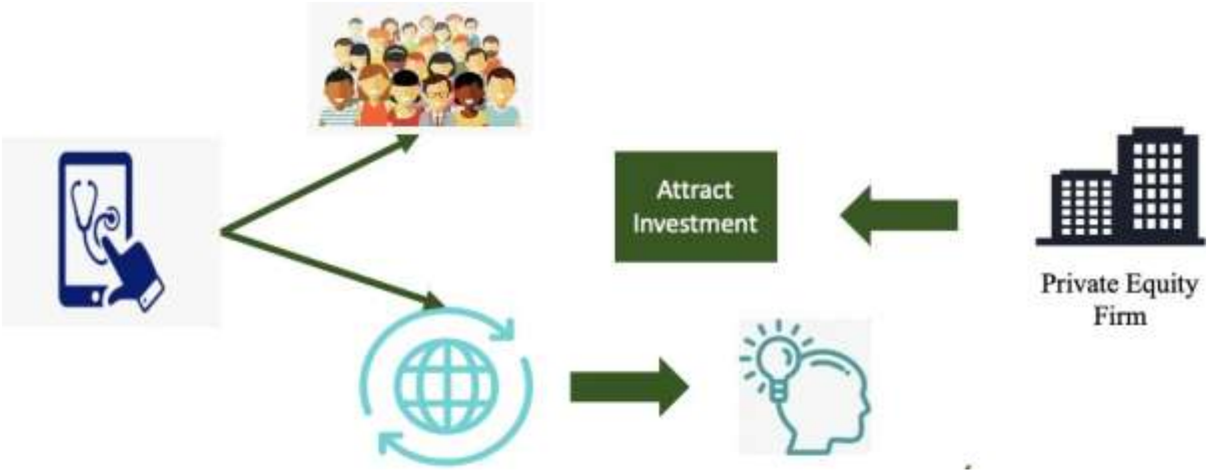
Ideation Stage

The ideation is the first stage in which an entrepreneur can look to raise funds. Generally, in this stage, the investor puts in money for research and development as she has complete confidence that the entrepreneur's idea is creating**intellectual property**and has**mass marketability**.

Intellectual Property

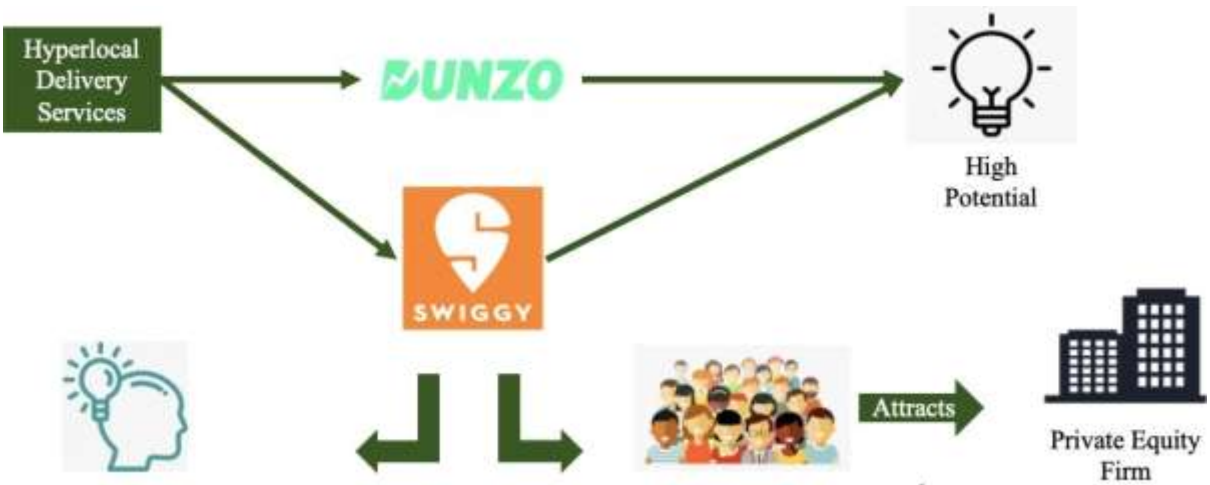
Intellectual property refers to a set of intangibles that are a result of a person's creativity. For example, the heath tech industry. There are several companies who have developed technology in healthcare in order to improve diagnosis and treatment of patients. Developing this technology has involved years and years of research and a lot of money has gone into it. The company that is involved in developing such products often requires money at an early stage to gain access to the correct type of resources and team, which are critical to the product's success. In easier words, they need the money to sustain themselves and the business as the product has not yet commercialised.

As many healthcare products have a wide impact and potential for commercialisation due to the problem that they solve using intellectual property, there are investors who are willing to give monetary support to the team building it and hence such a company is able to attract PE investment at an ideation stage.



Mass Marketability

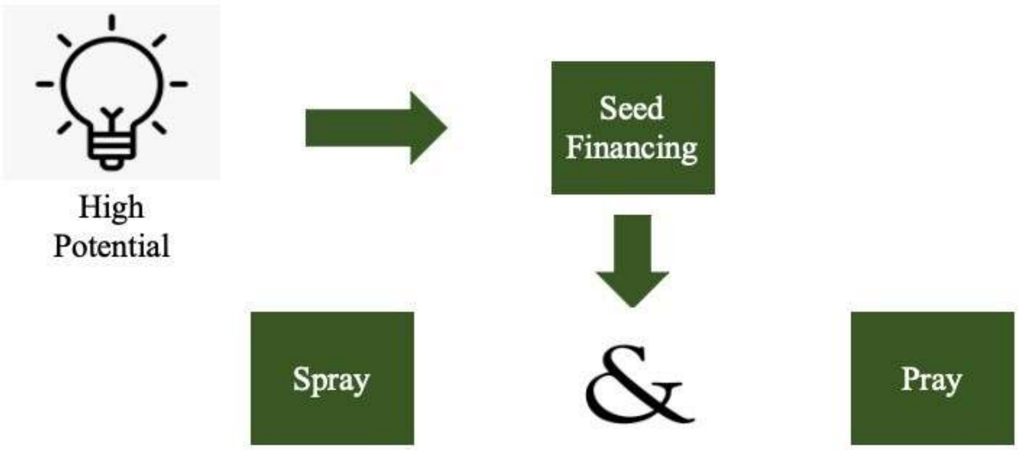
Mass Marketability refers to the goods and services produced for a large market size. For example, hyperlocal delivery services. Popular hyperlocal delivery services such asDunzo or Swiggy have raised funds at an ideation stage. These companies have developed intellectual property using technology, however the marketability potential that they have attract investors to them. This marketability potential is determined by the amount of people that the product or idea can impact. Keeping the previous example in mind, the number of people that a health tech product impacts are far lesser than the number of people that a hyperlocal delivery service impact. Both are priced differently as well but it is the sheer market potential of hyperlocal services that attract investment towards them.



Seed Financing

The PE investment made in ideation stage is known as Seed Financing. An important approach in private equity circles with regard to seed financing is 'spray and pray' approach.

This means that an investor has to invest in around 10 companies and pray that at least one of them succeeds. However, when an investment in seed stage succeeds, the return is in such a high multiple that it broadly makes the investment portfolio profitable.



Example:

Company	Initial Investment	Current Value	Return (CAG
A	10,00,000	11,00,000	3.22%
B	10,00,000	5,00,000	-20.62%
C	10,00,000	1,00,000	-53.58%
D	10,00,000	12,00,000	6.26%
E	10,00,000	45,00,000	65.09%
Total	50,00,000	74,00,000	13.96%

This is case of 5 companies of an investment portfolio. The investor has invested around Rs. 10 lakhs in 5 companies, each of which has gone on to take a different path. A holding period of 3 years has been used to calculate the CAGR. We can see that in company A and D, the value of the investor's holdings has broadly remained the same, with a sub-par CAGR between 3 – 6 %. In company B and C, the value of the investor's holdings have depreciated from the initial investment of Rs. 10 L to a current value of Rs. 5L and 1L respectively. It is only in company E, that the investor has got a 4.5x multiple on his initial investment, where his initial investment of Rs. 10L is now valued at 45L. Due to the various paths that these companies have taken in terms of returns, the investor's portfolio has got a return of around 14%. The fact that this overall return is tremendously lopsided and is driven by single company makes it a typical early seed stage investment portfolio.

First Phase of Commercialization

The primary difference between this stage and the ideation stageis that in ideation stage, an investor is betting on a product. In this stage, an investor is betting on a business plan.

It is vital to note that an investor is still exposed to a high degree to risk and market uncertainty in this phase as an investment in this stage is essentially a bet placed on the entrepreneur.

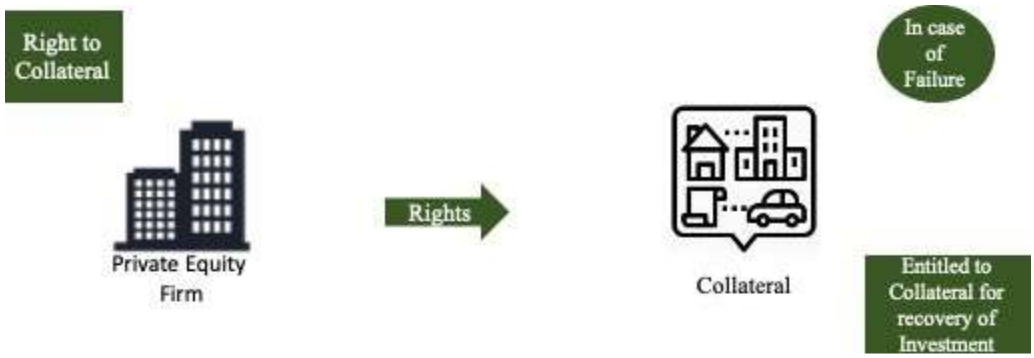
To safeguard her investment and harness maximum potential from it, an investor can use various methods:

1. Put Option

This is an option in which an investor is basically exiting his stake in the company by selling his shares to the entrepreneur. Basically, this means that if the business plan does not work out –the entrepreneur will have to pay off the investor by purchasing his shares.

2. Right to Collateral

This is an option in which an investor can have the right to the physical collateral of the company, in case of a failure. She is then entitled to this collateral to enable her to recover the investment that she put in in the company.



3. Convertible Note

In many occasions, it is very difficult to determine the valuation of an early-stage company. Therefore, in many cases, an investor invests using a convertible note. A convertible note is a loan extended to an early-stage company, that is convertible to equity after achievements of certain milestones in a defined time period. The percentage of conversion varies on what extent is the company able to achieve its slated milestones that it has mentioned in the convertible note agreement.

Example:

Initial Investment	Milestone (Users)	Conversion Rate
25,00,000	1,00,000	6%
25,00,000	75,000	9%
25,00,000	50,000	13%
25,00,000	25,000	18%

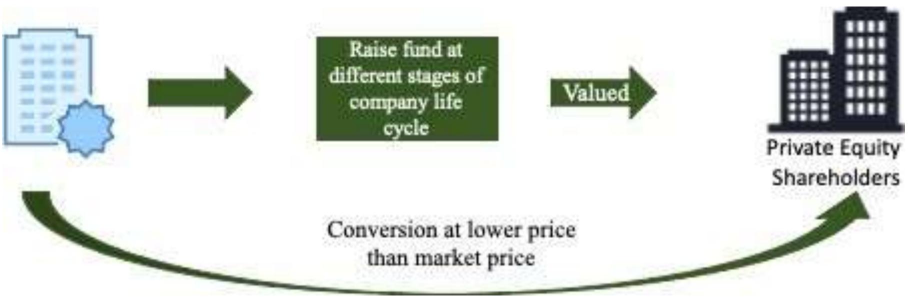
A company that has raised Rs.25L as a convertible note for a one and a half year period. As per the convertible note, the defined milestone for the company is the number of users that it can onboard. As a result, the equity conversion percentage for the investor is determined by the number of users that a company can onboard. In the first case, if the company is able to reach its milestone of 1L users, the founder has to dilute only 6% of his shares to the investor. However, in the 4th case, if the company reaches only 25,000 users; the founder has to dilute 18% of his shares to the investor.

From this table, one can interpret the following:

- How an inverse relationship is present between the milestone and conversion rate. This leads to more motivation for the entrepreneur to achieve his slated targets in the convertible note agreement as non-achievement of this can lead to him losing more equity.
- This is safeguarding the rights of an investor, who takes the risk on an entrepreneur in an early stage of the company life cycle.

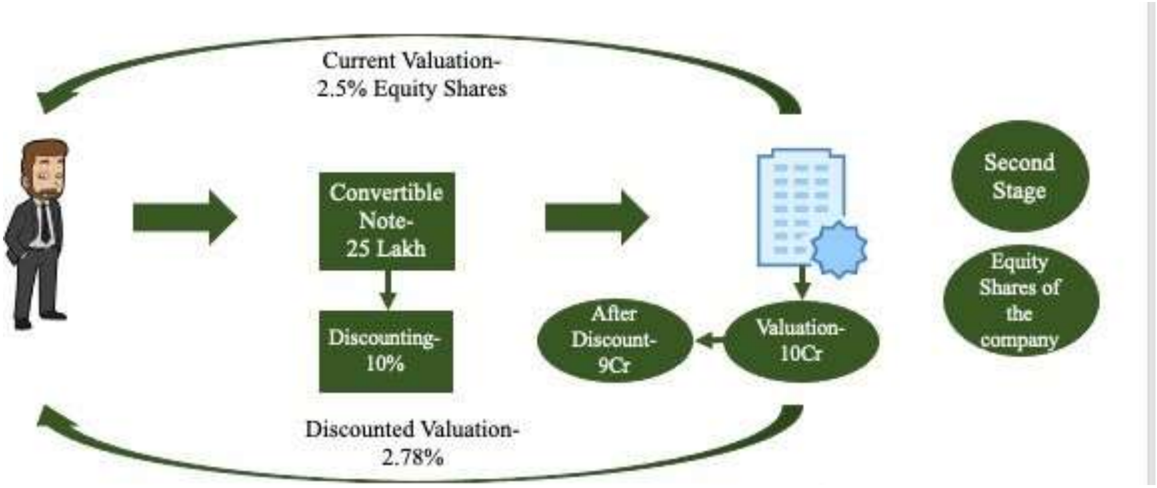
4. Conversion of Shares at Discounted Valuation

This is a technique that is implemented by PE investors in which they benefit through a discounted valuation. Many firms continuously raise funds at different stages of the company life cycle. Whenever, a company raises funds, it gets valued. In this technique of share conversion, early stage holders of a convertible note get their shares converted at a lower rate than prevailing rate of the shares of the company.



Example:

An investor has invested Rs. 25L in a convertible note of a company. The company is now in its second fund raising stage, where the investor will now be getting equity shares of a company. The company is now valued at Rs. 10 cr. Therefore, going by current valuation, she would be entitled to 2.5% shares of the company. However, when a discounted conversion clause is present in the investment agreement, her shares will be converted at a certain discounted rate to market valuation. For example, if her investment agreement mentions a discounting rate of 10%, then the conversion will happen at a valuation of Rs. 9cr. Therefore, she will now be entitled to 2.78% shares of the company. The logic behind a discounted valuation is that the investor is getting rewarded for the risk that shetook by investing in the company in an early stage.

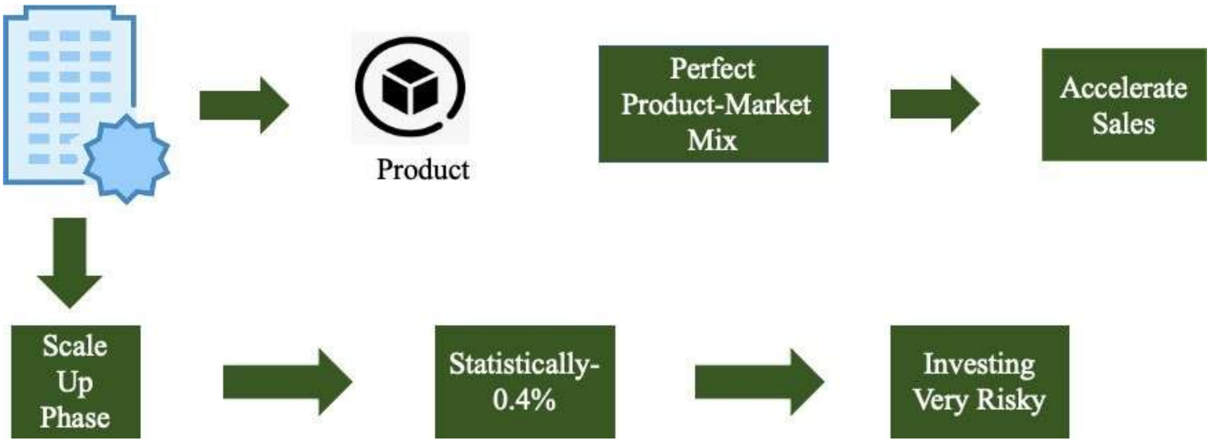


Early Growth Stage

In the early growth stage, the company has already established its product market fit and now wants to accelerate sales and usage.

This is the 'scale up' phase in a venture from start-up terminology and statistically speaking only 0.4% of companies scale us. This leads us to believe that investing in this stage can also be very risky.

Contrary to the previous stage, where an investment is made into a business plan; in this stage, an investment is made into a business plan that is already in motion.



At this stage, the scalability of the business plan is checked. Scalable business plan means that the company can achieve a product-market fit across a wide variety of audiences. For example, Dunzo is a hyperlocal delivery service, which was started in Bangalore in 2014. The company launched its services in Bangalore and post that has quickly moved to launch in other Indian cities including Gurugram, Pune, Hyderabad, Chennai, Delhi and in 2019, it commenced operations in Mumbai as well. This means that the model was scalable.

What made Dunzo'sbusiness model scalable?

- Technology: It not unique to a single city and could be replicated across cities
- Delivery Executives: They may be difficult to find and onboard, but they are available across cities.
- Smartphone – driven: Dunzo's delivery mechanism is through a smartphone-driven as an app and as most urban audiences use it, t made Dunzo's model scalable.
- Demand for groceries, food, fruits, vegetables are also not restricted to a single city or audience and are present across cities.

The definition of a wide market audience can vary according to how you intend to study the business. Here, Dunzowas studiedwith a geographic view of audiences. One can also take a demographic or a socio-economic view, while studying a business.

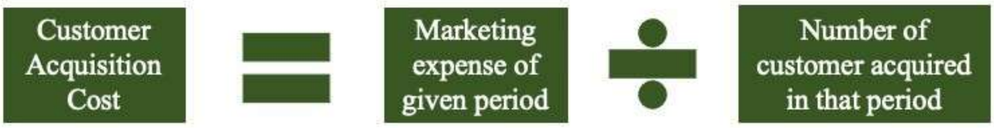
Growth Stage

When a company reaches this stage, its offerings are widely accepted in the market and its sales are growing at a very high rate. Maintaining this rate of growth in sales is the primary objective for a company to raise investments.

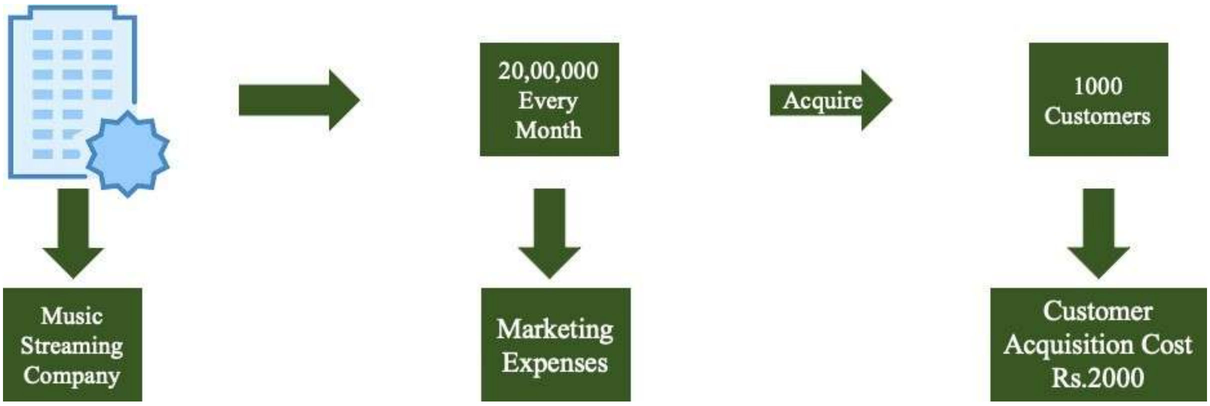
A high rate of sustainable sales growth is possible when a company has reached a potential for revenue growth through a repeatable and scalable customer acquisition process and customer lifetime value that exceedsthe cost of acquisition of the customer.

Customer Acquisition Cost

Customer acquisition cost is Marketing Expenses of a Company in a Given Period Divided by the Number of Customers that they acquired in that Period.



For example, company ABC Ltd, a music streaming platform, spends Rs. 20,00,000 on its marketing, every month to acquire 1000 customers –its customer acquisition cost is Rs. 2000.



Customer Lifetime Value

Customer Lifetime Value is the total money that a customer is expected to on a company's offerings during a customer's lifetime.

Example:

Avg. Value of Customer Purchase	No. of Times a Customer will Purchase	Time Period of Customer's Purchase	Customer Acquisition Cost	Customer Lifetime Value	Cu Pr
200	4	12	2000	800	-1

Avg. Value of Customer Purchase	No. of Times a Customer will Purchase	Time Period of Customer's Purchase	Customer Acquisition Cost	Customer Lifetime Value	Cu Pr
200	8	24	0	1600	-4
200	12	36	0	2400	40
200	16	48	0	3200	12
200	20	60	0	4000	20

We have assumed that ABC Ltd. charges Rs. 200 for a 3-month period. Therefore, it can be assumed that a customer has to purchase 4 times each year. This table shows the 5-year analysis of Customer Acquisition Cost and Customer Lifetime Value.

In the first year, the company earns Rs. 800 from the customer and as mentioned previously in the module, it has spent Rs. 2000 as CAC to acquire the customer. Therefore, from a unit economics perspective, the customer is not yet profitable for the company as it is losing Rs. 1200 on him.

If the customer continues with the streaming service in the second year, its lifetime value has increased to Rs. 1600 as he has made 8 purchases. However, the company is yet losing Rs. 400 on the customer as it had initially incurred Rs. 2000 as the CAC.

Only when the customer continues with the service in the 3rd, 4th and 5th year; the company achieves a Customer Lifetime Value of Rs. 2400, Rs. 3200 and Rs. 4000 from him respectively. In this period, the customer becomes profitable for the company.

From this table, one can see how difficult it is can be for a company to have a profitable customer. In this case, ABC Ltd. has to keep innovating and enriching the customer experience for a minimum period of 3 years to achieve customer loyalty to an extent that it can cover its customer acquisition cost.

Therefore, when it comes to investments in growth stage investments, PE firms look at:

a. **Whether the company has a model to achieve sustainable customer lifetime value exceeds customer acquisition cost as this is important for long term profitability**
b. **The time period taken by the company's model to achieve a customer lifetime value that exceeds its customer acquisition cost**
c. **The most important –whether this model of customer lifetime value and customer acquisition cost can be replicated across markets – as this is critical for the company to achieve a high rate of sales growth. By this we mean, the company has to answer questions like:**
    - **Is this financial model, replicable across geographies?**
    - **Is it replicable across demographics?**
    - **Is it replicable across socio-economic classNamees?**

At this stage, the PE investor is more concerned about whether the combination of marketing & financial strategies that are deployed by the business, are scalable in working across markets.

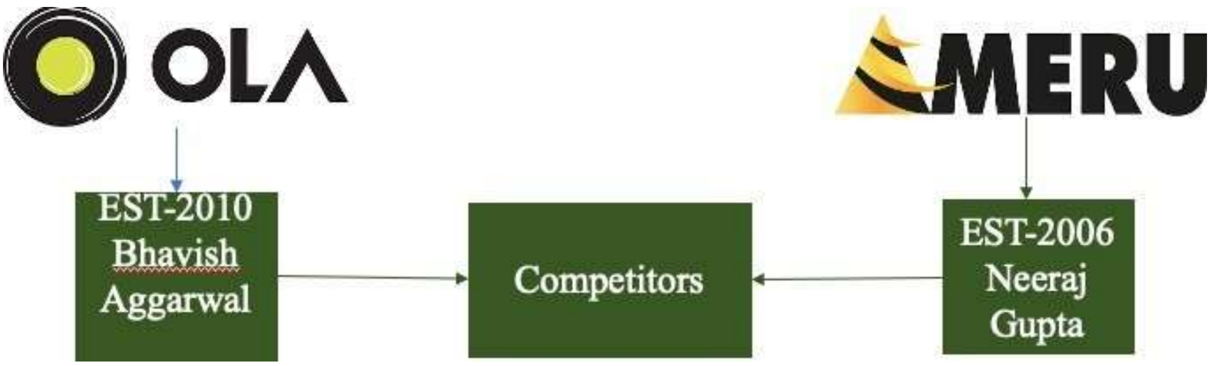
Stability Stage

In this stage, the company's sales are growing at a high rate and the company has already achieved a significant share in its market. The core aim of the company to raise funds here is to protect and grow its existing market share.

There are two kinds of threats that a company faces:

Threat from existing players

Even though these players were present in the market, once the company raises funds and grows exponentially, their attractiveness to raise funds increases. This is what makes them a big threat. For example, Indian ridesharing companies. Ola Cabs, broadly leads the ridesharing market in India. It was established in 2010 by Bhavish Aggarwal. Another ridesharing company is Meru Cabs, which was actually established before Ola in the year 2006 by Neeraj Gupta. Though, their business models were different in the start but they converged as the competitive rivalry among them increased.



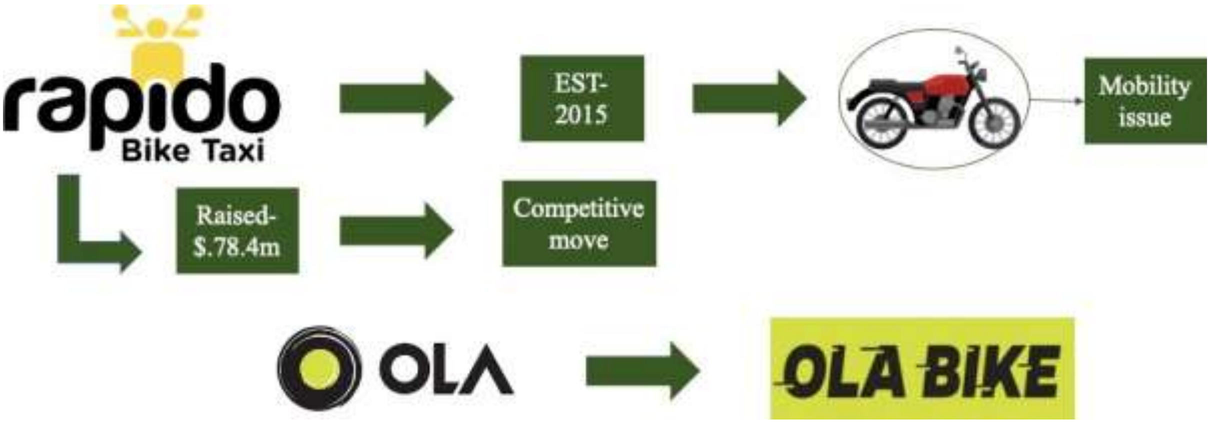
According to their fund raising history, Ola has been much more aggressive in terms of fund raising and has raised $3.4 bn, while Meru has been able to raise $75m and has got acquired by Mahindra & Mahindra in the process.

Meru was able to raise funds aggressively, after Ola had already overtook it in the market, using the funds it had raised. This is a typical case that shows how the attractiveness of Meru, an old existing player to attract private equity investors increased after Ola, a new player beat it in the market using PE investment

Threat from new entrants

Once a player becomes extremely successful in amarket using PE investment and delivers return for PE investors, the broad industry & market attractiveness goes up. This increase in industry attractiveness helps new players to aggressively raise PE funds, which enables them to compete with the now-established player.

Continuing the example of ridesharing services. Ola was established in 2010 and Meru was established in 2006. Ola has raised $3.4bn in funding, while Meru has raised $75m in funding. Rapido, which was established in 2015. Rapido is an online bike aggregator, which solves the same urban mobility problem as Ola but by using a bike. In an extremely short period, this bike hailing service has raised $78.4m in private equity funds. As a competitive move, Ola launched Ola Bike, a similar serviceto Rapido in many Indian cities.



From this case, one can note four things, the first being how the attractiveness of the Indian ridesharing industry, led by Ola. Secondly, how an increased industry attractiveness was beneficial to both existing and new entrants to raise funds. Thirdly, how Ola had to retaliate with new offerings to protect its market share from new entrants. Lastly, how Ola needs to raise funds in order access the resources that will enable it to continue its lead in the market and ward off competition.

Crisis Stage

In this stage the company is in a decline and needs money to survive. Therefore, it can be extremely difficult to raise money at this stage.

Example

ABC Ltd. is a music streaming service and we previously calculated customer lifetime value and customer acquisition cost analysis of its offerings. From that analysis, it would take at least 3 years for the company to reach a stage, where the customer lifetime value exceeds the cost of acquisition of the customer. Now, the company is unable to make most of its customers stick to its services for 3 years and hence, the value of the company is depreciating.

For an investor, investing in it would not typically make sense. However, there can be a different perspective.

Imagine that the investor are working for a company, which is ABC Ltd.'s competitor and has grown by taking away most of ABC Ltd.'s customers. However, there are certain regional music categories in which ABC Ltd. dominates the company that you are working with. Now, would investing or acquiring ABC Ltd. make sense for your company?

The answer can be tricky but different from the first case. The investor may want to look at acquiring ABC Ltd. by investing in it, in order to gain a strong hold in those regional markets, where they have a stronger footing. As ABC's growth is broadly declining, there is a chance that she may get the company at a cheaper rate than she would get for a company, that has a similar base to ABC Ltd. but is on an upward trajectory.

This is a typical case of investing in crisis, where a company, takes over a troubled competitor – in order to gain a strong footing in those sub-markets, where the competitor is doing better than the company. As the competitor is troubled, the company is often able to be acquire it at a cheaper valuation.