PRIVATE EQUITY FUNDING
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  - Recent Trends
  - General Process
  - Valuations
  - Structures and Instruments
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  - Advantages and Disadvantages
  - Important factors for consideration
- REGULATORY FRAMEWORK OF FOREIGN VENTURE CAPITAL INVESTOR

Private Equity

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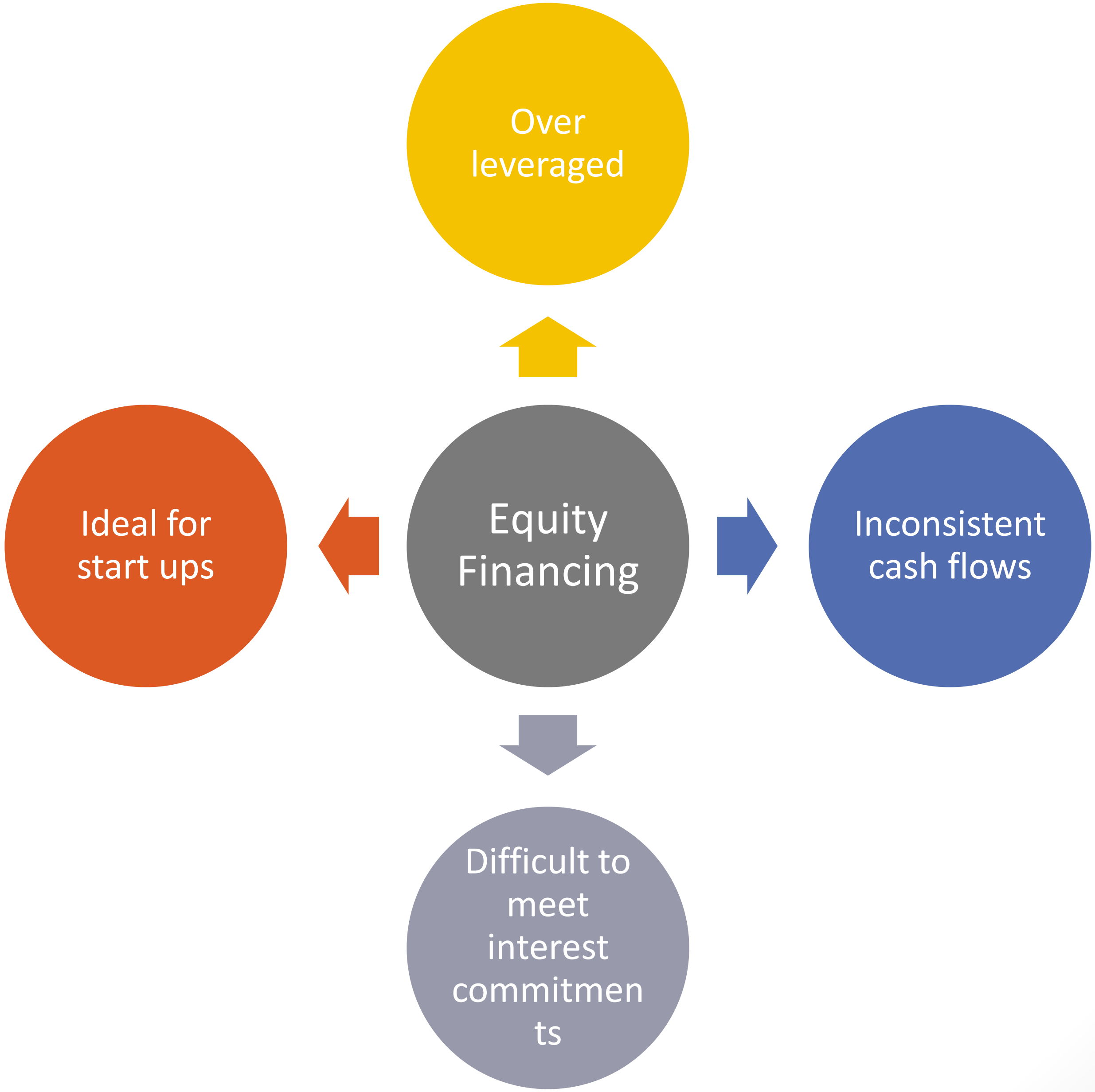
Private Equity

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

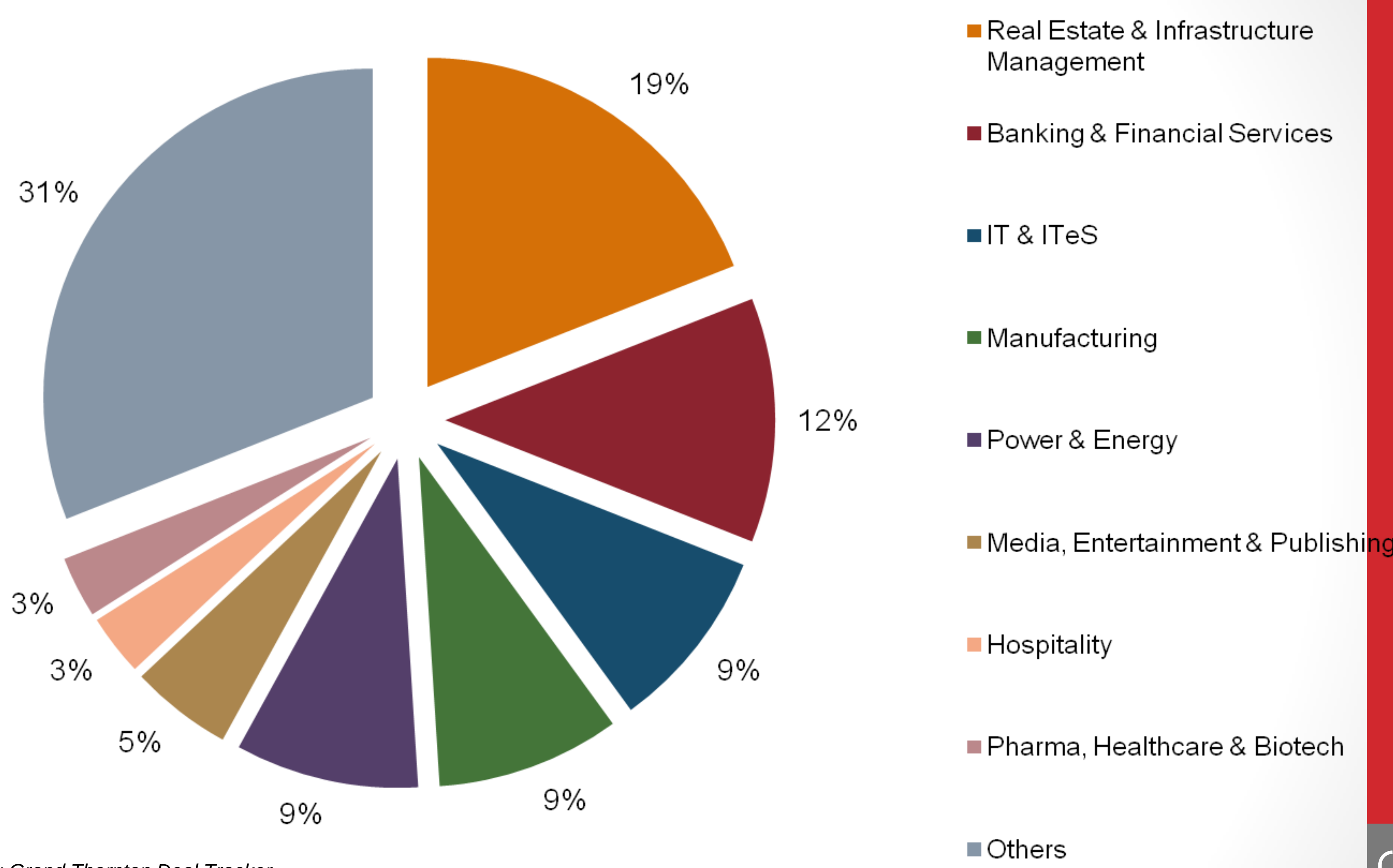
When is equity financing preferred?



Forms of Private Equity Funding

Stages of Business	**Ideas**	**Micro Business**	**SME's**	**Mid - Large Business**	**Mature Business**
Types of Private Equity Funds	Incubation Funds by Promoters	Family & Friends, "Angel" Investors & Venture Capitalist	Venture Capital, Private Equity & Mezzanine	Capital Markets / Private Equity	Capital Markets

Recent Trends in PE - Sectorial Breakup



Source: Grand Thornton Deal Tracker

Types

Angel Investor

Venture Capital

Private Equity

Angel Investor

- Provides ‘seed funding’
- Usually affluent individual providing capital for business start-ups
- Different from venture capitalists
- Limitation on amount of money that can be raised
- Bear high risk
- Require very high return
- Investment holding period of <5 years

Venture Capital

- Typically occurs after seed funding stage
- Subset of private equity
- Venture capital consists of investing in equity, quasi equity and/or conditional loan in order to promote unlisted, high risk or high tech firms driven by technically or professionally qualified entrepreneurs.
- The risk anticipated is very high
- Follow the concept of "high risk, high return"
- Year 2011 had been record year for early-stage Venture Capital investing
  - Deal values & volumes at all time high
  - Euphoria around e-commerce, across mobile, internet and related verticals
  - Evident from recent deals of InMobi, Fashionandyou, Snapdeal

Venture Capital

Sector

Majorly in emerging sectors

Early Stage

Funds start up & early expansion

Key Driver - Innovation

Highly skilled professionals, scientist & innovators with innovative business idea, new product & new technology

Investment & Exit

Upto $10 mn, exit through strategic sale or IPO

Success

High mortality rate & few great success

Private Equity

- Equity investments in relatively mature, primarily unlisted companies requiring growth capital
- An asset class that involves value enhancement and high returns generation by sharing business expertise of the Investor complementing the Entrepreneur
- Typical value additions from the PE Fund House could include Strategy Formulation Financial Formulation, Expertise and Global/Domestic Networks (including other investee companies)
- Offer greater opportunity to exercise control over investments as compared with other passive asset classes like equities, mutual fund, real estate, commodities, fixed income
  - Active involvement and influence on the company, including board seat
- Each investment is backed by an investment thesis which plays out over a period of 3 to 5 year

Growth Stage – Private Equity

Sector

All growth sectors

Growth Stage

Investor funds at growth stage of the company

Key Driver - Innovation

Capacity expansion, new products, new geography etc.

Investment & Exit

From $5 mn to $500 mn, exit through IPO

Success

Few failures & great success

Transactions (Illustrative)

QFI INDIA

OnMobile

karROX

Manipal
INSPIRED BY LIFE

NEO SPORTS

ims

JAIN
Jain Irrigation Systems Ltd.

Go

Café COFFEE DAY

MAX

PIPAVAV SHIPYARD

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Buyout Funds

- Globally most important strategy of PE; though not a very prevalent strategy in India
- Generally buyout's done at matured stage of business
- Mature companies with leading market position, active management team, strong cash-flow
- Taking a controlling stake in the company through leveraged buyout (LBO) or through management team alongside the PE fund (MBO)
- PE funds provide capital for expansion, promoters' / corporate divestures, succession issues…
- Development of a business plan over 4 to 6 years in order to add value
- Revenue growth + Margins improvement + deleveraging = added value

Transactions (Illustrative)

Company	Financial Investor	Value (US$ Mn)	Type
Flextronics Software Systems	Kohlberg Kravis Roberts & Co.	900	LBO
GE Capital International Services (GECIS)	General Atlantic Partners, Oak Hills	600	LBO
Phoenix Lamps	Actis Capital	29	MBO
Nilgiris Dairy Farm	Actis Capital	65	MBO
WNS Global Services	Warburg Pincus	40	MBO
Infomedia India	ICICI Venture	25	LBO
Nirula's	Navis Capital Partners	20	MBO
Gokaldas Export	Blackstone	165	MBO
Paras Pharmaceuticals	Actis Capital Sequoia Capital	N.A.	MBO

Sector focused funds

- Real estate funds
  - Focus on investments in real estate and real estate intensive businesses
- Infrastructure funds
  - Roadways
  - Port projects
  - Railway projects
  - Power projects
  - Telecom
  - Logistics

Key Differentiators

Particulars	Stage	Level of risk	Assessment Focus	Investment Size
Angel Investors	Very Early	Very High	Mostly Technology	< $ 1 Mn
Venture Capital	Early	High	Mostly technology	< $ 10 Mn
Private Equity	Growth	Moderate	Diversified	> $ 10 Mn
Buyout’s	Mature	Moderate	Diversified	> $ 50 Mn

General Process

	Preparation	Investor Identification	Term Sheet	Final negotiations and Closing	
Stage	**Preparation**	**Investor Identification**	**Term Sheet**	**Final negotiations and Closing**	
Timing	**3-4 weeks**	**3-5 weeks**	**4-6 weeks**	**4-6 weeks**	**Total Time** 14 – 21 weeks
Process	» Understanding and evaluating historical performance » Recast of Historical numbers; if needed » Preparation of IM and Projections » Industry Overview	» Identify target Investors » Share Information » Follow-ups	» Promoter Meetings » Plant visits » Negotiate valuations and other terms of the transaction	» Due Diligence » Definitive Agreements	» Pre & Post Closure formalities

Sign NDAs

Sign Term Sheet

Sign Definitive Agreements

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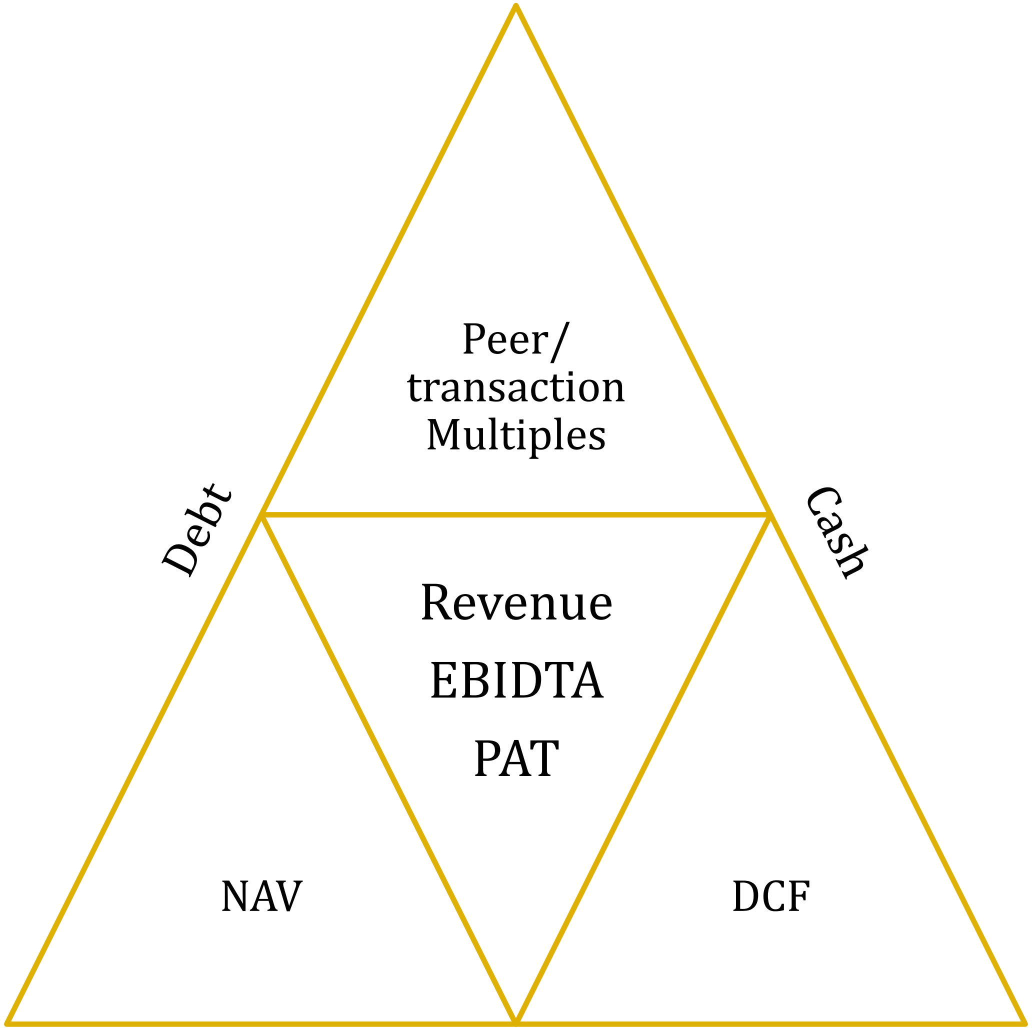
Valuations



Willing Buyer – Willing Seller

PE Terms: Valuation

Straight Valuation

- Puts a pre-investment fixed equity or enterprise value to the company
- Equity value usually as a multiple of earnings; Enterprise Value usually as a multiple of EBITDA
- Best in terms of alignment of incentives and simplicity
- Could lead to mismatch in valuation expectations, since many Promoters have unrealistic expectations of the future potential of their business

Earnings Convertible Structure

- Valuation to be calculated in the future as a multiple of earnings in a pre-determined future year
- Solves the problem of mismatch of future expectations between Investor and Promoter since valuation is future performance based
- Could potentially lead to temporary misalignment in incentives
- In some sectors, especially in young companies, accurately measuring earnings can be challenging leading to unnecessary friction

Other Return Sharing Structures

- Several creative solutions depending on the needs of the Promoter and Investor

- Earning /Peer comparison/Market Multiples
- Comparable Transactions
- Discounted Cash Flow
- Weighted average of all other methods

PE Investment: What is the Goal of Terms?

- **Acquiring Value**
  - Getting in at the right valuation
  - Ensuring rigourous understanding of the business, risks and rewards
  - Avoiding legal liabilities, misinformation etc
- **Protecting Value**
  - Robust governance to prevent fraud and mismanagement
  - Ability to prevent destruction of investment value through inappropriate changes in capital structure, ownership structure etc.
- **Creating Value**
  - Management rights needed to act as partners with management and aid strategy and growth
- **Exiting with Value**
  - Exit rights needed to ensure that Investor gets market value of investment

PE Investment: The Context

PE funds invest capital sourced from others

- PE funds are generally in the form of unconditional commitments from individuals and institutions
- These investors put their trust in the fund manager's commitment to protecting their interests

PE funds are usually minority investors

- Need to promote value addition initiatives
- Need to safeguard in corporate governance

PE funds are long term sources of capital but with finite horizon

- PE funds need to return capital in four to eight years
- Therefore mechanisms are needed to ensure effective return of capital

Structures and Instruments

Primary Investment

- Involves fresh infusion of capital in the company against issue of fresh shares to augment future growth
- Ideal for growth companies

Secondary Investment

- Involves payment to existing shareholders of the company
- Could be either on account of buying out or providing some liquidity to existing shareholders
- Ideal when promoters wants to cash out (fully or partially) or buyouts

Structures and Instruments

- Private Equity Investment
  - Primary Investment
    - Direct Equity
    - Convertible Preference Shares / Debentures
    - Warrants / Options
  - Secondary Investment
    - Equity Purchase

Exit Options

- **Three important pillars**
  - **Valuations**
  - **Timings**
  - **Restrictions, if any to exit**
  - **Modes of exit**
  - **Initial Public Offering (IPO)**
  - **Exit via M&A**
  - **Sale to another investor**
  - **Secondary sale on stock markets**
  - **Buy Back / Call / Put Option**

Advantages

Fills funding gaps for long term capital

No interest cost. Seeks return through capital appreciation rather than immediate and regular interest payments

Adds value because, apart from funding, PE contribution includes:

- Financing expertise and strategic management support
- Networking and Global Integration
- Confidential as compared to IPO or even debt funding
- Independence of the capital markets volatility

Positive signaling effects to the market:

- Debt, IPO
- M&A
- Employees, Suppliers and Customers
- Increases Industry Visibility

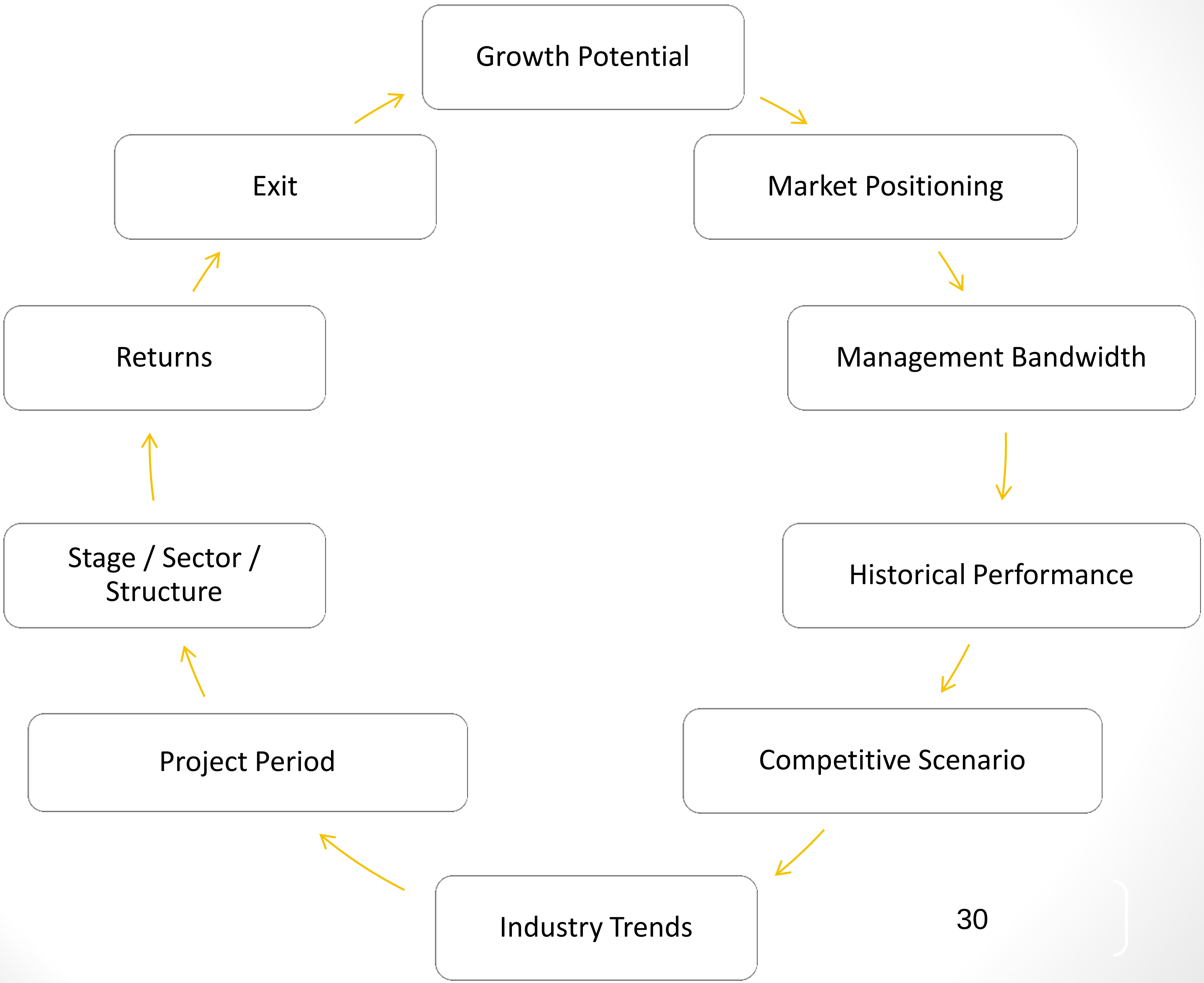
Relatively less expensive fund raising exercise in comparison to IPO

Corporate Governance

Disadvantages

- Raising Private Equity finance is demanding, time consuming; at times the business may suffer if promoter devotes more time for the transaction
- Depending on the investor, promoters may lose a certain amount of power to make management decisions
- Will have to invest management time to provide regular information for the investor to monitor
- Might create conflict or differing opinion in long-term strategy due to pressures of EXIT from the investor
- The cost of complying with regulations could be relatively higher
- Non-alignment of Interest of fund manager on the board and entrepreneur could hamper the growth of company

Important factors for consideration



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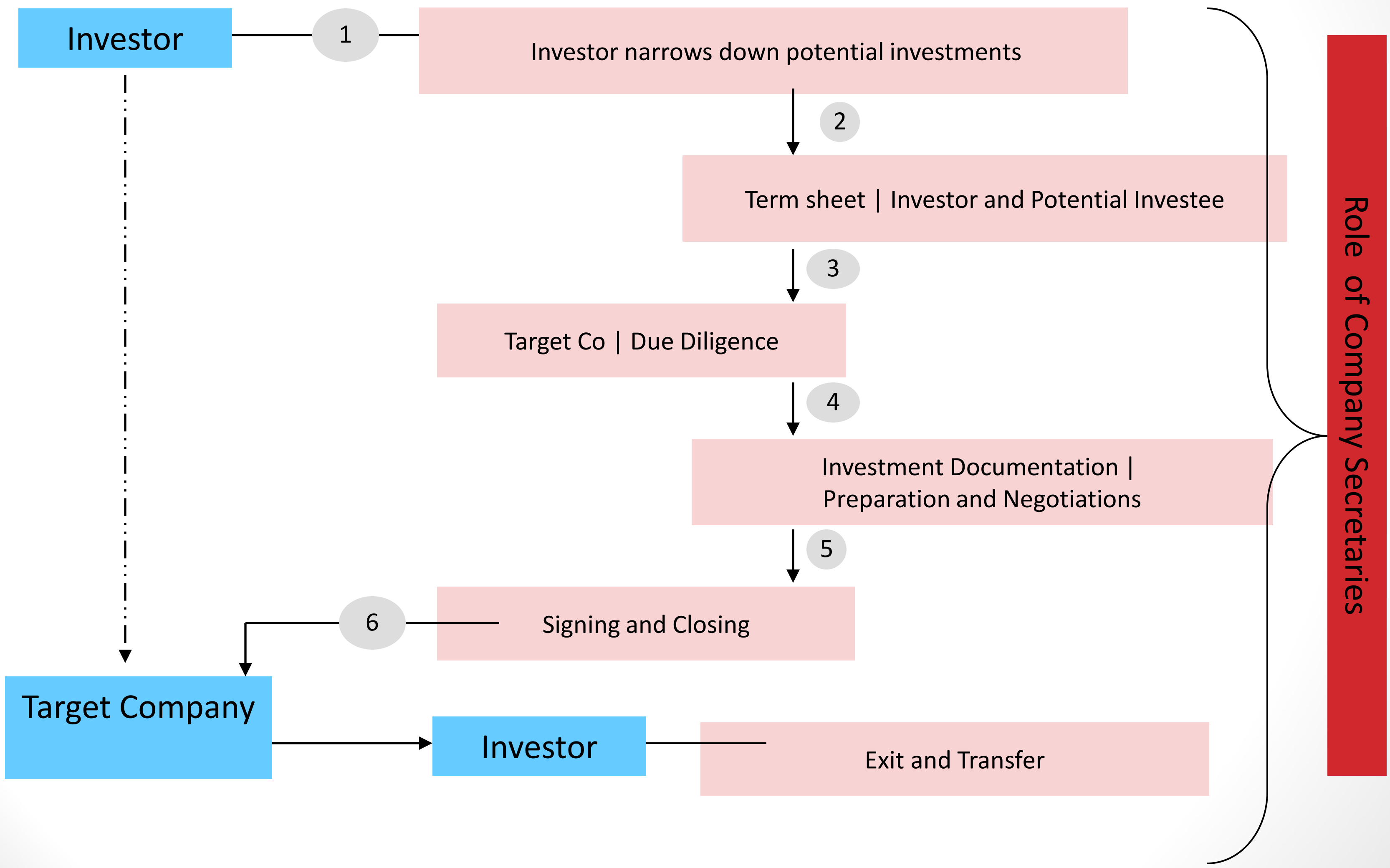

Investor
1
Investor narrows down potential investments
2
Term sheet | Investor and Potential Investee
3
Target Co | Due Diligence
4
Investment Documentation | Preparation and Negotiations
5
Signing and Closing
6
Target Company
Investor
Exit and Transfer
Role of Company Secretaries

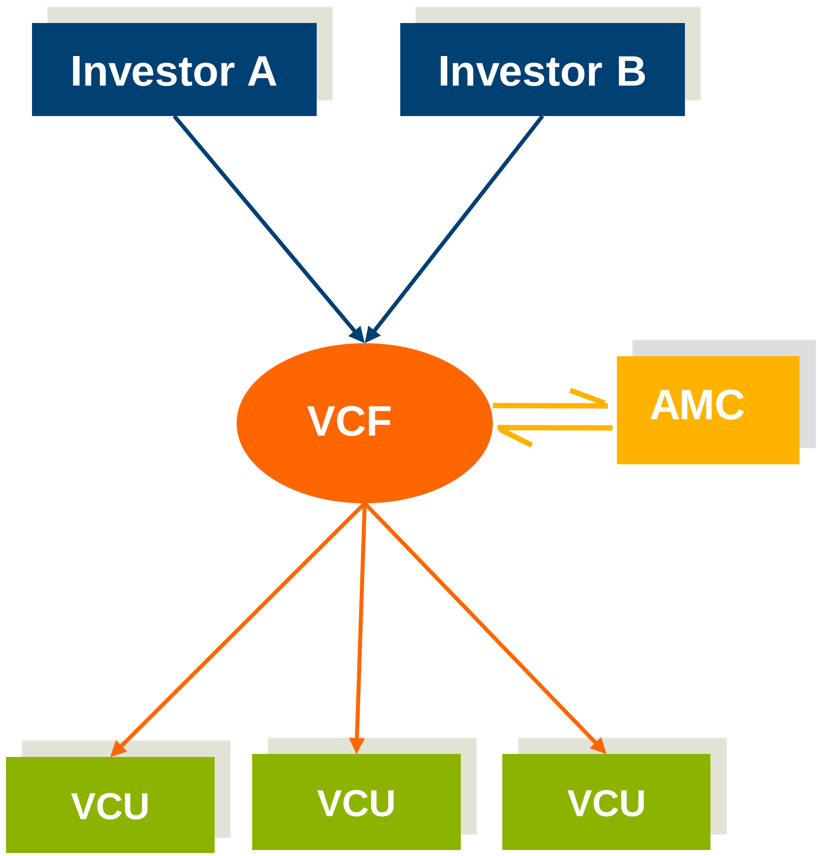
Foreign Venture capital Investor

OVERVIEW OF VENTURE CAPITAL FUND (VCF)

- VCF is a pooled investment vehicle that invests in
  - Immature;
  - High-potential; and
  - Hugely risky projects

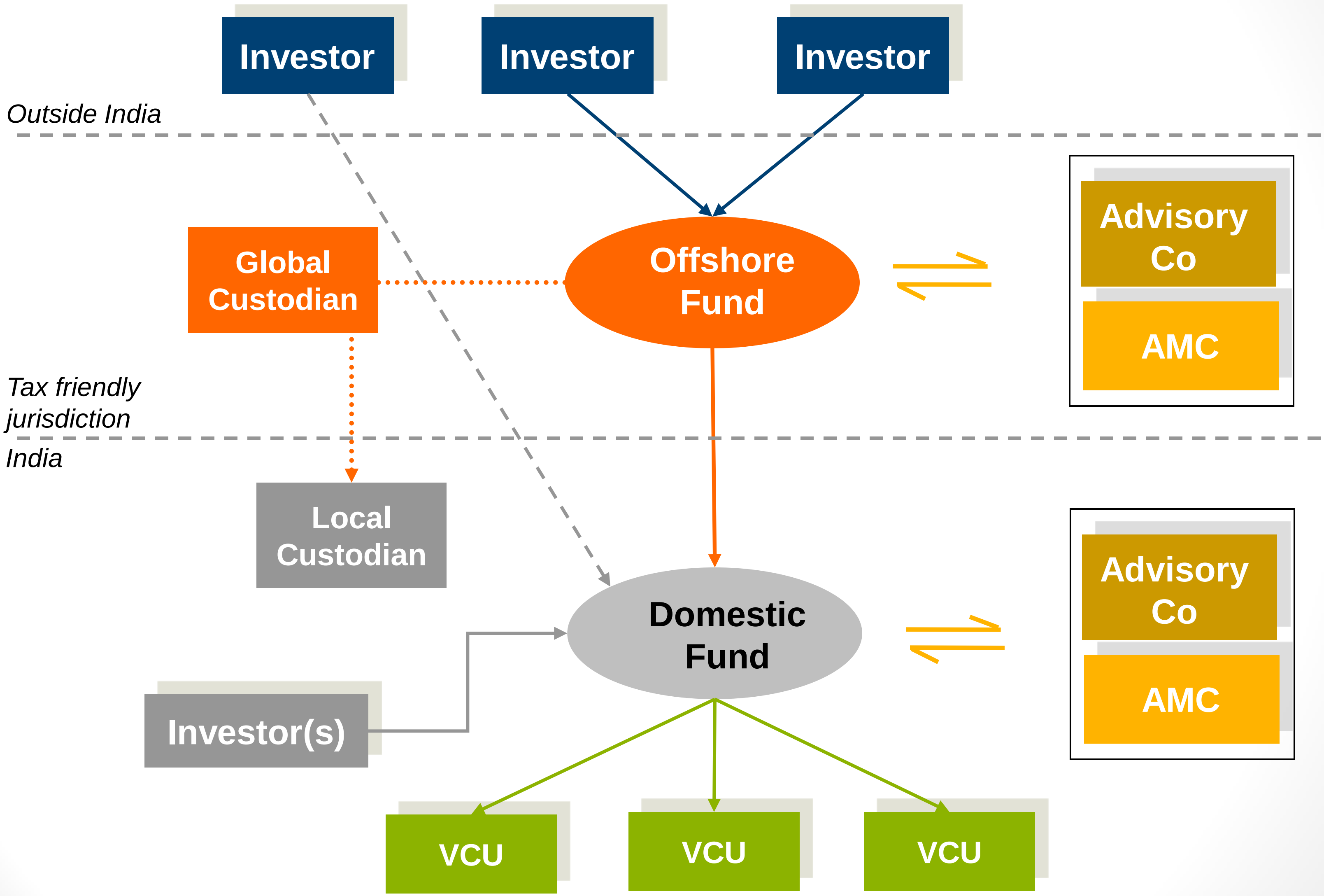
- Investors in VCF include high net worth individuals, insurance companies, pension funds, banks etc
- VCF is a vehicle to channelize investments in unlisted venture capital undertakings (VCUs) having potential for huge return on investments
- Major sectors attracting investments from VCFs include IT-ITES, healthcare, life science and manufacturing

FUND STRUCTURE

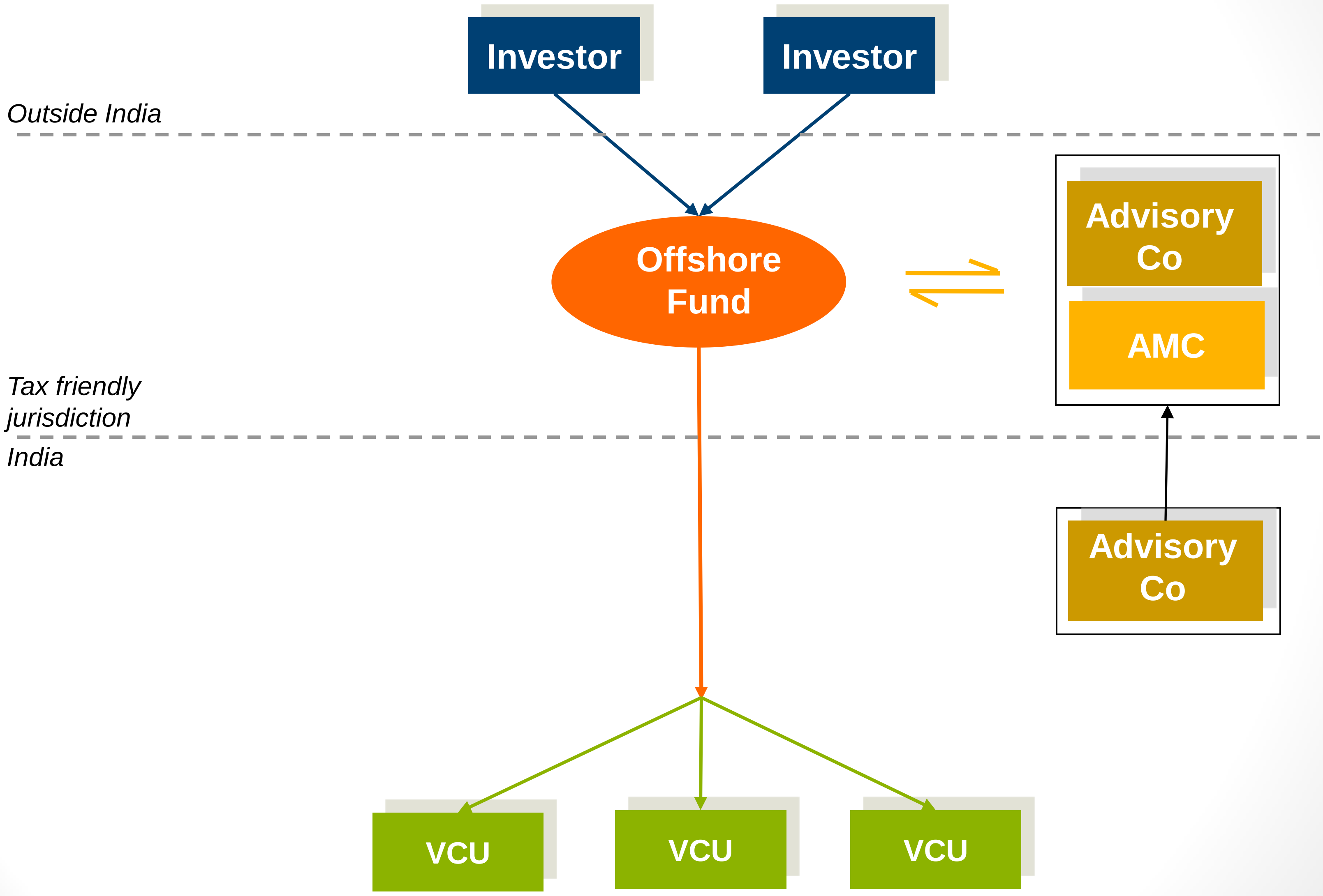


- Investors pool their funds in a VCF
- Investments by VCF are managed by an asset management company (AMC) for a fee
- VCFs invest in capital of unlisted VCUs
- Thus, key elements in a VCF structure are:
  - Investors
  - Fund / VCF
  - AMC
  - VCUs

A TYPICAL FUND STRUCTURE



PURE OFFSHORE FUND STRUCTURE



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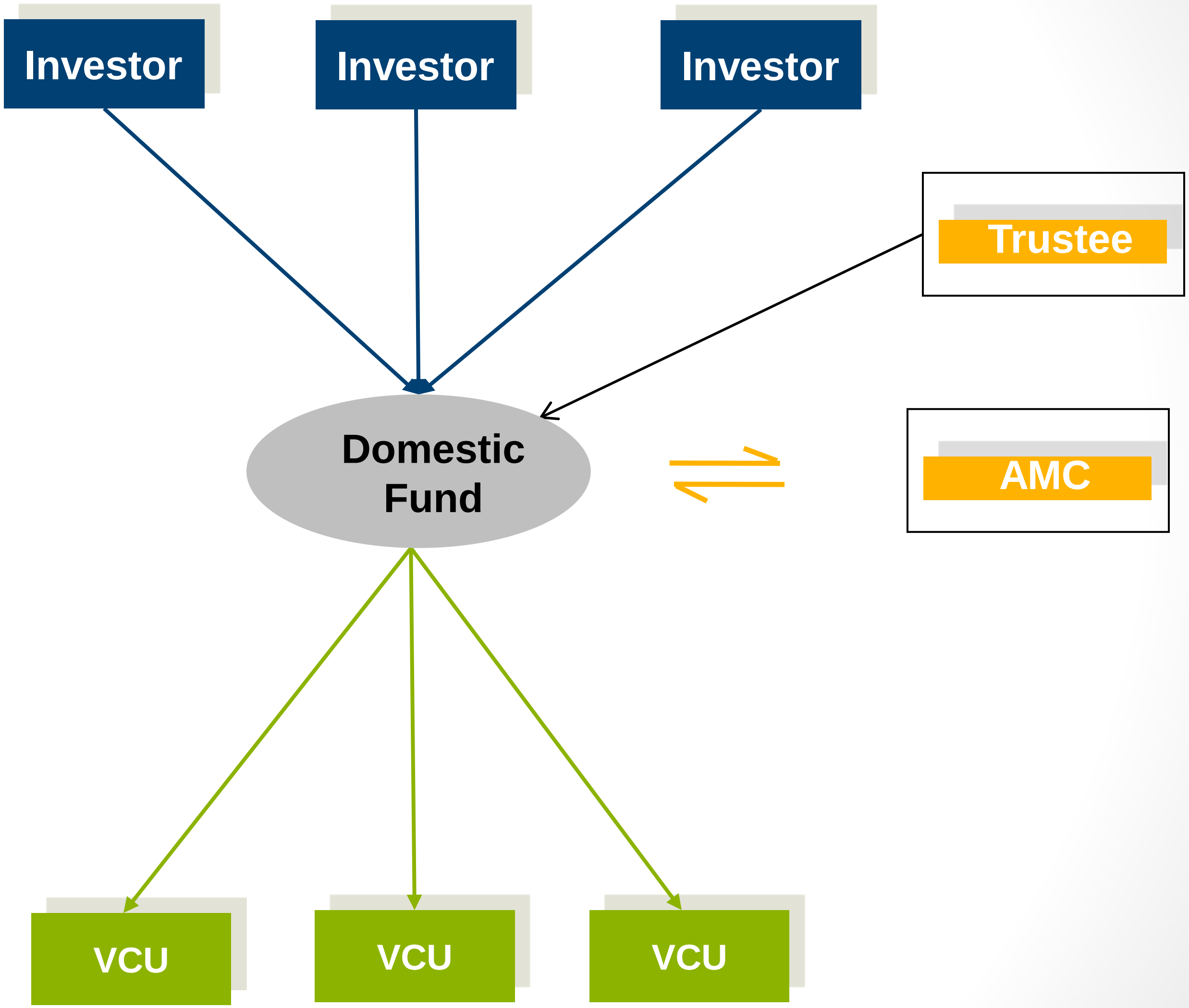
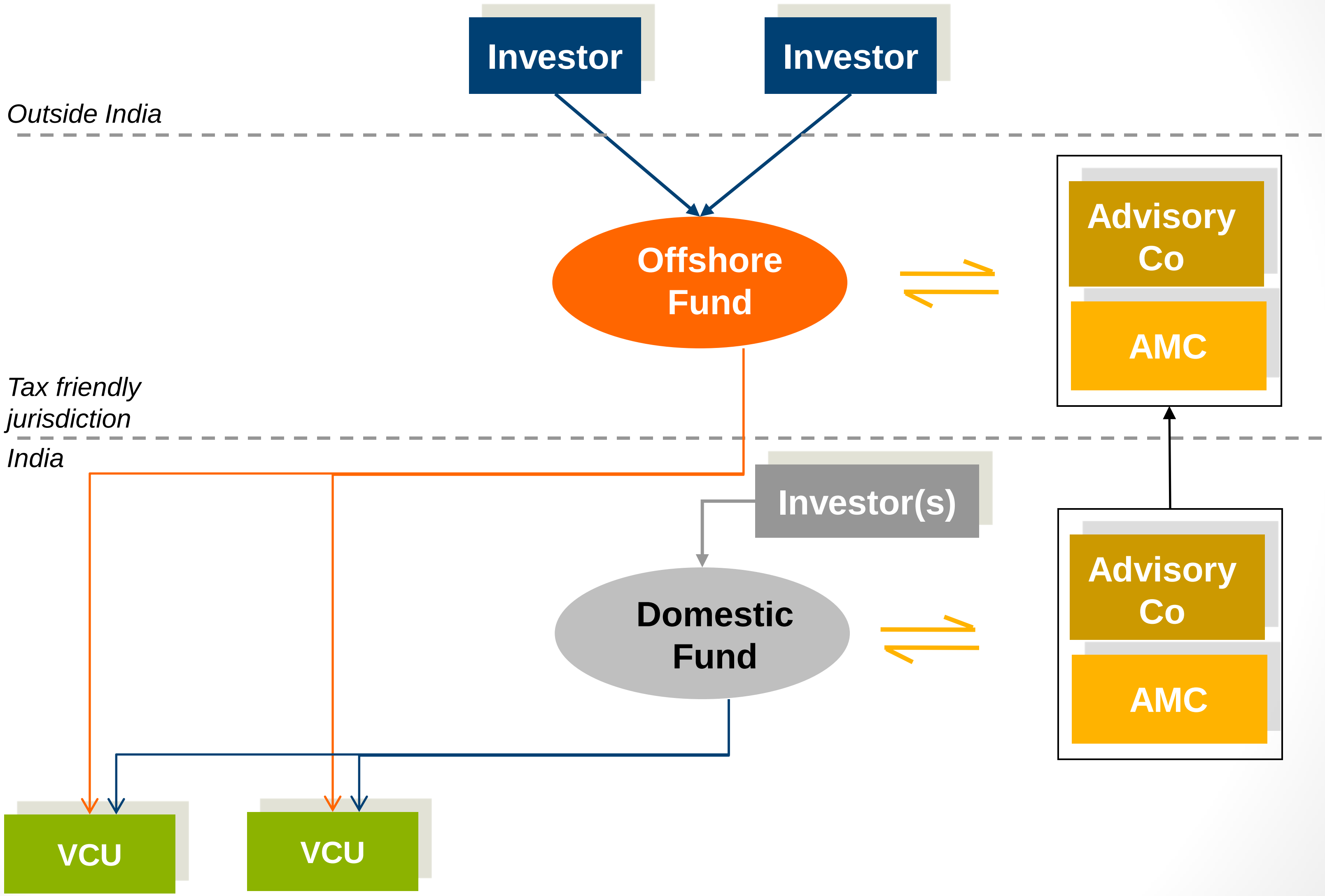
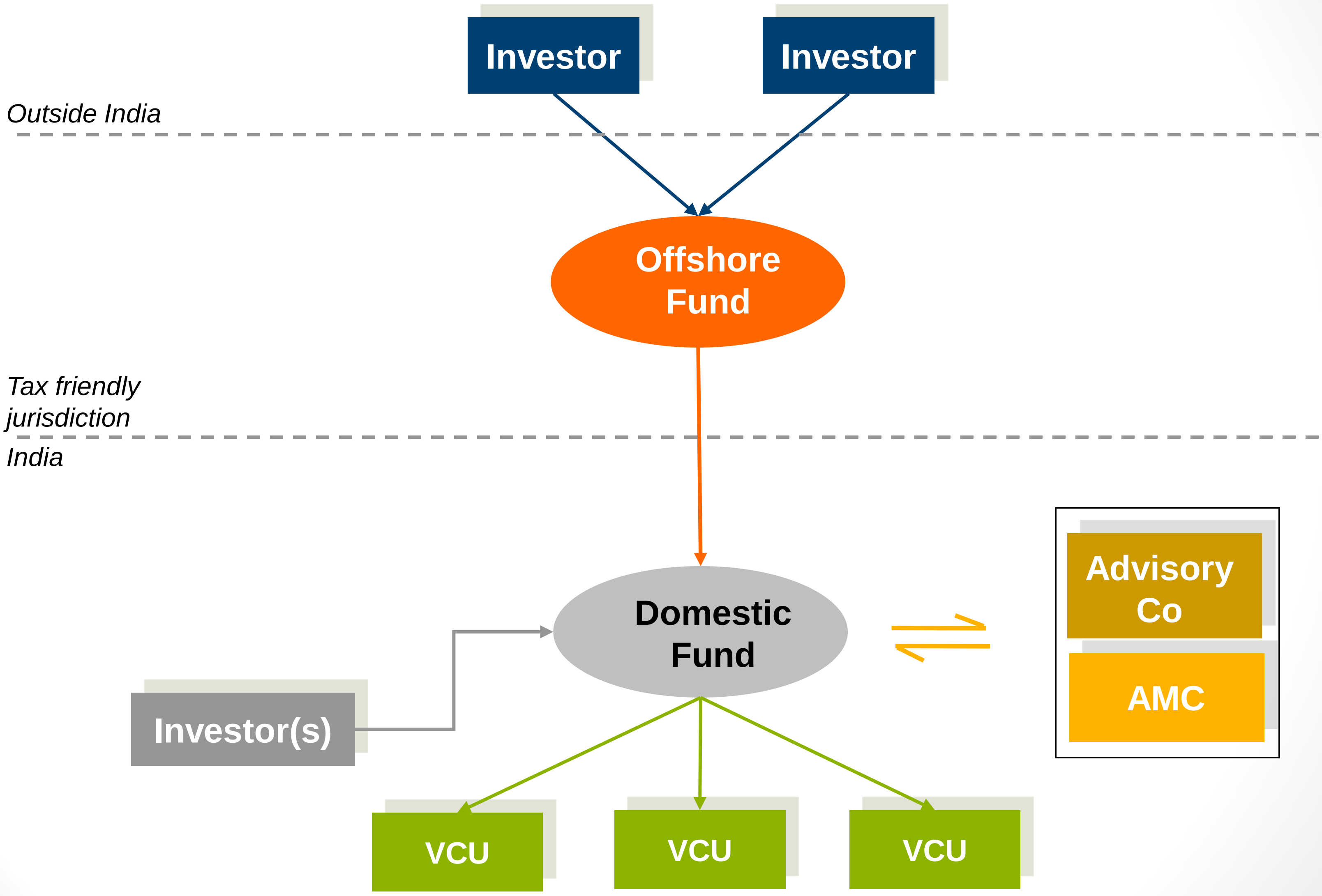
PURE ONSHORE FUND STRUCTURE



CO-INVESTMENT FUND STRUCTURE



CO-MINGLED FUND STRUCTURE

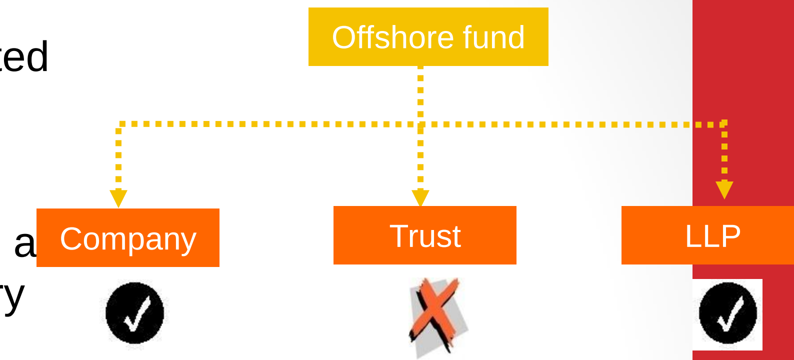


CHOICE OF ENTITY STRUCTURE

- A fund can be set up either as a company, limited liability partnership (LLP) or a trust

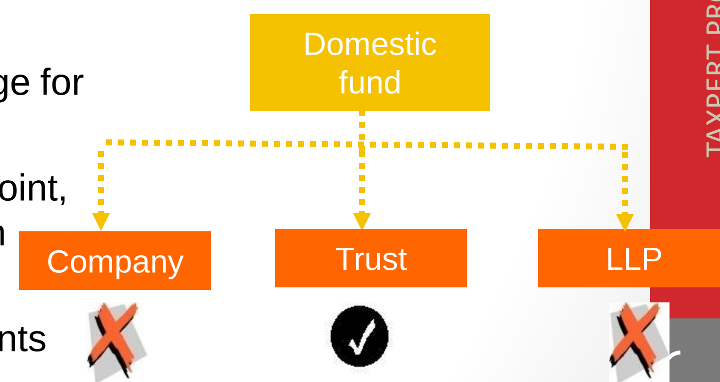
Entity structure for offshore fund

- In practice, offshore fund is generally set up as a company or a LLP for distinct tax and regulatory reasons



Entity structure for domestic fund

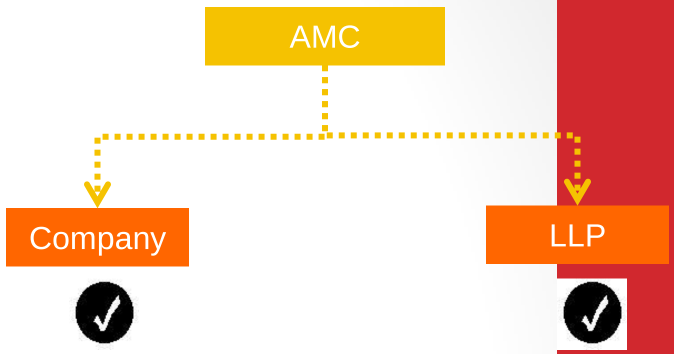
- A domestic fund is typically established as a trust due to the following reasons:
  - Trust may be tax efficient entity structure in certain cases, if the beneficiaries are non-residents
  - A trust structure provides more flexibility at exit stage for investors
  - From a pure administrative and compliance standpoint, trust could be more efficient entity structure than an incorporated company
  - FDI is not permitted in an LLP for making investments



CHOICE OF ENTITY STRUCTURE

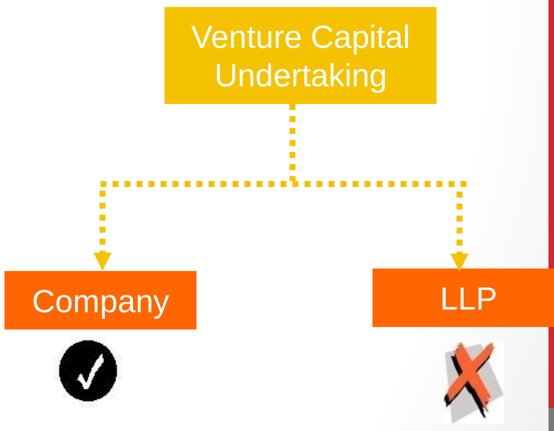
Entity structure for AMC

- AMC can be set up either as a company or an LLP
- Given that LLP is a recent concept in India, not many AMCs are set up as LLPs; however from tax and regulatory perspective, LLP form seems better suited for AMCs



Entity structure for VCUs

- A VCU can be only be a domestic company in India satisfying the following conditions:
  - The company's shares should not be listed on a recognized stock exchange in India
  - The company should be engaged in providing services, production or manufacture of article or things
  - The company should not be engaged in such activities or sectors which are specified in the negative list issued by SEBI
- An LLP is not selected as a VCU since a registered VCF as well FVCI are not permitted to invest in an LLP



REGULATORY FRAMEWORK

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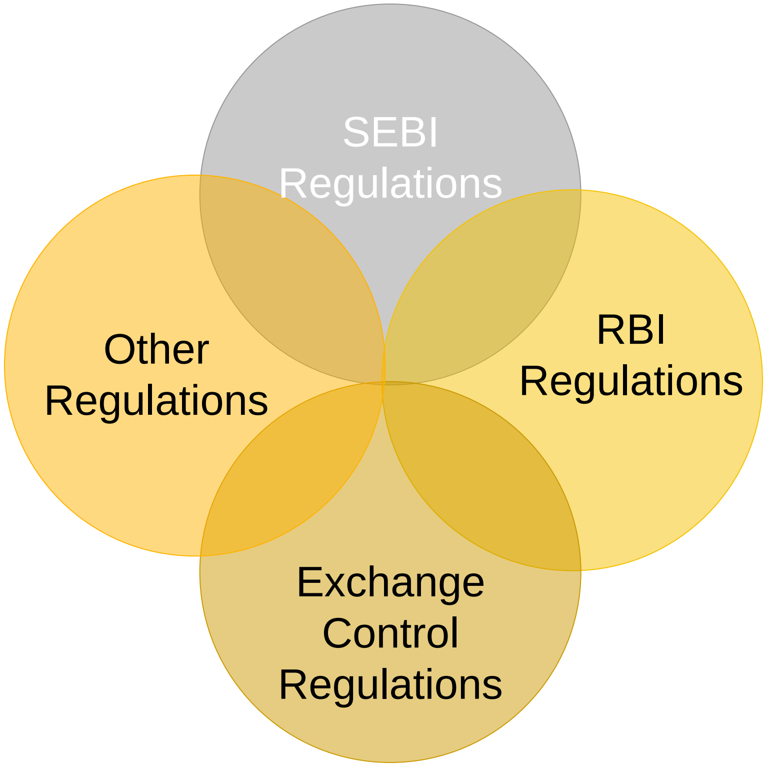
- Key regulations governing setting up and operation of VCF in India are:



SEBI REGULATIONS

- Securities and Exchange Board of India (SEBI) has issued separate regulations for an offshore and domestic VCF:
  - SEBI (Venture capital Funds) Regulations, 1996
  - SEBI (Foreign Venture Capital Investors) Regulations, 2000
- The regulations define VCF and VCUs as follows:

VCF

A fund established in the form of a **trust** or a **company** including a body corporate and registered with the SEBI and

- has a dedicated pool of capital
- raised in a manner specified
- make investments in accordance with the regulations

VCU

A domestic **unlisted company** engaged in the business of providing services, production or manufacture of article or things

VCU should not be carrying on activities or be engaged in sectors specified in SEBI negative list

SEBI REGULATIONS

Imperatives	Domestic Venture Capital Fund (DVCF)	Foreign Venture Capital Investor (FVCI)
Eligible applicant	Any company, trust or a body corporate (LLP) incorporated in India	Investment company / trust / partnership / AMC/ pension fund / mutual fund / endowment fund / university fund / charitable institution or other entity incorporated outside India
Other eligibility criteria	• MoA / trust deed should have activity of a VCF as its main objective • Company / trust should not make an invitation to the public to subscribe to its securities • Director / trustee / employee of the company / trust should: ▪ be fit and proper person ▪ not be involved in any litigation connected with the securities market ▪ not have at any time been convicted of any offence involving moral turpitude or any economic offence	• The applicant should satisfy following conditions: ▪ Should be regulated by an appropriate foreign regulatory authority or an income tax payer ▪ Prior approval of the Reserve Bank of India (RBI) through SEBI for making investment in India required – single window clearance ▪ Should be authorized to invest in VCF or carry on activity as FVCI ▪ Track record, professional competence, financial soundness ▪ Should be fit and proper person and should not have been refused a certificate by SEBI

The life of the DVCF / FVCI should be limited and should be specified in the application for registration made to SEBI

SEBI REGULATIONS

Imperatives	Domestic Venture Capital Fund (DVCF)	Foreign Venture Capital Investor (FVCI)
Investment conditions and restrictions	• Not to invest more than 25% of the corpus in a single VCU • Should not invest in associate companies • May invest in securities of foreign companies on compliance with condition prescribed by RBI / SEBI • Disclosure of its investment strategy to the board • Disclosure of the duration of life-cycle of the fund	• It can invest its total funds in one DVCF • Disclosure of its investment strategy to the board • Disclosure of the duration of life-cycle of the fund • Other investment conditions are similar to that specified for DVCF
Pattern of investments	• At least two- third of the total investible funds should be invested in unlisted equity shares or equity linked instruments of VCUs • The balance may be invested in the following manner: ▪ Subscriptions to IPO of VCUs whose shares are proposed to be listed ▪ Preferential allotment of equity shares of a listed company (subject to a lock in period of one year) ▪ Equity shares or equity linked instruments of listed financially weak companies or sick industrial companies ▪ Debt / Debt instruments to be issued by VCUs in which equity shares are already held	

The limits specified with regard to the pattern of investments have to be complied with during the life of the fund

SEBI REGULATIONS

Imperatives	Domestic Venture Capital Fund (DVCF)	Foreign Venture Capital Investor (FVCI)
Source of funds	• DVCF may raise monies from any investor by way of issue of units • Minimum investment from any investor - Rs 5 lakhs • Each scheme / fund shall have minimum commitment of Rs 5 crores from the investors	• Minimum commitment of USD 1 million from the investors at the time of making the application for registration
General obligations and responsibilities	• Maintenance of proper books of account, records, etc – for 8 years • Submission of reports to SEBI • Reporting of the venture capital activity	• Appointing domestic custodian for the purpose of custody of securities • Appointing designated bank for opening bank accounts • Maintenance of proper books of account, records, etc - for 8 years • Submission of reports to SEBI • Reporting of the venture capital activity in the prescribed form

RBI REGULATIONS

RBI registration for VCF

- No requirement of an RBI registration - requirement of RBI registration for a VCF has been dispensed with in case of a SEBI registered VCF*
- However, in case of an unregistered fund organised as a company, requirement for RBI registration as NBFCs / CICs

RBI approval for FVCI

- Conditions for SEBI registration for FVCI requires a prior **RBI approval** for making investments in India
- Before granting approval to FVCI, the RBI may require the applicant to make adequate representations / submit necessary details of the proposed activities in India
- Recent trends - RBI has been granting approvals with sector restrictions for FVCI to invest in

**(Notification No. 163 / CGM(CSM) – 2002 dated November 28, 2002)*

EXCHANGE CONTROL REGULATIONS

- Foreign investment in domestic VCF is subject to Indian exchange control regulations and Foreign Direct Investment (FDI) policy

- The relevant regulations are as following:

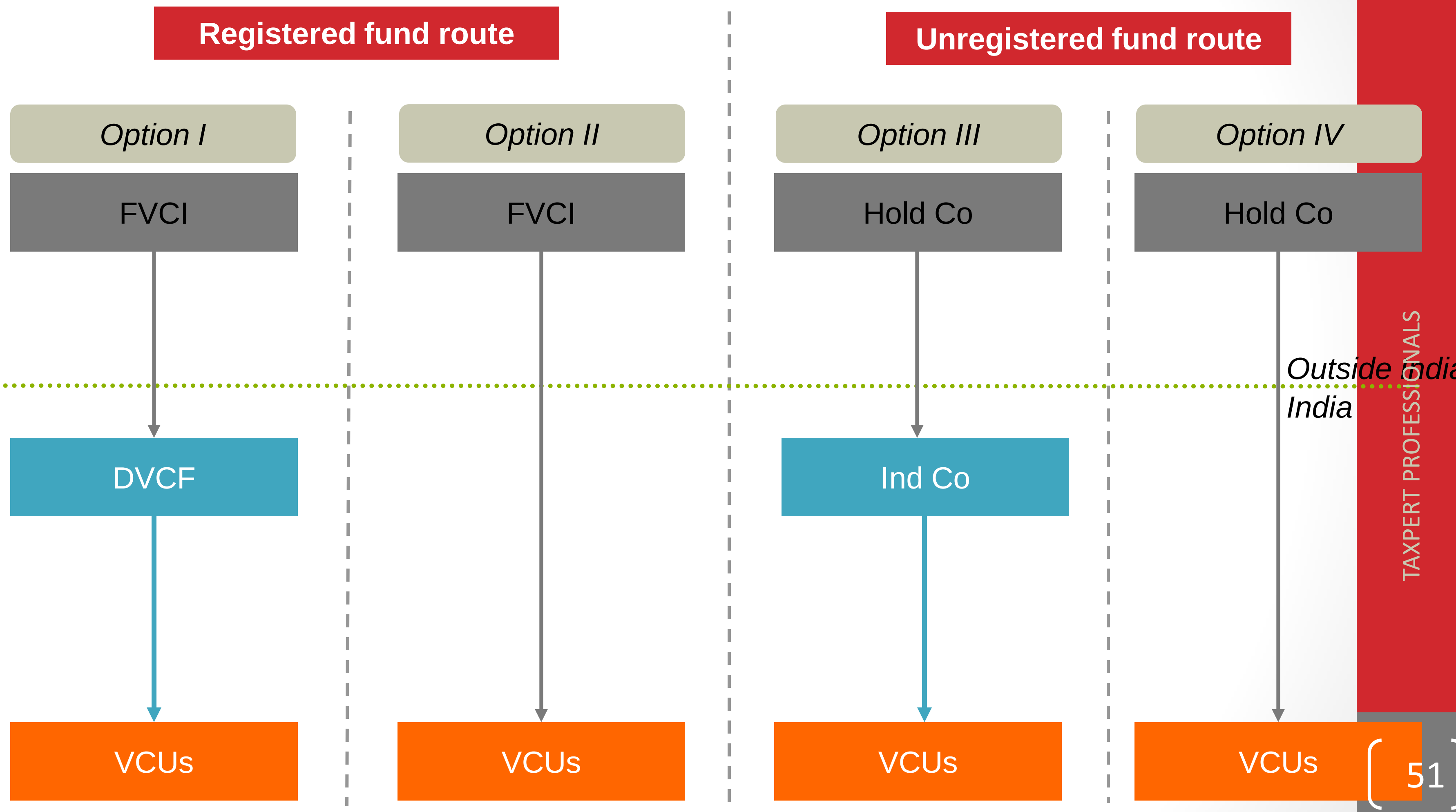
FDI in registered DVCF

- A SEBI registered FVCI is permitted to make investment in a domestic VCF subject to FEMA regulations and applicable FDI policy
- Foreign investment in domestic VCF set-up as a trust from sources other than a SEBI registered FVCI requires **prior approval of Foreign Exchange promotion Board (FIPB)**
- Foreign investment in domestic VCF set-up as a company from sources other than a SEBI registered FVCI can be made under the automatic route of FDI scheme subject to the pricing guidelines, reporting requirements, mode of payment, minimum capitalization norms etc

EXCHANGE CONTROL REGULATIONS

- Investments by VCF (which has received foreign investment) / FVCI in VCUs shall be subject to sectoral caps as prescribed by the DIPP
- Pricing guidelines prescribed under regulations for purchase / sale of shares, debentures and units do not apply to SEBI registered FVCI if investments are implemented in accordance with the RBI approval – FVCI can thus purchase /sale shares at a price mutually acceptable to the buyer and the seller

EXCHANGE CONTROL REGULATIONS



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EXCHANGE CONTROL REGULATIONS

Imperatives	FVCI – DVCF	FVCI – VCUs	Hold Co – Ind Co	Hold Co – VCUs
Investment Route	Automatic(?)	Automatic	Automatic	Automatic / Approval
Sectoral cap on downstream investments	Applicable	Applicable	Applicable	Applicable
Pricing guidelines	Not applicable	Not applicable	Applicable	Applicable
NBFC Regulations	Not applicable	Not applicable	Applicable	Not applicable
Minimum Capitalization	Not applicable	Not applicable	Applicable	Not applicable

OTHER REGULATIONS

- Provisions of the following Acts /laws shall apply as appropriate:
  - Companies Act, 1956
  - Indian Trust Act, 1882
  - Indian Stamp Act, 1899
- Key benefits of registering as a DVCF / FVCI
  - A SEBI-registered DVCF / FVCI, will not be subject to the one year lock-in period
  - The income of these funds is exempt under section 10(23FB) of the Income-tax Act, 1961 subject to fulfillment of the conditions prescribed therein
  - These funds also qualify as 'Qualified Institutional Buyers' which entitle them to subscribe to the securities of the VCU at the time of the IPO of the VCU

Thanks

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