Private Equity – An Introduction

Raising equity for companies via private equity (PE) route has been one of the most important aspects of the investment banking services after mergers and acquisitions. Individuals, aristocrats, syndicates and merchant banks have been providing a form of PE for centuries. Professional private equity investing dates back to 1946, to the launch of American Research and Development Corporation, a $4 million fund that pooled individual and institutional money to invest in private companies.

PE is a major component of the alternative investments universe and is an established asset class within many institutional portfolios. In India, sums committed to private equity funds have increased dramatically over the last ten-twelve years.

Private Equity is a form of investment in equity capital of a company that is not quoted on a public exchange. *Obtaining PE 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 your success or failure.*

PE is All About Capital and More Than Just Capital

Two important features of private equity investing include —

It's All About Capital…

Private equity investing means putting capital into a business to expand, develop new products or fund changes to ownership and management. Private equity investors do more than buy the rights to share in a company's return – they provide working capital.

…And More Than Just Capital

PE investors generally provide their capital in exchange for a sizeable stake in the business. They also invest their expertise – in management, finance, marketing, strategic direction and networks. By exercising some control through board seats and management agreements, PE investors can protect and grow their investments. This alignment of interests and the ability to add value to the business often means that PE investors can generate higher returns than those available from traditional 'hands-off' equity investing.

Need For Private Equity Investments

There are several reasons as to why a company looks for PE investment, but the two key reasons could include:

- **Value Enhancement:** The Company has grown by itself so much that it requires a fresh injection of funds from outside (i.e. other than promoters) to grow further and reach higher economies of scale.
- **Value Unlocking:** The management has plans to go public at some later stage (say after 5-7 years). Bringing the PE investment is considered one of the best ways for companies to go public.

Venture capital and private equity investments play an instrumental role in making the companies a success story. Examples include such investments in companies like:

Private Equity Process

Private equity firms are always on hunt for the right opportunities to park their funds. Similarly, entities looking for equity capital look for PE firms to source the funds. A company, looking for PE, can either directly approach a PE firm or can approach via investment banks. Similarly a PE entity can either directly approach a company looking for PE funding or can source those target companies through investment banks. Irrespective of the fact that the company is approaching PE directly or indirectly, PE firms follow a procedure for making an investment, which may vary from PE firm to PE firm. However, some common steps are outlined below:

(1) Scouting Investment Opportunities (Deal Sourcing)

Scouting investment opportunities or deal sourcing or as some call it deal origination is how a PE firm gets deals – a potential deal can either come through a company owner approaching directly to PE firm or from an intermediary (Investment Banker) who will try to bring both the parties (Company and Deal Maker) to close the deal. In some cases, PE firms may just approach companies who are expanding fast and wish to grow further.

(2) Preliminary Investment Analysis

Preliminary investment analysis includes assessing if the target company meets the investment parameters like funding size, profit margins, growth aspects, and IRR etc. The PE firms sign non-disclosure agreement (NDA) with the company/investment bank; post that information memorandum is shared with PE firm. Meetings with top management (CFO, MD, promoters etc.), and plant/factory visits etc. are done to complete the preliminary analysis.

(3) Investment Committee Approval & Term Sheet

The PE analyst presents the case to the internal investment committee for its approval. Investment committee consists of the senior management team of the PE firm, which takes the final decision on investments. A term sheet is prepared giving the tentative terms and conditions as to % stake to be acquired, amount to be invested, decision on board seat, etc.; and is presented to the target company for its approval. The term sheet may be revised after, if any, the concerns are raised by the target company.

(4) Due Diligence

Due Diligence is like 'doing the homework'. Before starting detailed negotiations, PE players try to make sure everything is fair and square. Auditors and Consultants are appointed to conduct the Financial, Tax, Legal and Technical Due Diligence. All the information collected at this time, is then used during negotiation.

After the completion of due diligence, case is presented to the investment committee of PE firm for the final investment approval.

(5) Deal Negotiation & Structuring

With the inputs from diligence report, the deal may be renegotiated between the two parties with respect to investment amount and percentage stake to be acquired. Deal structuring includes as to what type of securities will be issued – equity shares, convertible preference shares, convertible debentures etc.

(6) Deal Closure

Deal closing is the conclusion of the deal, the signing of all Agreements (Investment Agreement, Share Purchase Agreement, Management Agreement, and Advisory Agreement etc.) and transferring funds to the company, conducting other administrative functions (usually done by a separate entity) like updating any articles of association, etc.

(7) Post Acquisition Monitoring

Post Acquisition Monitoring requires the Deal Team (those who have worked on putting the deal together) to closely monitor the company, both from an operational and financial point of view against the expansion plan and budgets that were setup earlier by the company. Improvements to business, from Corporate Governance, Financial Reporting, and Information Flow to Strategy are made at each level through either the company's management or its board.

(8) Exit

As the company matures (usually after 4–5 years) with the presence of the Deal Team, PE players prepare for an Exit from the company. There are different exit routes, and normally an exit route is decided at the time of making the deal.

- Selling Shares back to the management
- Selling shares to another investor (e.g. another PE firm)
- A trade sale (the sale of a company shares to another company)
- Exit via listing of private company (IPO)

Investment bankers play a key role in raising private equity funding for the companies. It is the investment bankers who do the valuations of the target company, assist the target companies in deal negotiations and structuring, due diligence etc.