Transaction Life Cycle in Private Equity

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Overview: Private Equity

Private Equity in India – Recent trends

- PE investments increased to \$10.5 billion across 660 deals in 2013, versus \$9.5 billion across 754 deals in 2012. In 2014 YTD, we have already seen 411 deals aggregating to \$7.5 billion
- IPO offerings witnessed its lowest fund raise in last twelve years of only \$260 million which is significantly lower compared to PE fund raise for the same period . Only three companies were able to raise 2/3rd of the total IPO money raised
- PE funds made some of their largest investments in 2013 in sectors such as Outsourcing, E- Commerce, Healthcare, etc
- PE exits through IPO took a beating but there were exits through strategic sale and secondaries
- In 2013, PE fund raising for India was also cautious with most of the LPs taking a cautious view and insisting their GPs to show them good exits before committing money to their new funds
- PE fund raising 80% of PE investments is through FDI route and balance is mainly through HNI's as regards domestic fund raise
- Early stage and VC funding has significantly increased to \$1.04 billion over 401 deals in 2013 as compared to \$777 million (390 deals) in 2012. In 2014 YTD, we had 214 deals aggregating \$675 million
- Increasing share of PE buyouts from 8% of total pie in 2012 to 20% in 2013

Private Equity in India - Beyond 2013

- Importance of PE as an asset class and understanding of Private Equity importance and terms amongst promoters to get sophisticated
- Some important consumption driven and defensive sectors such as e-commerce, food and Agri, healthcare to continue to garner interest
- Certain other neglected sectors such as infrastructure and ancillaries, financial services, auto, logistics and niche warehousing, etc to get interest from PE investors with important steps taken by the new government in these sectors and revival of growth cycle
- Allocation of Rs 10,000 crore by government in the recent budget and new rules by SEBI on crowd funding to give boost to attraction of Private Equity as an asset class amongst domestic investors in India
- Private equity funds will increase the focus on due diligence and in many cases use it as a document to carry out a 100 day plan post acquiring stakes in companies which increases the need to carry out vendor due diligence before raising PE funds
- Out of approximately $90 billion of PE money invested so far, only one third has been returned so far. The pressure on exits by PE funds

Various Types of Risk Capital

Types of Risk Capital

Angel:

- Funding sourced through established angel networks
- Post establishment of basic idea and market sensing, funding for proof of concept
- Typically structured as straight equity, investment is high risk – high reward

Venture Capital:

- Funding to enable institutionalization and establishment of processes and systems, first phase of scaling up
- Usually structured as convertible with minimum requirements on IRR

Private Equity:

- Funding for investments to scale up
- Structured as equity through negotiated valuation, clear delineation of rights, controls etc
- Funding through debt could also be an option in case of asset backing

Funding Options & Size

All figures in INR	Duration	Fund Size	Typical Commitment
Friends and family	Up to 1 year	NA	< 25 lacs
Angel	6 months – 2 years	> 10 cr	< 5 cr
Venture Capital	2 - 4 years	< 500 cr	10 – 25 cr
Private Equity	4 – 10 years	> 500 cr	> 50 cr
Strategic Partner	NA	NA	NA
IPO	NA	NA	> 100 cr
Secondary Issue	NA	NA	NA

Source: Funding for start ups, Signal Hill Capital research

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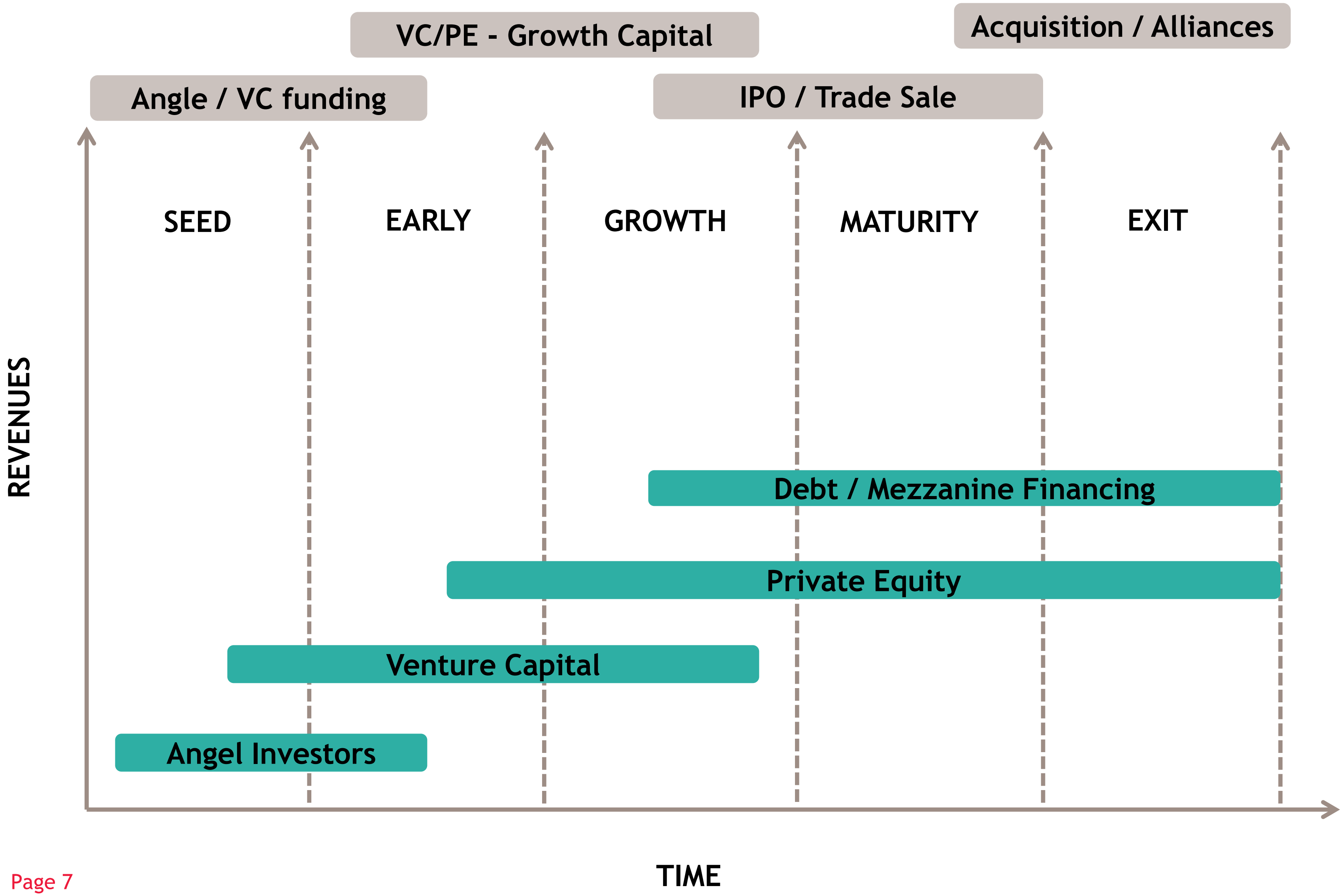
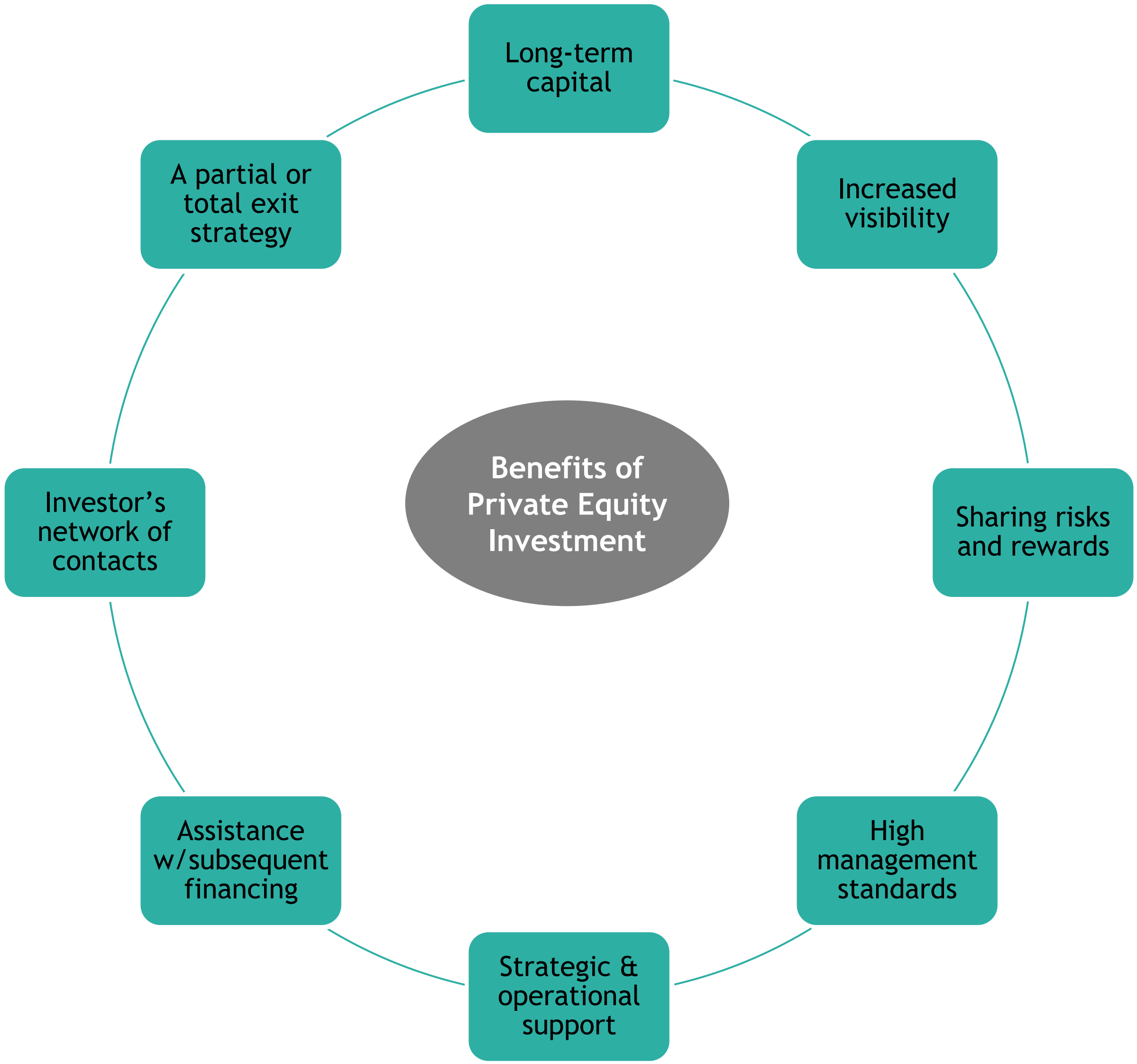
Deal Analysis and Investment Process

Life cycle of a Company and Role of Private Equity



What does Private Equity bring to the table?



Private Equity Investment Model

Establishing the Fund

Typically, investors include both private and state pension funds, funds of funds, life insurance companies, foundations and other institutions

Mapping Potential Investments

Generally, the targets need to fulfill certain criteria in terms of size, industry and life cycle phase in accordance with the fund's strategy

Making an Investment

After an investment target is identified, a more detailed analysis on the business is performed and based on outcome, investment is made

Developing the Target Company

In addition to finance, the fund supports the target company by providing sector knowledge, operational experience and access to a wider business/industry network

Exit

Most commonly, exits take place via:

- Trade sale to an industrial buyer
- Secondary sale to another PE fund
- Listing through IPO
- Sale to the management group

Deal Evaluation Parameters

Parameters	Explanation
Business and Strategy	Business strategy should be clearly articulated as PE funds scout for high growth opportunities
Macro Economics	Broader macro economic cycles always have an impact on the sentiments which drive the investment appetite and valuation
Promoter and Management	Promoter and the management are key asset in which the fund is placing its investments as most of the PE investments tend to be minority investments
Valuation and Expected ROI and IRR	Each fund has a target return based on their internal bench mark, mainly driven by stage of the Company and the Sector which in turn may drive the valuation
Exit Strategy	PE funds have to realize their return at the end of their investment horizon and hence clarity on exit options is critical
Ticket Size	Different funds have different ticket size and hence should be targeted accordingly

Typical Requirements of PE Investors

Requirements of PE investors

- *Board Representation*
- *Minimum size of investments (> $5 million) and minimum stake (10% or more)*
- *Consent before important strategic decisions & restrictive covenants*
- *Reporting requirements*
- *Return expectations from the Company and pressure to exit*
- *Management interface (higher as compared to Debt providers)*

Indicative Time Frame

1 - 3 months: Preparing for stake divestment

3 - 9 months: Identifying investors → Initial Negotiations → Due Diligence → Value Realization and Closure

Preparing for stake divestment	Identifying investors	Initial Negotiations	Due Diligence	Value Realization and Closure
✓ Agree on Strategy ✓ Prepare stand alone business plan ✓ Prepare teaser and marketing documents	✓ Identify potential investors ✓ Shortlist investors ✓ Based on initial interest, share NDA and process letters	✓ Distribute sales documents ✓ Conduct initial rounds of discussions ✓ Invite non-binding bids	✓ Open virtual data room ✓ Invite final offers ✓ Shortlist final list of investors	✓ Final negotiations with shortlisted investors ✓ Signing share purchase agreement and closure

An Advisor plays an important role in assisting the Company throughout the Fund raising process

Fund Raising Process for a Company

Broadly, the lifecycle of a PE transaction involves:

- Writing a Business Plan
- Reaching out to Potential Investors
- Managing Negotiation Process and Valuation Expectation
- Due Diligence
- Closing the Deal

Fund Raising Process for a Company

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Business Plan

A business plan is a written description of a business's future, a document that tells what it plans to do and how it plans to do it

Essential Areas to Cover

a. Executive Summary
b. Company Background
c. Management Team
d. Products and Services
e. Business Operations
f. Financial Projections
g. Amt of Capital required and its use
h. Exit Options

Need for having a robust Business Plan

Typical Deal flow

Total number of investment opportunities received	100
Number of investment opportunities after initial screening	60-70
Number of investment opportunities which are considered for due diligence	10-15
Number of investment opportunities for which term sheet is signed	5-7
Number of investment opportunities finally approved for Investment	2-3

In today's competitive deal environment, a business plan that effectively showcases a Company's unique value proposition increases its chances of making it through the screening process

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Reaching out to Potential Investors

The Company should select only those private equity firms whose investment preferences match the investment stage, industry, location preference, and amount of equity financing required by the business proposition.

The PE Firms evaluate a business plan based on following aspects:

- *Is the product or service commercially viable?*
- *Does the company have potential for sustained growth?*
- *Does mngt have the ability to exploit this potential and control the Co. through the growth phases?*
- *Does the possible reward justify the risk?*
- *Does the potential ROI meet their criteria?*

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Managing Negotiation Process and Valuation Expectation

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The Negotiation Process

- If the private equity firm is interested in further discussion (after having gone through the business plan), then the stage is set to undertake detailed negotiation on the conditions of the transaction

- When conducting negotiations during a fund raising mandate, great care must be taken not to make unsubstantiated representations about the business

- Important areas:
  - ✓ Deal structure
  - ✓ Warranties
  - ✓ Representations
  - ✓ Covenants
  - ✓ Minority protection rights
  - ✓ Exit options

- One other crucial element in this process is the valuation of the Company

There is no right or wrong way of valuing a business as it is based on hypotheses which have an element of subjectivity in it.

Important Clauses that form part of PE Investments

(Term Sheet clauses)

No.	Clauses
1	Dividend rights
2	Nature of Shares to be issued
3	Liquidation Preference
4	Redemption rights
5	Anti-dilution (Price protection rights)
6	Right of first refusal (ROFR)
7	Drag along (Bring along) rights
8	Tag along (Co sale) rights
9	Pre-emption rights
10	Representations

No.	Clauses
11	Warranties
12	Consent rights
13	Board Seat(s)
14	Information rights
15	Registration rights
16	Conditions Precedent
17	Tranche Disbursement
18	Exit Options / Rights
19	Non Compete Clause
20	Special Audit

Valuations

Valuation Expectation

- The value expectation gap is typically one of the most problematic area during transactions
- The valuation methodologies will vary depending upon the stage of the business as a very early stage business will have a developed concept with early commercialization thus the valuation view will be based on the concept and demand rather than established cash flows etc
- Valuation and structures drive the emerging shareholding pattern as most investments will be in the form of a convertible instruments

Valuation Methodologies

- The most common methods of valuation include:
  - ✓ Discounted cash flow
  - ✓ Comparison with similar companies

<u>Fundamental Analysis (DCF)</u>

- ❑ Business Plan provided by the Company is critical input for carrying out valuation exercise
- ❑ Discussion and Refinement of the Business plan and review of the same
  - ➢ Discussion of the Company's assumptions for the long term performance
  - ➢ Identification and discussion on the most sensitive variables and risks of the forecasts and development of alternative scenarios

<u>Market multiples /comparables</u>

- ❑ Comparison with market and transaction multiples

Transaction Structuring

High → Risk to Investor → Low

Option 1	Option 2	Option 3	Option 4	Option 5
Straight Equity	Base Valuation: Valuation Adjustment for certain project milestones	Floor & Cap Convertible Linked to project milestones	Base Valuation: Upside sharing with promoters	Convertible linked to IPO Valuation at fixed IRR

Low → Valuation → High

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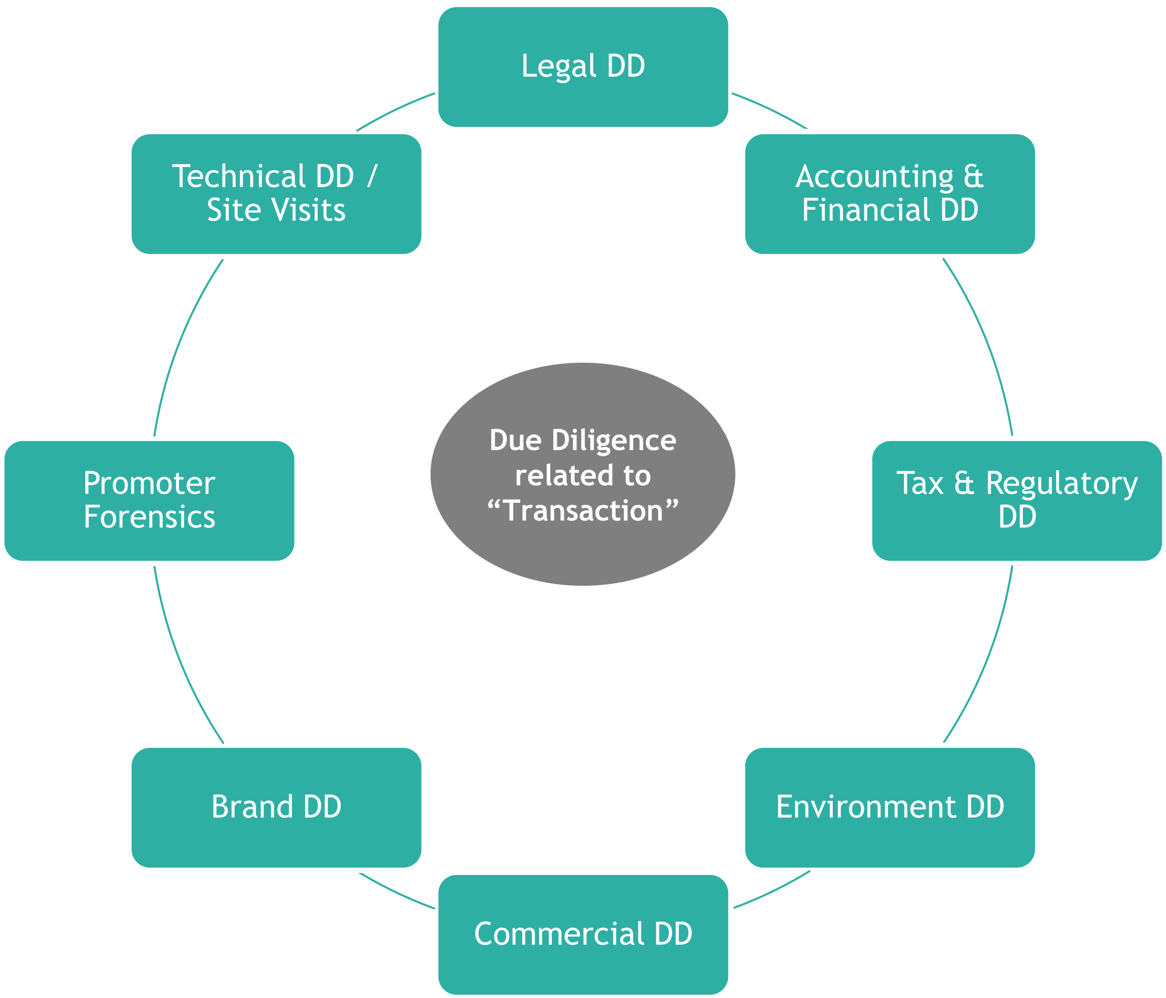
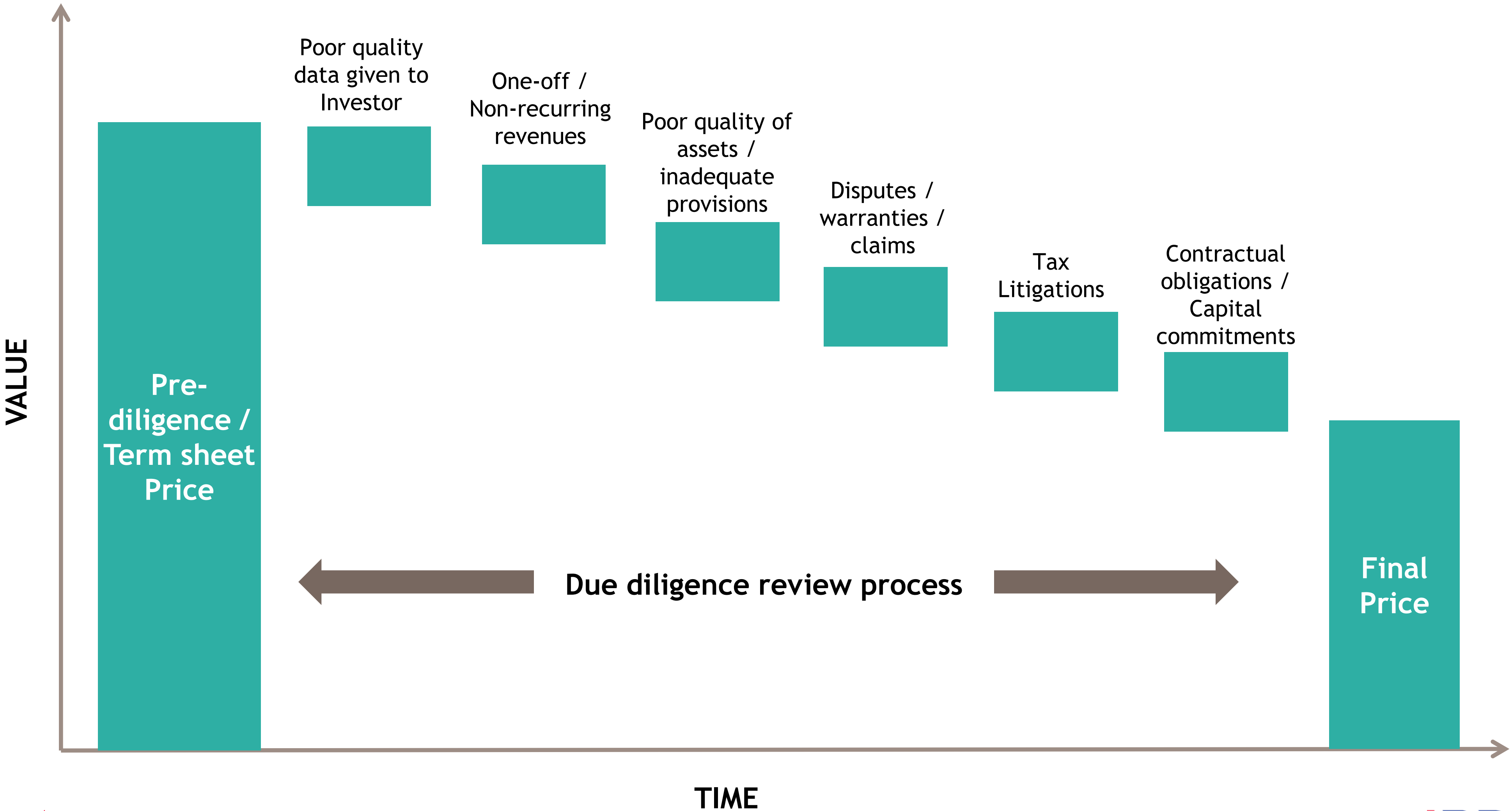
Due Diligence (DD)



Key points of discussion in DD

- Quality of earnings
- Balance sheet exposure
- Contingent liabilities
- Representations, indemnities and warranties
- Transaction structuring

Impact of Due Diligence Findings



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Legal Documentation and closing

- The legal advisors usually have the primary responsibility for drafting/reviewing the documents; commercially the focus should be to ensure that:
  - ✓ Valuation is accurately captured and Conversion formula is clear
  - ✓ The commercial substance of terms agreed is accurately reflected in the legal document
  - ✓ The purchase consideration structure, particularly in regards to application of any formulae is correct
  - ✓ The nature of financial and commercial warranties together with the warranty liability limits are appropriate
  - ✓ The completion process and holdbacks are appropriate
  - ✓ Diligence price adjustments are clearly reflected

- Once the due diligence process is concluded, which involves in-depth analysis of the company, and the PE firm is satisfied with the prospects of the business, the last stage of the deal will involve:
  - ✓ final negotiations of the terms and conditions, and
  - ✓ signing of the agreement

Reps and Warranties

- The purpose of warranties and indemnities is to protect an Investor against pre-investment unknown liabilities or other matters which lead to a diminution in value of the Company as at investment date

- Another reason for having warranties is to elicit disclosure from the Company and the management team, so that Investor can price the deal accordingly

- **The principal difference between warranties and indemnities are:**
  - ✓ A warranty is a representation by the Company that a matter is as stated (sub to disclosure letter) breach of which may give rise to a claim for damages based on an assessment of the actual loss suffered by the Investor as a result of the breach
  - ✓ An indemnity comprises an absolute obligation on the part of the Company to pay the Investor a calculable amount in the event of the occurrence or discovery of a particular circumstance (e.g. tax indemnity, litigation, etc.)

- Warranty disclosure – The Disclosure letter which is signed at the same time as SPA, is a means by which a Company can restrict his liability

- The letter discloses to Investor the facts or matters which are contrary to the warranties, and which could therefore give rise to a claim for the breach of warranty but for the fact that they are disclosed to the Investor prior to the signing of definitive documents

Role of Advisors

Preparation & Pre-deal activities	Marketing data	Executing the Deal	Post deal work
▪ Strategic / Lead Advisor ▪ In-house teams	▪ Lead Advisor ▪ Tax Advisor	▪ Lead Advisor ▪ Lawyer ▪ Tax Advisors ▪ DD Accountants ▪ In-house F&A team	▪ Principals i.e. Company & PE Investors
▪ Strategic review ▪ Finalization of Business plan & Fund requirements ▪ Prepare Information Memorandum ▪ Carve out financials & VDD, if required	▪ Roadshow – Approach PE Funds and connect with them ▪ Valuation – Strong technical capabilities ▪ Deal structuring ▪ Term sheets & Negotiation	▪ Due Diligence ▪ Transaction Structuring ▪ Negotiation ▪ Management meetings, site visits ▪ Finalize agreements	▪ Board / Management Changes, if any ▪ Reporting & Information flow

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