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Private Equity Funding

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BY-
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SYNOPSIS

- Private Equity Funding - Introduction and Meaning
- Stages of Private Equity investment
- Valuation Techniques
- Ways of Controlling Firm
- Exit Terms
- Drawbacks Equity Financing route
- Startup – An Opportunity

Introduction and Meaning

Private Equity investment is one of the most popular and fastest growing segment of investment in the business. Its usually refers to an equity investment in potentially successful company that is not listed in the exchange. However, in some cases, investments are also made in listed entities as part of broader funding to startups. In most parameters, it is like venture capital financing, and hence understood as one.

Private equity investments are usually made by private equity firms and high net worth individuals in a business operating as a Private Limited Company.

Introduction and Meaning Cont…

Private equity is funded individually or through a special vehicle where it is pool of money from institutional investors, pension funds, endowments, and investment companies and high net worth individuals. Private equity firms usually return the capital back to investors after a long period of at least 10 years with handsome profits. They predominantly funds startups, new ideas, breakthrough inventions etc. Private equity funding in a startup takes care of the firm till a stage when a company ready for listing in the public space i.e. stock exchange.

Stages of private equity investment

1. **Seed stage investment:** Here, capital is provided for a business idea. It generally supports product development and market research.
2. **Early stage investment:** After the product is developed, when the companies move into operations and before commercials sales are to begin, further capital is provided.
3. **Formative stage investment:** In formative stage investment Capital is provided for scaling up of operations.
4. **Later stage investment:** Capital is provided for further expansions and scaling up prior to the company going public.

Valuation Techniques

1. **Discounted Cash flow method:** The value of company is estimated by discounting expected future cash flows of the company at an appropriate cost of capital (Discount rate). Discount rate will be high for higher risk firms and vice versa.
2. **Relative Value Method:** Earning multiple of comparable publicly traded companies are applied to the earning of target company. Earning multiples are calculated by averaging the earnings and value of similar companies, traded in stock markets.

Valuation Techniques Cont…

3. **Replacement cost method:** Estimates the value of a business by calculating the estimate cost to recreate the business as it stands as of the valuation date. This is usually used to calculate the value of companies operating in the seed or early stage.

Ways of controlling the firm

1. **Corporate Board Seats:** All major decisions in a firm are taken at the board level. Thus, inducting a person from private Equity firm on the Board of Directors of the company will ensure the private equity firm's interests are protected in case of major corporate events like share sale, business takeover, restructuring, IPO, bankruptcy, or liquidation.
2. **Noncompete Clause:** At times, the founders may have an ides of starting a new firm and establishing their own brand as they may fed up if frequent interference of outside equity contributors. Noncompete clauses are therefore imposed on founders and prevents the founders from restarting the same activity during a pre-defined period of time.

Ways of controlling the firm Cont…

3. Preferred dividends and liquidation preference: Private equity firms generally come first when distribution take place. As per terms agreed at the start in most cases, a minimum guaranteed value would be returned at various stages which are usually multiples of their original investment before other shareholders receive their returns.

4. Reserved matters: Some strategic decision such as change in business plan, acquisitions or divestitures are subject to approval or veto by the private equity firm.

Exit Terms

Exit from the company is the most critical element to unlock value in private equity investment. Like venture capitalists and angel investors, private equity firms consider their exit options prior to investing. The following are some of the exit options for the private equity investors:

1. **Initial Public Offering (IPO):** Listing the company in an exchange is the final stage in private equity funding when these private equity funders look to exit. It is among the most favourite exit option for private equity firms as it provides higher valuation multiples, enhance liquidity and provides the business with more funding to fuel further growth.

Exit Terms Cont…

2. **Secondary market sale:** Sometimes, when the listing is far away or when the market is unlikely to offer right value for the firm, secondary market sale is chosen to exit. Here private equity players sell the share to a financial investor or other financial investors or to strategic investors. Secondary market exits are the most common type of exit.

3. **Management Buyout:** At times, the management who is running the show/firm, is willing to take over the business completely. They are willing to buyout the equity held by private equity players. They take over the firm by raising debt or other type of funds.

Exit Terms Cont…

4. **Liquidation:** This is the worst case option wherein the private equity firms liquidate their shareholding in the company at floor price if the company is no longer viable.

Drawbacks Equity Financing route

In Most of cases there are Clash of ideas between founders and the investors because of different working style.

This often leads to loss of original intent and idea of the founders.

Startup – An Opportunity

Startup – An Opportunity

A startup is a young company that is just beginning to develop. Startups are born out of a founder's brainwave, and backed by strong idea, and in most cases using one's own capital. They offer a product or service that is not currently being offered elsewhere in the market, or that the founders believe is being offered in an inferior manner.

In the early stages, Startup companies' expenses tend to exceed their revenues as they work on developing, testing and marketing their idea.

Startup – An Opportunity Cont…

As such, they often require financing. Startups may be funded by traditional small business loans from banks or by grants from non-profit organizations and governments. Incubators can provide startups with both capital and Advice, while friend and family may also provide loans and gifts.

From the prospective of an investor, Startup don't have much history and may have yet to turn a profit, therefore investing in them is considered high risk. This is exactly why private equity, and other financing options available to startups are so important.

Thank you!

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