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VISHAL BHOJANI
INVESTMENT BANKER
MBA Finance

Sources of Finance

Long Term

- Equity (Public)
- Private Equity
- Debt
- Hybrid
- **Mezzanine**

Short Term

- Trade Credit
- Bank Finance
- Commercial Paper
- Project Finance
- Certificate of Deposits

Commercial Papers (CPs)

- Commercial papers can be compared to an unsecured short-term promissory note which is issued by top rated companies with a purpose of raising capital to meet requirements directly from the market

- They usually have a fixed maturity period which can range anywhere from 1 day up to 270 days

- They offer higher returns as compared to treasury bills. They are automatically not as secure in comparison. Also, Commercial papers are traded actively in secondary market

Certificate of Deposits (CD's)

- This functions as a deposit receipt for money which is deposited with a financial organization or bank. The Certificate of Deposit is different from a Fixed Deposit receipt in two ways. i. Certificate of deposits are issued only of the sum of money is huge. ii. Certificate of deposit is freely negotiable.
- The RBI first announced in 1989 that the Certificate of Investments have become the most preferred choice of organization in terms of investments as they carry low risk whilst providing high interest rates than the Treasury bills and term deposits.
- CD's are also issued at discounted price like the Treasury bills and they range between a span of 7 days up to 1 year.
- The Certificate of Deposit issued by banks range from 3 months, 6 months and 12 months.
- Note: CD's can be issued to individuals (except minors), companies, corporations, funds, non–resident Indians, etc.

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Trade Credit

- It's a (B2B) agreement in which a customer can purchase goods on account without paying cash up front, paying the supplier at a later scheduled date
- Usually businesses that operate with trade credits will give buyers 30, 60, or 90 days to pay, with the transaction recorded through an invoice
- In this way a trade credit can act like a 0% loan on the balance sheet
- Trade credit is most rewarding for businesses that do not have a lot of financing options
- A supplier may give a discount if a customer pays within a certain number of days before the due date


PRIVATE
EQUITY

What is Private Equity?

- Private equity is an asset class consisting of equity and debt investments in companies, infrastructure, real estate and many other assets
- Capital invested in this asset class is typically raised from a range of investors privately, rather than public
- Private equity firms typically seek to invest in quality assets at attractive valuations and use strategic, operational, and financial expertise to add value
- After a suitable holding period, a private equity firm seeks to monetize its investment at a premium to its acquisition cost, generating positive returns for its investors

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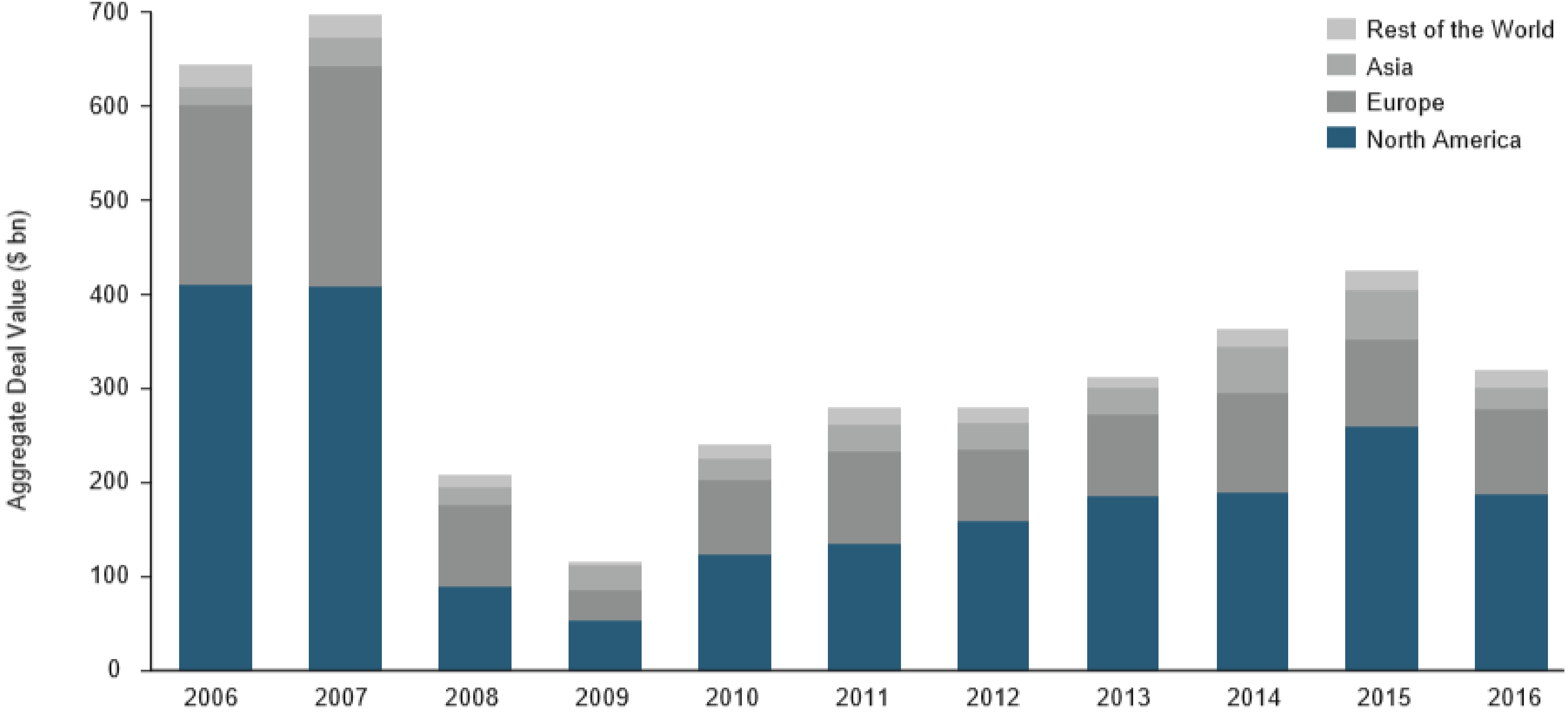
Venture Capital	Growth Capital	Buyouts	Mezzanine	Distressed	Infrastructure	Real Estate
Venture capital investments, which include seed, early stage, and late stage investments, are usually made as equity or equity-like investments in companies that are in the early stages of growth.	Growth capital investments typically involve minority investments in established companies with strong growth characteristics.	Buyout investments are typically acquisitions of public or private companies, or divisions of larger companies, that are repositioned for sale at a multiple of the equity invested by unlocking value and enhancing opportunities through financial, managerial and/or operational improvements.	Mezzanine investments are debt investments that are unsecured and are subordinate in right of payment to all other debt.	Distressed investments generally involve the purchase of equity or debt securities in a company that is experiencing hardship.	Infrastructure investments generally involve financing large private infrastructure assets such as utilities (e.g., conventional and renewable power and transmission, electricity, gas and water networks) and/ or transportation infrastructure (e.g., airports, ports, railways, and roads).	Real estate investments include a variety of property, location, and maturity types, as well as investments in operating companies with significant real estate portfolios, that may afford investors a relatively diverse set of risk/reward characteristics.
Characterized by a higher risk and a small number of outsize successes, venture capital has the most volatile risk/reward profile of the private equity asset class.	These companies typically maintain positive cash flow and therefore present a more stable risk/ reward profile compared to venture capital investments.	Buyout investments are generally exited through an initial public offering, or IPO, a sale to a strategic rival or another private equity fund, or through a debt-financing special dividend, called a dividend recapitalization.	As the most junior form of debt, mezzanine debt has the most repayment risk if the borrower files for bankruptcy, and in return for that risk, mezzanine debt generally pays a higher interest rate and comes with warrants that give investors the ability to participate in the capital appreciation of the borrower, if any.	Distressed investments offer the opportunity to invest in debt securities that trade at discounted or distressed levels with the potential for higher future value if the company recovers.	Infrastructure investments are typically characterized as providing steady cash flows and having high barriers to entry.	Real estate investments include the potential of benefitting from the appreciation of the related real property, as well as any income earned from the use of the property during the time that it is held.

Figure 15. Private Equity Deals by Region 2006 – 2016.



Source: Preqin, Ltd., 2017 Preqin Global Private Equity & Venture Capital Report. Data reflects buyout fund deals, which account for approximately 60% of total private equity assets under management as of December 2016.

Figure 3. Current Average Private Equity Allocation by Investor Type

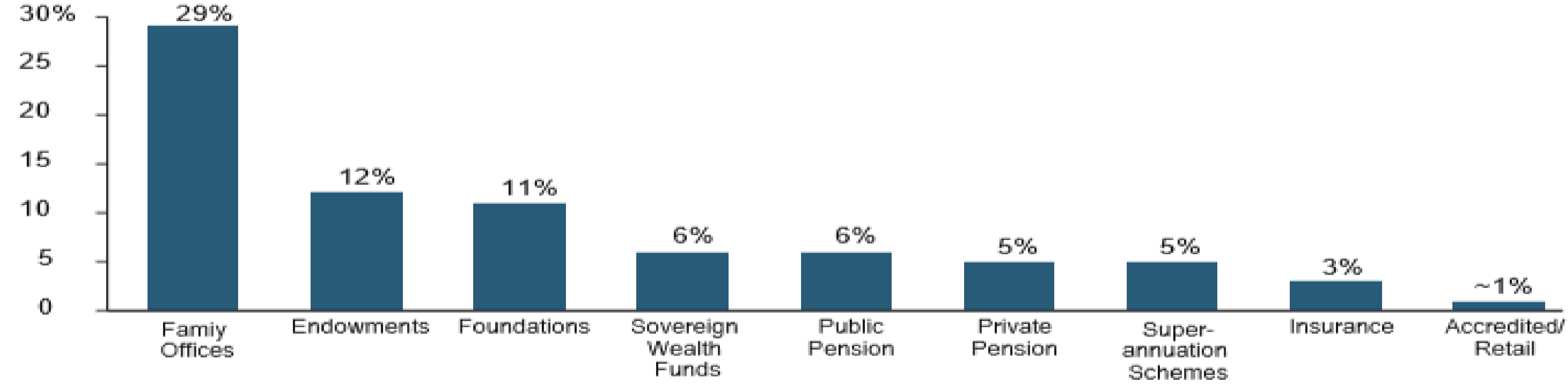
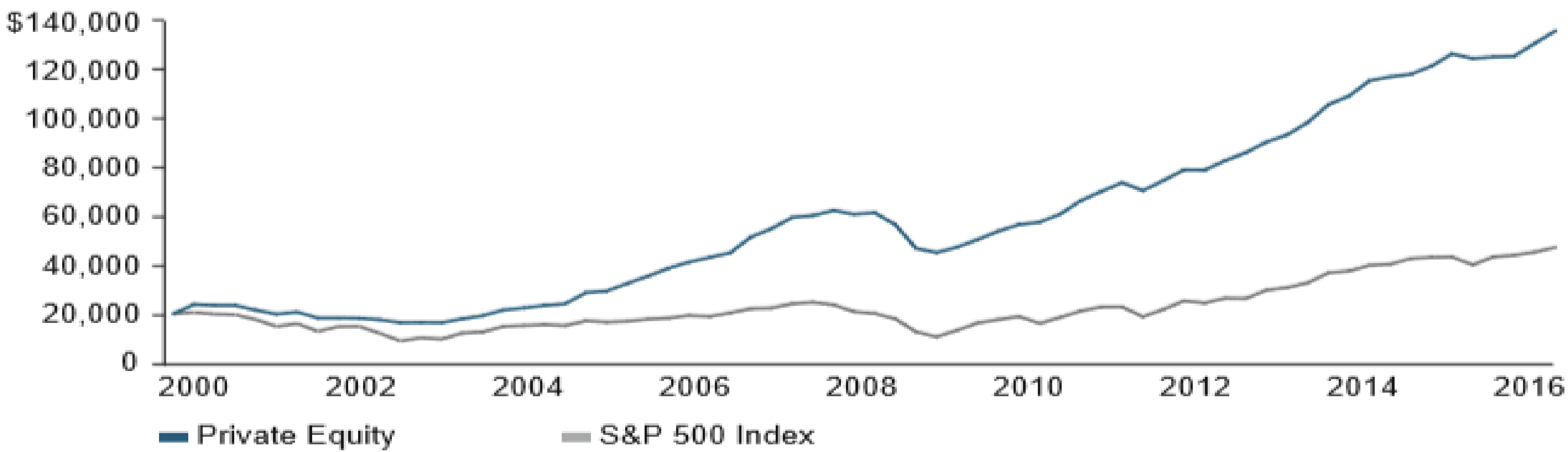


Figure 4. Private Equity Returns vs S&P 500, December 2000 - September 2016



How Do PE Firms Add-Value?

- The right private equity partnership provides capital and/or other resources to help address a variety of common growth and business transition challenges

Growth Capital	Capital to support expansion initiatives – employee hires, working capital, capital investment
Knowledge Capital	Experience executing key strategic initiatives – system integration, geographic expansion, capital decisions
Management Depth / Transition	Access to management resources required to support next stage of growth
Balance Sheet and Financing Solutions	Strengthen balance sheet to add stability to operations. Relationships with finance sources
Industry Experience & Relationships	Macro level industry knowledge – access/relationships with key target customers or markets

What is the Investment Criteria of Private Equity Funds?

Limited Prospects	Valuation / Attractiveness Scale	Strong Appetite

Company Scale / Momentum

Limited Prospects	Strong Appetite
• Sales < $10M, EBITDA < $2M	• Sales > $30M, EBITDA > $5M
• Limited growth opportunities (flat sales)	• Visible, defined growth opportunities

Operations & Management

Limited Prospects	Strong Appetite
• Customer and channel concentration	• Blue-chip, diversified customer base
• Need for additional financial discipline	• Recurring, highly visible revenue
• Lack of management depth	• Management depth (institutionalized knowledge)
• Significant capital expenditure requirements	• Established systems and procedures

Market Trends / Product Offering

Limited Prospects	Strong Appetite
• Small, competitive industry	• Attractive industry dynamics (size, growth prospects, fragmentation)
• Commoditized product with margin pressure	• Diverse, differentiated product line
• Limited product line	• Proprietary products or processes

Mezzanine - What It Is and How It Works - A

- Let's say you want to buy a small Pizzeria in your hometown

- The pizza shop earns $200,000 per year in operating income, and the owners will sell it to you for $1 million

- You don't have $1 million laying around to invest, so you find a senior lender who will finance $600,000 of the purchase price at a rate of 8% per year

The capital structure looks like this:

- The senior lender contributes $600,000 of debt financing at a cost of 8% per year

- You, the equity investor, contribute $400,000 in equity

Mezzanine - What It Is and How It Works - A

- With this in mind, we can calculate the return on your investment
- We know the business produces $200,000 in operating income per year
- We need to subtract the $48,000 in interest payable to the senior lender, thus arriving at pre-tax profits of $152,000
- We'll assume that the profits are taxed at 35%, so the after-tax profit is $98,800
- Thus, your return on your $400,000 equity investment is $98,800 annually, or 24.7% per year -- not bad!

Mezzanine - What It Is and How It Works - A

Example A: Financing the Pizzeria with Senior Debt and Equity	
Operating income	$200,000
Interest Expense	-$48,000
Pretax income	$152,000
After-tax income	$98,800
Annual return on your $400,000 investment	24.7%

Mezzanine - What It Is and How It Works - B

- But what if you could reduce your equity investment?
- What if another lender could come in behind the senior lender and add more leverage?
- Suppose you could find mezzanine lender who will provide $200,000 of financing at a rate of 15% per year

The new capital structure would look like this:

- The senior lender contributes $600,000 of debt financing at 8% per year
- The mezzanine lender contributes $200,000 of debt financing at 15% per year
- You, the equity investor, contribute only $200,000 in equity

Mezzanine - What It Is and How It Works - B

- Starting from the same $200,000 in operating income, we need to subtract the $48,000 in interest for the senior loan, and $30,000 in interest for the mezzanine loan
- Thus, our pre-tax profits fall to $122,000
- Take out TAX 35% cut, and you, the equity holder, will earn only $79,300 each year
- By including a mezzanine debt investor in the deal, your after-tax profits fell from $98,800 to $79,300.
- However, your required investment was less -- you only need to **invest $200,000** of your own capital instead of $400,000

As a result, your total annual profits fall, but your return on equity rises from 24.7% per year to **39.7% per year**

Mezzanine - What It Is and How It Works - B

Example B: Financing the Pizzeria with Senior Debt, Mezzanine Debt, and Equity

Operating income	$200,000
Interest Expense	-$78,000
Pretax income	$122,000
After-tax income	$79,300
Annual return on your $200,000 investment	39.7%

Factors Affecting an Entity's Capital Structure

- Financial leverage of trading on equities
- Sales
- Cost of Capital
- Control
- Flexibility
- Profitability
- Cash flow Availability
- Company Features
- Regulatory Framework
- Stock Market Position
- Floatation Costs

Capital Structure Theories and Approaches

- Net Income Approach
- Net Operating Income Approach
- Traditional Approach
- Modigliani-Miller Approach

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vishal@mieindia.in
www.mieindia.in
+91 9920418496

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