act 1976)
16. Limited Liability Partnership - Redefining Partnerships & its changing role
17. NRI's Guide to Investment in Immovable Property and Tax Planning