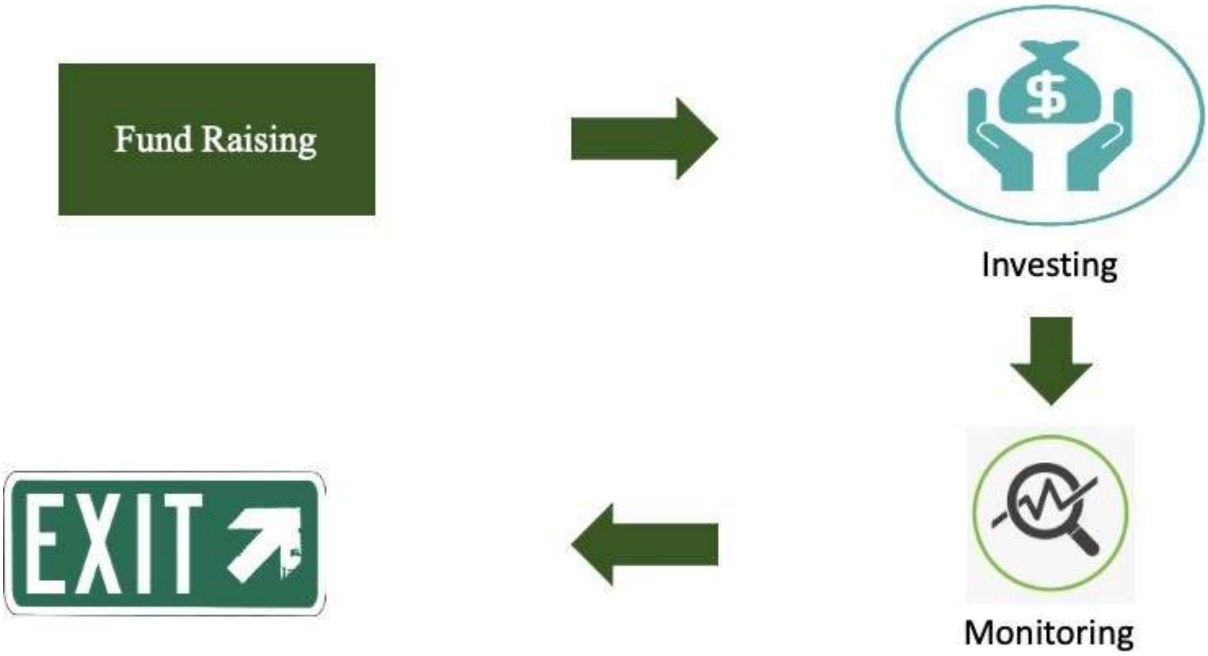
Cycle of Private Equity Fund



Fundraising

The first task of a Private Equity Fund is fundraising. Broadly there are three types of investors:

- High Net-worth Individuals: They broadly invest their personal wealth into companies and are mostly active in the venture capital stages of private equity investing.
- Family Offices: These are families, who invest their personal wealth into companies. Their ticket size of investmentsis often greater than that of high net-worth individuals. Depending on the ticket size of investment, their participation is not limited only to the venture capital stage. Famous family offices in India include that of the Dabur family, among others. It is important to note that family offices are often professionally run with qualified fund managers managing investments
- Private Equity Funds: They are basically organizations that are engaged in the practice of private equity investing and fund management. The biggest difference between HNIs, Family Offices & PE Funds are that PE Funds have multiple investors, as

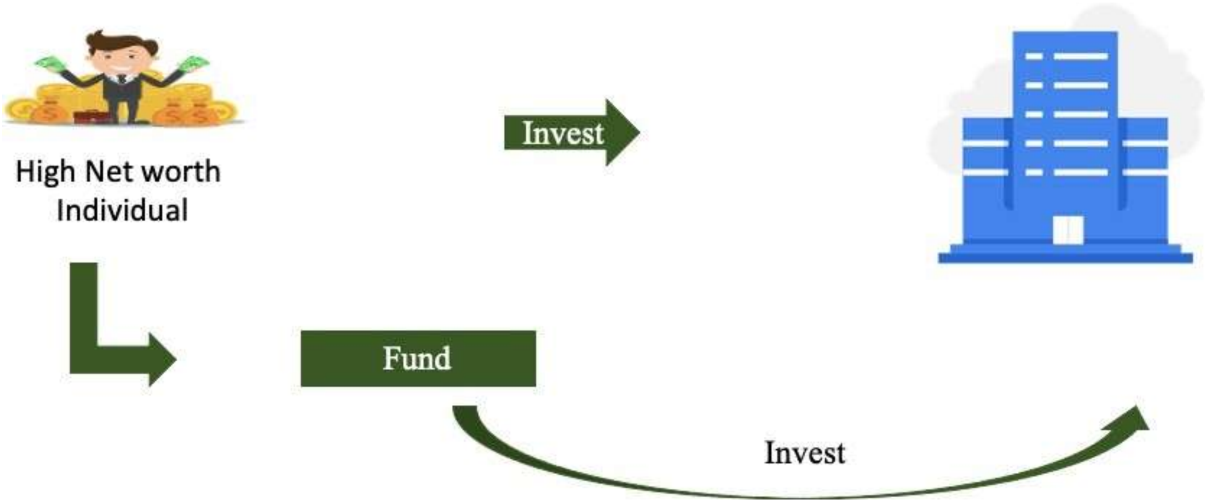
opposed to HNIs and Family Offices, who're either backed by an individual or a particular family.

The three types of investors are also interconnected as the investors in Private Equity Funds are often High Networth Individuals or Family Offices.

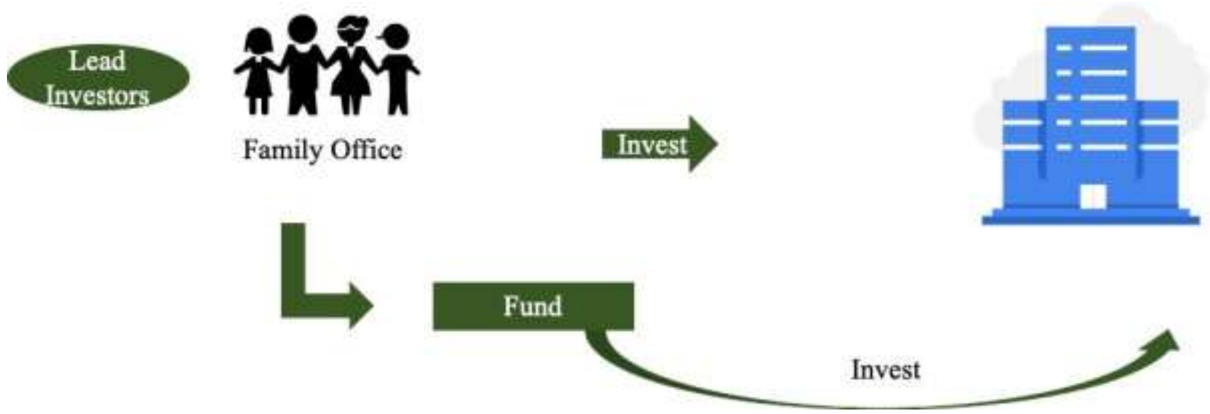
As Family Offices are also professionally run, they have now progressed towards launching funds in which they're the lead investors.

From a participation standpoint, let us classNameify this:

HNIs participate in PE investments either by directly investing in the target company or by investing in a fund that goes on to invest in companies.



Family Offices participate in PE investments either by directly investing in the target company, or by investing in funds that invest in target companies or by launching private equity funds, in which they are the lead investors and managers; who go on to raise more money from other investors – and then invest in target companies.



Private Equity Funds participate in PE investments by raising money from multiple investors and investing in target companies. All participants have the same objective – to increase the value of companies that they're investing in by helping them perform well. When we speak about fundraising, we are now talking about it from a Private Equity Fund's perspective and not from a company's perspective.

Here, the Private Equity Fund may be launched by a group of fund managers with a proven track record or may also be launched by a family office and in that case, the family is the lead investor into the fund.

In this stage, the promoters of the PE fund have to pitch the idea of the fund to prospective investors in order to get their participation for it.

Investment Pitch

There are four primary aspects in a PE fund's investment pitch:

1. **Fund Structure and Targets: The fund structure will be based on how many investors is the fund aiming to onboard to raise**

a particular amount that it is targeting. As a very simple and basic example, a fund can target a size of Rs. 200 cr. and it can aim a group of 20 investors; with each investor on an average contributing Rs. 10 cr. This is only an average and does not necessarily be the case. If say a Rs. 200 cr. fund is being promoted by a family office, there can be a case of the family contributing Rs. 50 cr. in it. Managing investors is a big task and it often depends on the relation between the fund managers and the investors and therefore fund managers mostly prefer a small number of investors in a fund.

Another fund target, is the targeted return. It is up to the fund manager's discretion to propose this and the risk profile of the investors is often based on the targeted return that the fund manager is proposing. The greater the proposed return, the higher the risk and investors with a greater risk appetite would be required. Continuing the previous example, a fund manager can propose a return of say 15% and a now very basic fund structure would now be a corpus of Rs. 200 cr., with a target of 20 investors, contributing on an average Rs. 10 cr. for a proposed return of 15%.

2. Holding Period: The fund manager also has to give a proposed holding period to prospective investors. As we can now sense, private equity has a long term gestation period. Proposed holding periods can be 3 years, 5 years or even more.
3. Sector Specific/Sector Agnostic: The third aspect of the fund is whether it wants to be sector specific or sector agnostic. Sector specific funds can choose to invest in only a specific sector. For example, there are health-tech specific funds, consumer tech specific funds among others. Sector agnostic funds are those that can invest across sectors. This aspect of the PE fund also determines the investors that it attracts. For example, a consumer tech specific fund can be attractive for

an HNI, who has spent majority of her career in the consumer tech space.

4. **Investment Approach: This can be further divided into two parts: The type of Investment and whether it is an active or a passive approach.**

In the first part, the PE fund has to make it clear as to what type of investments is it going to make. There are various types of PE investments and the type of PE investments are dependent on the stage at which the company is. Therefore, when a PE fund is pitching for fundraising, it has to make it clear as to which stage of the company life cycle, would it be participating.

In the second part, it has to specify whether it would be following an active or a passive approach. An active approach is when the fund management team will take active involvement in the workings of their portfolio companies. In an active approach, it is increasingly important for the PE fund to have the correct set of experts, who can possibly add value to its prospective portfolio companies. A passive approach is when the fund management team takes limited involvement in the workings of their prospective portfolio companies. In this approach, involvement is limited to scheduled quarterly board meetings that help them monitor the company's progress.

The criteria for a PE fund to be called successful, include:

- **The first criteria is that a PE fund receives a letter of commitment from its investors, which includes the amount of their commitment.**
- **The second criteria is an objective benchmark on whether the fund was able to meet its targeted raise. For example, if a fund targeted a raise of Rs. 200 cr. and was able to reach that, it met its targeted raise.**

Investing

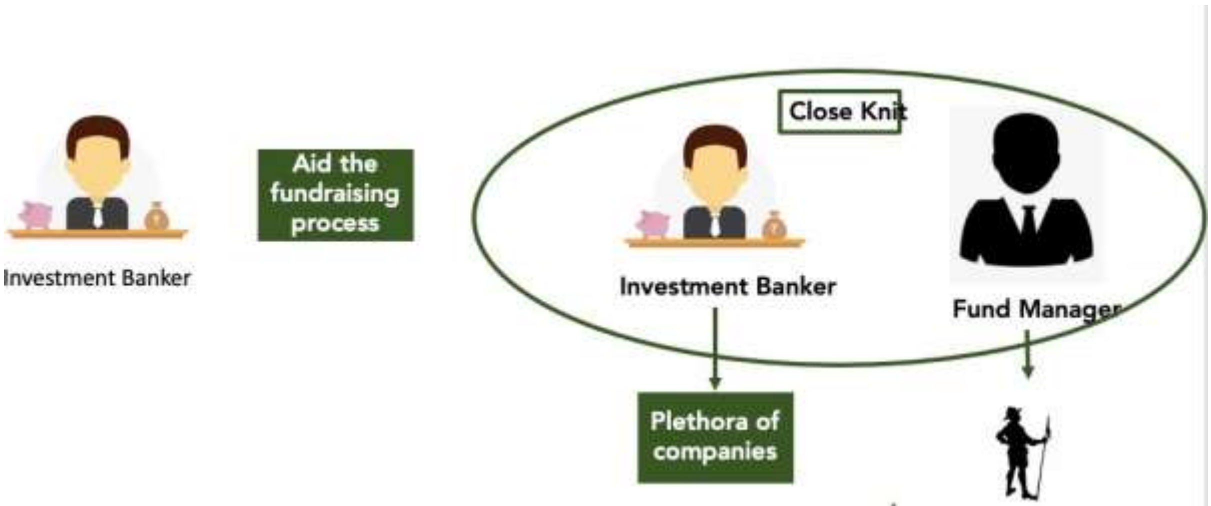
Identification of Target Companies

This is a critical aspect in the lifecycle of a Private Equity fund as much of its success is dependent on this. The first step in identifying target companies is to scout the market.

1. Scouting

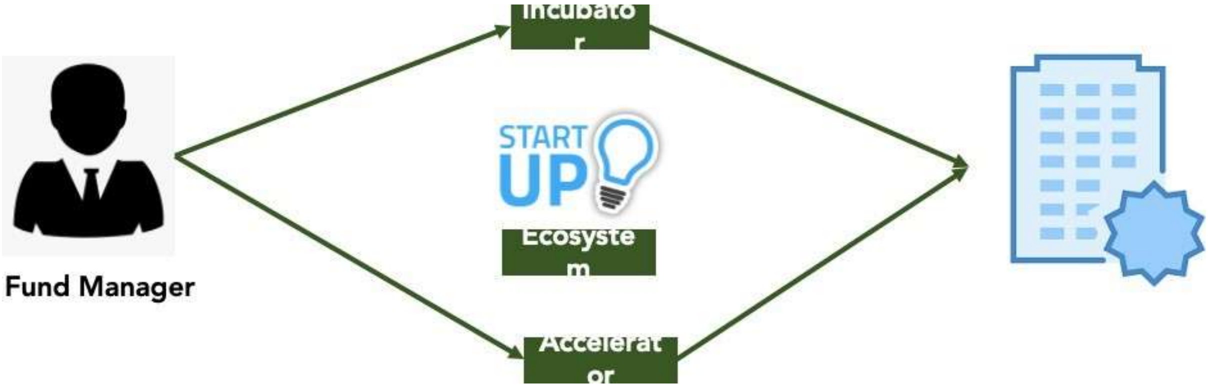
Fund managers use many techniques to do this, four such techniques are:

a. **The first technique isnetwork driven scouting.Most companies appoint investment bankers to aid their fundraising process. Fund managers and investment bankers are often in a closely knit network, which helps fund managers in their scouting process as investment bankers often introduce fund managers to a plethora of companies looking to raise money.**

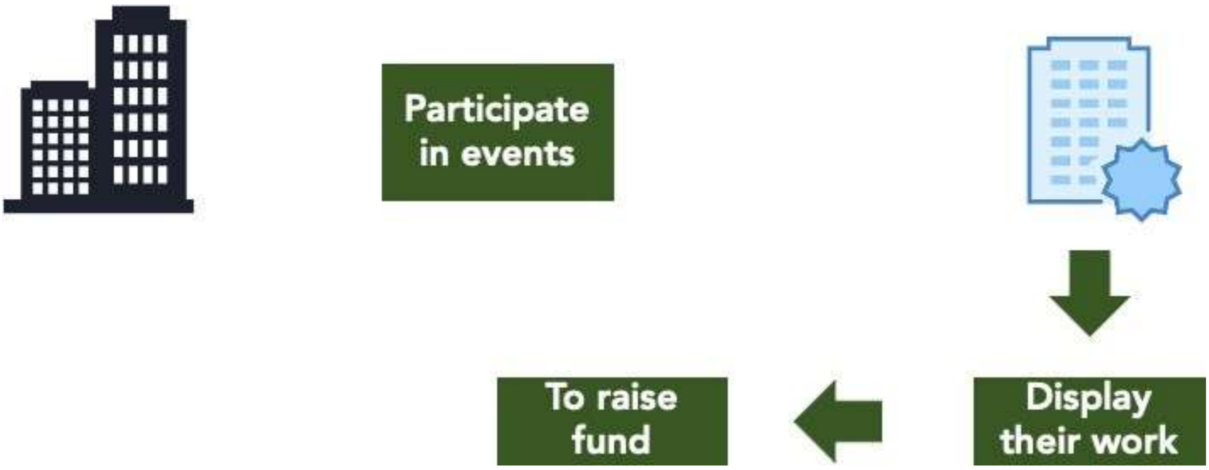


b. **The second technique isinstitution driven. Many fund managers directly interact with incubators and accelerators in the start-up ecosystem that helps them get introduced to companies with high potential. Incubators and accelerators are generally setups that identify ideas and companies of high potential and run programs that help them scale up. These programs culminate in a demo day, where the companies in**

that incubator or accelerator display their work in front of fund managers, with the aim of raising funds.



c. **The third technique isevent driven. Many PE funds participate in events, where companies display their work with the aim of raising funds.**



d. **The fourth technique iscompetition driven. Many PE funds host competitions, where companies can share and show their work to them. The technique used to scout the market, is often dependent on the type of private equity investment, which is in turn dependent on the stage of the company.**

2. Screening Process

Some of the parameters used in the screening process include:

- Nature of problem addressed by the company & idea
- Size of the market

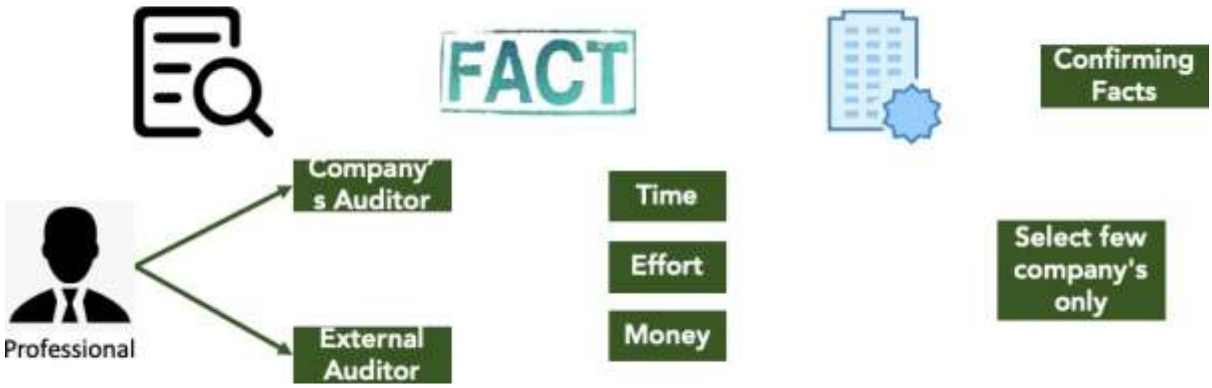
- Potential of the company to reach that market
- Background & qualification of the management team
- Growth & Performance of the company
- Amount of money that the company is looking to raise & whether synergetic with the PE fund's broad strategy.

Fund managers are not restricted by these methods and can include other parameters as well.

3. Due Diligence

Due diligence is an audit on the facts that are represented by a given company, with the aim of confirming those facts. The due diligence process is often done by specialised professionals, either in the company or externally appointed. As the process takes time, effort and in many cases – money as well; fund managers conduct this process on selected companies only.

For example, a fund manager may receive a review proposals of 100 companies, out of which 10 would make through the screening stage and to the due diligence stage.



4. Valuation

This is one of the most critical stages as it would be determining the nature of the relationship that a PE fund would be proposing to a target companies. The fund would broadly be valuing the target companies and be look at the amount that they are looking to raise.

This would in turn determine the PE fund's offer to target companies as a relationship between the amount that the target companies are looking to raise and the PE fund's valuation of target companies would lead to the amount of shares that a PE fund would be looking to purchase in that company.

Often, the valuation of a company done by a PE fund is lesser than the proposed valuation of the company. This leads to a negotiation between the target companies and the PE fund.

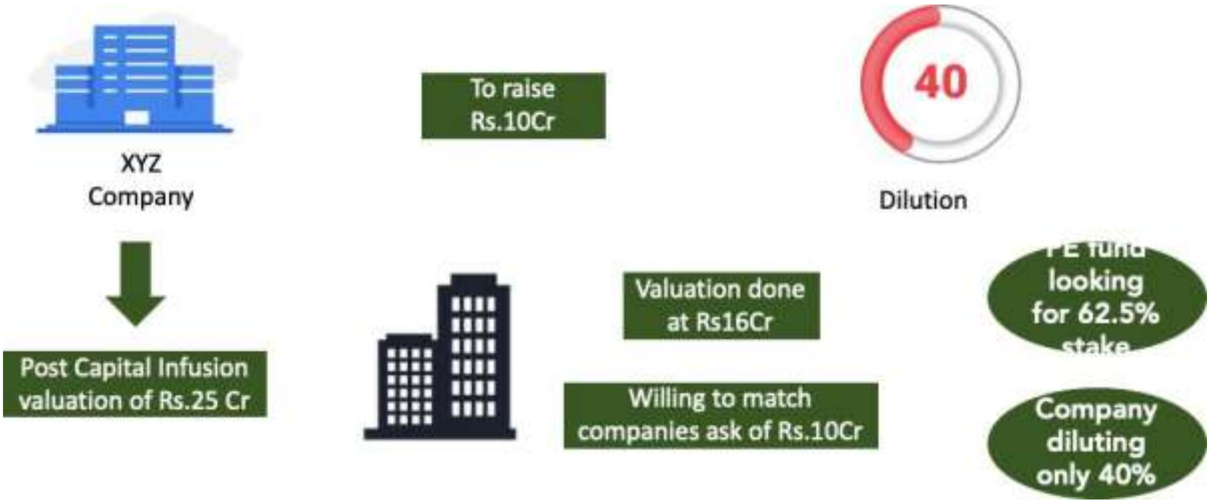
Negotiation

This stage comes after the PE fund has identified target companies and is now close to entering into a deal with them. Apart from negotiating on the valuation of the company, the negotiation also includes other parts like the type of shares issued by the company to the fund, the members appointed by the PE fund on the company's board and whether the PE fund will be giving the company's management, a part exit on their existing shareholding.

1. Difference in Valuation

When a company goes on to raise funds, it has a certain target in mind. The target has been set in accordance with the amount it is looking to raise and the percentage of shares that it is looking to dilute in the process.

For example, a company XYZ Ltd. is looking to raise Rs. 10 cr. and is willing to dilute 40% of its shares in the process. In this example, we can see that the company has given itself a post-capital infusion valuation of Rs. 25 cr. Similarly, a PE fund has valued the company at Rs. 16 cr., and is willing to match the company's ask of Rs. 10 cr. at this valuation. The difference is that the PE fund is looking for a 62.5% stake in the company; while the company is looking to dilute 40%.



From this example, one can understand why the company would be apprehensive to take this deal and negotiate on it. The PE fund's offer essentially places a majority stake with the PE fund, while the company's proposal keeps a majority stake with the company. This is the basis of the negotiation process between the fund and the company, where they may or may not be able to arrive at a mutually agreeable deal. It's important to note that we've taken an extreme case here as the difference in valuation to an extent, where the point of majority and minority ownership is coming into play.

2. Type of Share Issued to the PE Fund

The second aspect that gets determined in the negotiation stage is the type of shares that the company will issue to the PE fund.

- Common stock: Each share has proportionate amount of voting rights.
- Shares with an increased voting right: It is where the PE fund gets greater voting right as compared to its shareholding. In this case, the PE fund can exercise greater control over the affairs of the company that it is investing in. For example, the company may issue 2 votes for a share to a PE fund, where it gets 2 votes for each share held by it.
- Put Option: This allows the PE fund to sell those shares under specific circumstances.

3. Members Appointed by the PE Fund

The third aspect of the negotiation can be the members appointed by the PE fund on the board of the company. The company's board monitors its progress on a regular basis and the senior management of the company is often answerable to other members of its board. Therefore, having members on the board of the company is helpful for PE funds as they look to monitor the progress of the company, after investing. In many cases, decisions are taken by a vote of the board members and hence, the number of seats allotted to the PE fund on the board of the company can be essential in the control it has in the company.

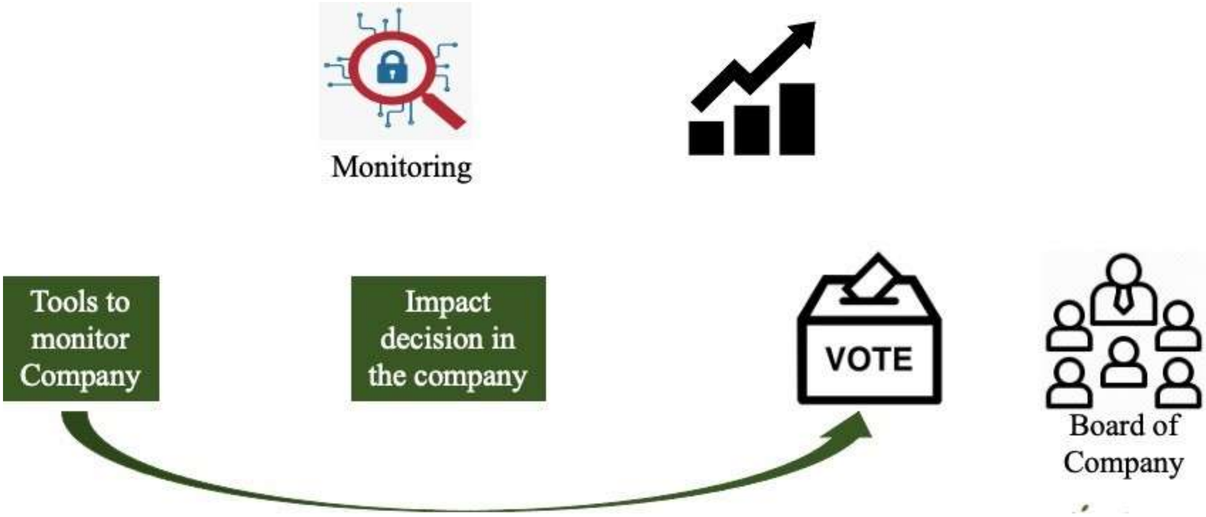
4. Giving an Exit to the Company's Founders

A fund raising can constitute two aspects:

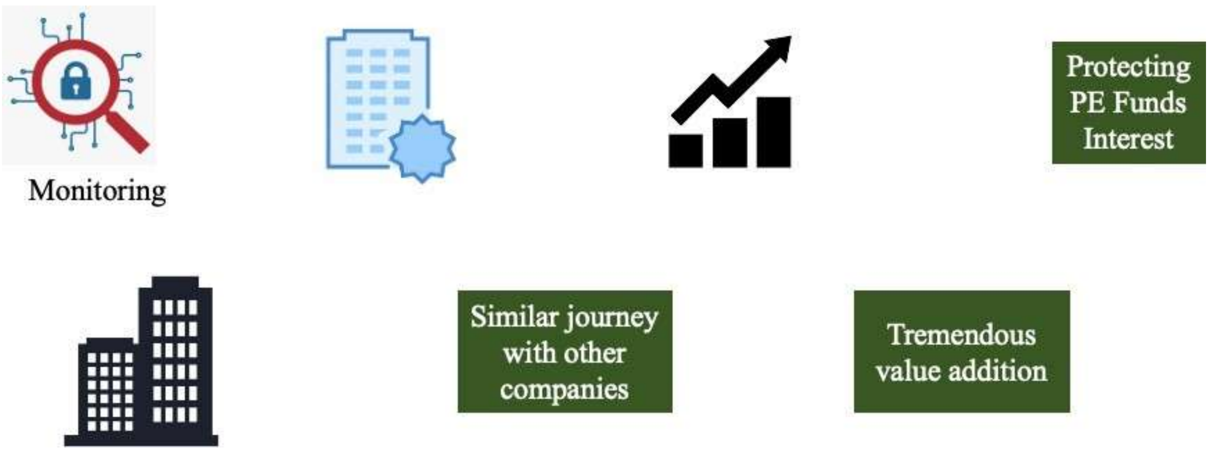
- The first aspect of fund raising is of capital infusion, which is the money that is invested in the company, for growth.
- The second aspect is of fund raising, can be giving an exit to the company's founders. This can be a part exit and is possible only in mature stages of the company's life cycle. In this case, a part of the fund goes to the company's founders as they dilute their stake in the company. For example, if a company is raising Rs. 25 cr. from a PE fund, the founders can keep a clause of a 10% exit. This means that the company's founders will get Rs. 2.5 cr. as part of the deal and the rest of the amount, which is Rs. 22.5 cr. will go in as capital into the company.

Monitoring

After a PE fund invests in a company, it has to actively monitor the progress of the company. These tools include voting rights on shares and seats on the board of the company.



From a PE fund's perspective, the core idea behind monitoring is to help the company grow, while protecting its interest at the same time. As the PE fund has undergone a similar journey with many companies before, its involvement can help be tremendously value additive.

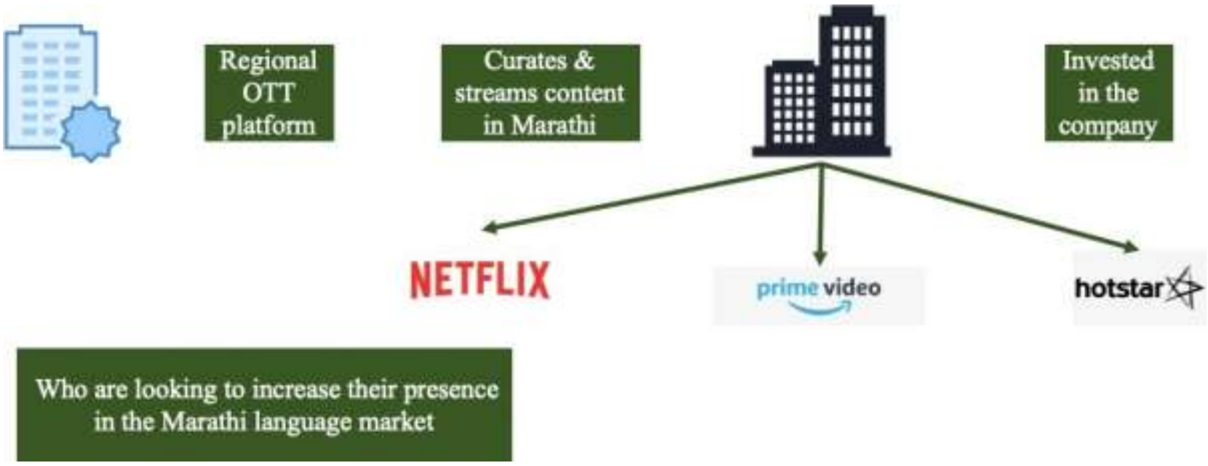


Exiting

In this stage, the PE fund exits the venture by selling its shares and hopes for capital appreciation in the process. Capital appreciation occurs when the company has grown and the value of its shares have increased.

There are many ways in which the PE fund can look to exit a company.

1. **Selling its shares to another company: For example, take the case of XYZ Ltd., a regional language OTT platform which primarily curates and streams content in Marathi. In this case, if the company and the PE fund that has invested in it exits to bigger platforms in the same domain like Amazon Prime Video, Netflix, Hotstar among others, who are looking to increase their presence in the Marathi language market, we can term this as a case of exiting to another company. Generally, larger companies go on to acquire smaller ones in the same market and give an exit to the PE fund that has invested in them. For the acquirer, the core idea behind such acquisitions is to strengthen its presence in sub-markets, where the acquiree has a strong presence.**



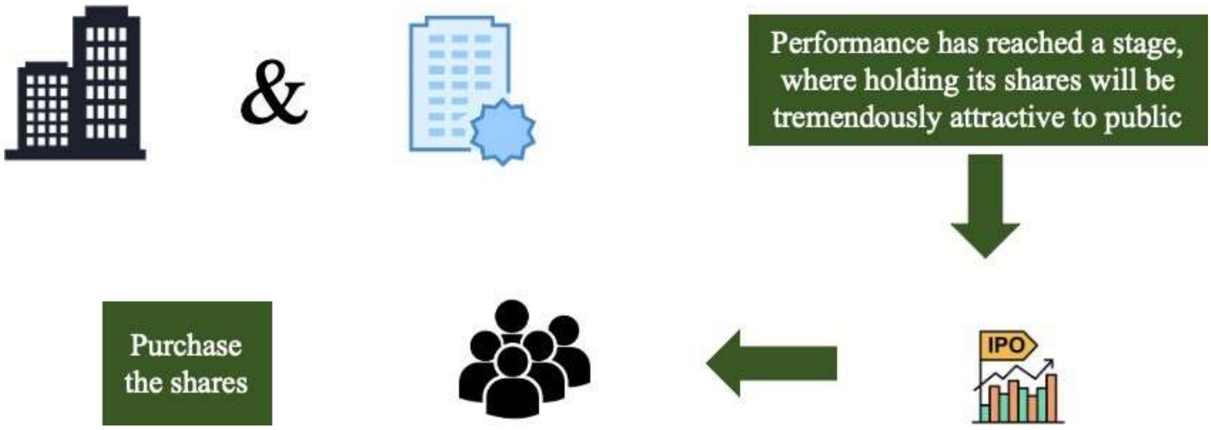
2. **Selling its shares to the company's founders: This is essentially similar to a buyback that is exercised in public markets. If the company's founders have the resources and are tremendously confident about the company's future, they can purchase the shares of the PE fund in the company. This gives more operational autonomy to the founders and they will also be gaining more, if the company goes on the grow further. There is also a grim case scenario that is forms a part of exits that are done in this manner. Recollect from the previous modules that a PE fund or an investor can have a put option on his investment in order to safeguard it. In this case, if the**

company does not do well, this option gets triggered and the founders have to give an exit to the PE fund by purchasing its shares.

3. **Selling its shares to another PE fund: This is one of the most common ways of exiting a company that is exercised. By now, we know that PE funds follow a strategy in which they participate at certain stages of the company's life cycle. Generally, while setting up a PE fund, the management team decides the broad stages in which the PE fund will be investing. Once a company has passed that stage, the PE fund may exit by selling its shares to another fund, who participates in the next stage of the company lifecycle.**

For example, a PE fund could be following a strategy of investing in growth and once a company has passed that stage, it could exit by selling its shares to another PE fund, who follows the strategy of investing in stability.

4. **IPO: An IPO is a process in which a company lists its shares on the stock exchange for the first time. Very few PE funds have exited companies using this method. An IPO process includes issuing of securities to the public that are tradeable over the stock exchange. For an IPO listing, a price band is shared by the company for the initial purchase of its shares by the public. Post this, the price of the shares is determined by demand and supply forces of the market – which in turn look at the company's performance as a benchmark for price determination. If the company and the PE fund believes that its performance has reached a stage, where holding its shares will be tremendously attractive to public; an IPO may be launched – where they can invite public to purchase their shares. For a PE fund, exiting through an IPO can be one of the toughest ways of exiting a company as the potential for capital appreciation is often determined by public perception.**



5. **Writing off investment: The last & most grim way of exiting a company for a PE fund is by writing off its investment. This is the last option for both the company and the PE fund and happens when it is not able to find a buyer for the company's shares; even at a discounted value to the fund's original investment. This can happen ifthe company has not performed according to the estimate of the PE fund and hence interest in its shares have dipped. This also incurs significant losses to the PE fund.**