

## CHAPTER

# 11

# PRIVATE EQUITY

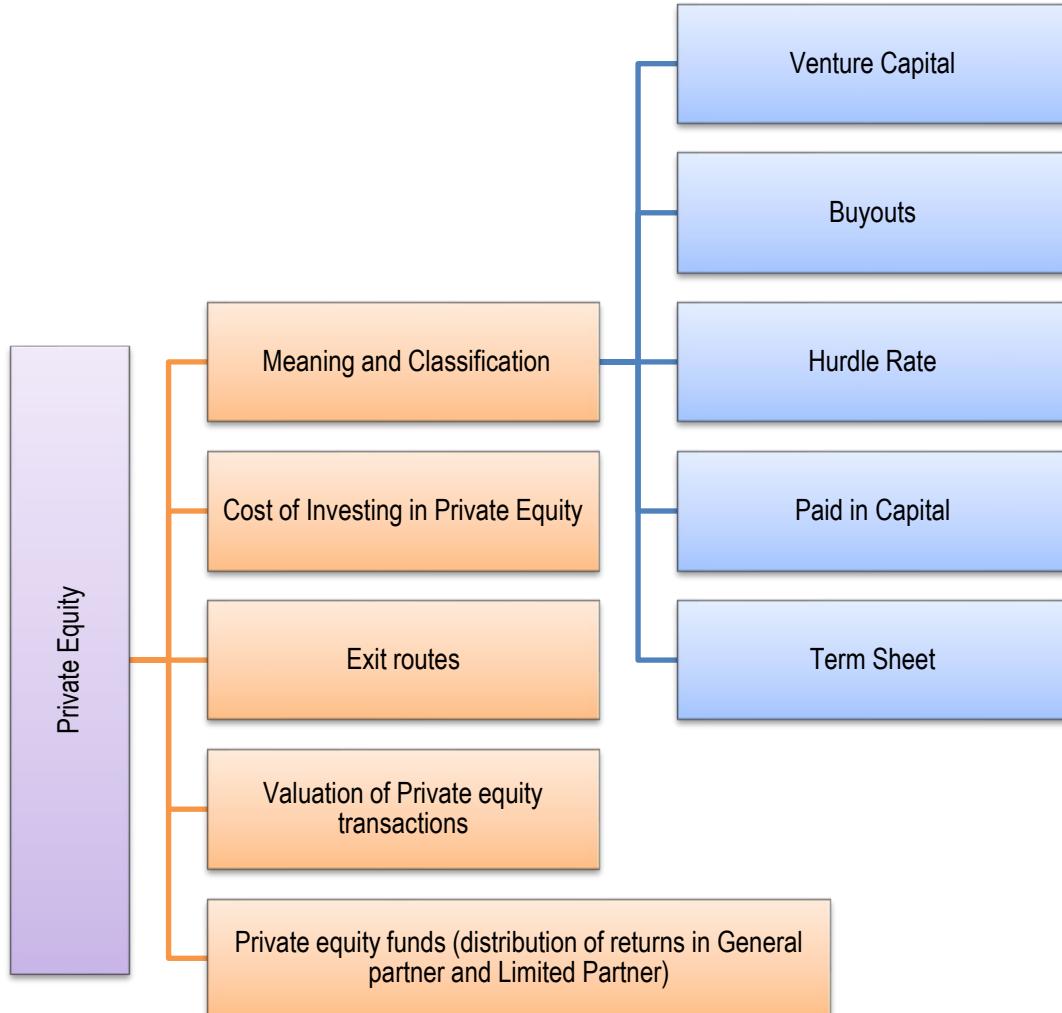


## LEARNING OUTCOMES

After going through the chapter student shall be able to understand

- Meaning and Classification
  - (1) Venture Capital
  - (2) Buyouts
  - (3) Hurdle Rate
  - (4) Paid in Capital
  - (5) Term Sheet
- Cost of Investing in Private Equity
- Exit Routes
- Valuation of Private Equity Transactions
- Private Equity Funds (Distribution of returns in General Partner and Limited Partners)

## CHAPTER OVERVIEW





## 1. MEANING OF PRIVATE EQUITY (PE)

Private Equity is the capital brought in by the Private Equity firms (simply called 'PE firms') into the enterprise as part of equity capital. PE firms are the investment fund companies who take a strategic stake in the enterprise. PE is one form of Venture Capital which takes the form of equity capital of the company. PE firms are in a broader sense, the long-term investors into the enterprise and act like 'mentors' to the management.

*Industry Overview:* The capital raised by way of Initial Public offer is referred to as public equity, however capital raised privately is known as private equity.

Private Equity (PE) is the different form of investment, as compared to publicly traded equity markets, where the PE investor (or the PE firm) invests majorly into startups and emerging sectors through strategies like early funding, venture capital, growth capital, etc. The main characteristic is that these investments function on a higher risk to reward model, and to amplify the returns, the PE firms use a leveraged approach of using debt as the funding instrument. The PE firms expect returns through valuation increase of the company in which capital is invested.

The PE industry has grown significantly in the past three decades, and over a period of time PE firms like Bain Capital, Blackstone have grown tremendously entering successfully into Asian markets too. There was a temporary setback in the PE industry during the dotcom bubble seen in 2000-2003, but has staged a comeback, stronger and more resilient. The growth in PE has also seen a marked increase in regulations in both the US and Europe. In the US, the SEC regulates PE industry, and in addition has added FATCA (Foreign Account Tax Compliance Act) and the Alternative Investment Fund Managers Directive to have greater transparency in the workings of PE.



## 2. CLASSIFICATION OF PRIVATE EQUITY

### 2.1 Venture Capital (VC)

#### 2.1.1 Introduction

Fertile brains can generate ideas – Venture capitalists provide the money to fuel these ideas and innovations to reality. Simply put 'venture capital' is the capital provided to especially new startups and entrepreneurship enterprises to stand up and deliver.

A venture capitalist is an institutional investor who has the access to liquid funds and is ever willing to part it with talented startups and innovative enterprises that require that extra bit of hand holding. Note the word used 'ever willing' will essentially be the distilled result of a strict selection criteria-

based evaluation of the startup, its promoters, its vision and of course, the numbers in terms of estimated cash flows, breakeven point, and a whole lot of similar parameters that we would see shortly.

Some of the most successful ideas in the new age world have got the momentum and the trajectory all but thanks to venture funds – WhatsApp, Spotify, Facebook – all had venture capitalists helping them to get the much required capital as well as to get them to get on to the big stage of mergers and takeovers by larger entities.

A venture capital fund, as opposed to a venture capitalist, is a firm that works as an investment fund having pooled resources from various self-styled and serious venture capitalists and is seeking private equity stake in startups and innovative enterprises.

VCs usually invest as either ‘early stage’ funds or ‘late stage’ funds. Early stage would mean the VC is taking a riskier approach of investing in startups exhibiting ‘raw potential’, whereas later stage would mean the less risky way of investing in firms having proven their business viability and are wanting to expand their operations.

*Who stands to gain from Venture Capital (VC) funding?*

1. Startups
2. Innovative enterprises who are still in the early stages of their growth
3. High risk – high reward business lines
4. Niche business segments, etc.

In the Indian scenario, the e-commerce segment has seen sustained interest for funding by VCs, for example:

1. Online services like Makemytrip, Taxi for Sure etc.
2. Online marketing portals like Bookmyshow, Myntra, etc.
3. Online health care segments like Practo, etc.

### **2.1.2 Setting up a VC.**

**Step 1:** Large corporate houses, mutual funds, Insurance companies, Banks, High net-worth individuals etc. along with Private Equity firms creates special purpose vehicle (SPV) for identifying and doing the investments. SPV is funded substantially by such corporate houses, mutual funds, insurance companies, banks, High net-worth individuals etc. and a certain portion of investments comes from the Private Equity firms too.

**Step 2:** Once SPV is funded and in place, General Partners and Limited Partners are also appointed to the SPV alongwith the Investment manager.

General Partners are responsible for management, operations, administration, and any kind of decision making in the SPV formed. They are appointed by the Private Equity firm to the SPV created.

Limited partners come with very limited control, with the objective of returns of investment. They are appointed by the institutions which fund substantially i.e. large corporate houses, mutual funds, insurance companies, banks, High net-worth individuals etc.

**Step 3:** Investment manager analyses the different proposals for investments into startups and gives feedback to General Partners.

**Step 4:** Once the deal is finalized, investment is placed in the form of private equity.

**Step 5:** An expert is also appointed to the Board of directors of the company to guide and govern the overall performance.

**Step 6:** Exit from the investment at the right time and right valuation later (generally 5-10 years).

### 2.1.3 Business Model for a VC

So, what is the business model for a VC? The first and foremost step will be to identify a startup or a diverse idea that can become a revenue generator and hence warrants capital funding. And this is the toughest part of the job. The selection matrix can involve a whole battery of parameters, the critical ones listed as below:

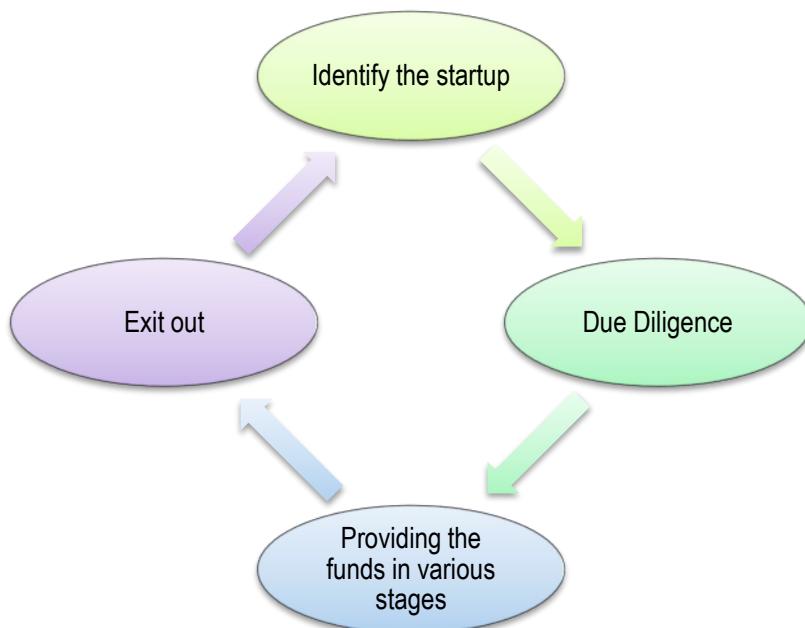
- (i) The fundamental 'idea' or the 'business model' of the company
- (ii) The ability to generate customer interest thereby increasing the possibility of a successful business manifold – which explains why e-commerce companies in India can garner a largesse of the VC funds.
- (iii) The breakeven point – obviously the shorter the time frame the better
- (iv) The future prospect of the startup to be taken over by a bigger entity.

Apart from the revenue perspective, a smart VC also investigates the possibility of how much a startup can create 'brand recall value' – the higher the possibility the more is the prospect of a valued takeover deal. For example, WhatsApp, in which VCs had strategic stake, had so correctly marketed the concept that it got the attention of Facebook. Its acquisition by Facebook has brought smiles to everyone involved – the VC got a good price, and so did the founders of the company, and Facebook has had its customer connect significantly enhanced.

The next important step would be to measure the exact amount of capital to be provided to the venture. This would entail the need to check the background of the promoters, business culture, current and future growth prospects, cash flow estimates, breakeven point analysis, and the brand value creation. This whole process can also be called as 'due diligence' process, and finally the VC will make an exhaustive report of the same, to justify the decision to finance the venture / enterprise or otherwise.

And the last step would obviously be the exit point of the VC from the enterprise. It's very important to appreciate the fact that the primary objective of any VC is to provide funds with a clear-cut time frame for returns on investment. Once the desired returns are achieved, the VC exits out of the enterprise, either through a stake sell-out, or through an outright merger with an outside enterprise.

The following is a pictorial representation of the basic VC investment cycle:



As stated earlier, once the target returns are achieved, the VC would like to exit out to realize the gains and move on to another investment. This brings us to the concept of 'private equity'.

### 2.1.3 Types of Funding by a VC

A VC will fund typically in the following ways:

1. Seed Capital
2. Crowdfunding

3. Early-stage funding
4. Interim funding - Bridge financing, mezzanine
5. Expansion funding

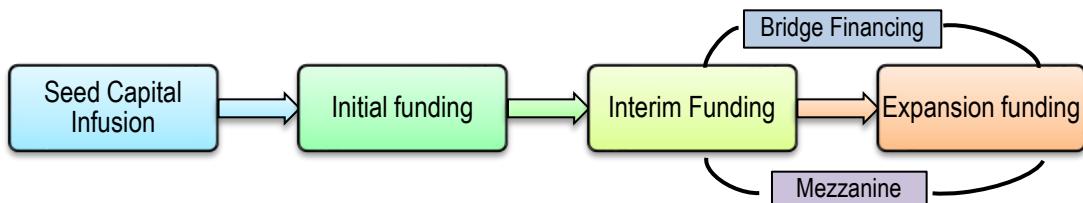
Let's analyze each of these in detail:

1. **Seed Capital:** This is the preliminary source of funds provided to the startup for either acquiring fixed assets of startup like computers, machineries etc; or for leasing out premises and such other operational setups. The seed capital is usually limited, and just enough for the startup to shore up its capital assets. In recent times, there are 'incubators' who have specialized in this type of funding purely for seed capital and seek to exit out once other investors find value.
2. **Crowdfunding:** This involves raising funds through platforms on which a huge number of small investors invest money in the different startups listed on that platform. As the name suggests, investment happens through crowd at large and hence crowdfunding.
3. **Early-stage funding:** This is typically the Series A funding where the VC provides the funds for setting up the entire plant / site / services line which may also include the infusion of working capital.
4. **Interim funding:** Once the enterprise breaks even, the immediate focus will be on having stable cash flows. In the meantime, the management may also seek additional capital to ramp up its' operations model to its full capacity. This can be done in different ways –
  - a. The management can seek a 'bridge loan' that is essentially a plank provided for stepping up to ramp up / reach the full capacity. A bridge loan, being a short-term financing loan, is an ideal way for enterprises to get a temporary source of funds before it can get replaced with a larger or a longer time frame-based loan.
  - b. The management can seek a 'mezzanine' financing which is typically a hybrid of debt and preferred stock finance. In some cases, the mezzanine is purely a debt form of finance. In both cases, the repayment schedule gets tailored to the enterprise's cash flows thereby exhibiting flexibility to the management. However, the fund comes at a price – the VC gets a direct stake in the equity of the enterprise post the conversion of preferred stock, which may make some management uncomfortable for this sort of an arrangement. There are variants of mezzanine funding with some VCs who estimate that if the enterprise has high future potential, it can forego the requirement for a collateral value altogether or atleast keep it to minimal levels, whereas some VCs

would like to have an asset-backed security for the debt component. The equity component also gives the VC a say in the management affairs of the enterprise, which makes this route quite attractive to them. From the borrowers' point of view, this may be the costliest form of funding as the rate of interest would be quite high, to recognize the risks getting carried in the form of uncollateralized debt. This can leave the management with a huge refinance cost; however, as stated earlier the VC would also take care of this in the tailoring of the repayment schedule.

5. ***Expansion funding:*** Once the enterprise is running full steam and has managed to create its own space in the market in terms of brand recall value, the VC will surely be interested to provide additional funding in terms of long-term finance for future growth prospects. This may also put the enterprise 'on the block' for potential buyers, especially large sized companies who regularly scout for smaller niche enterprises to add further variety to their developed shelf of products and services.

The following is a pictorial representation of the VC funding stages:



#### 2.1.4 Angel Investor

An angel investor is a multi-millionaire who has funds, usually idle with him or her, and wants to take a share of risk to promote a startup by investing in the same. In return, they usually get an ownership stake or a preferred stocks and board rights. Seldom do they settle for subordinated debt unless the case for investment is too strong to an opportunity to be missed. The biggest pitfall for an angel investor is that they need to bear extremely high risks, and hence their rate of returns is also the highest.

Usually, angel investors are retired fund managers and successful entrepreneurs themselves who have a know-how of the segment that they would like to invest in and rely a bit more on intuition and gut feel about a particular investment. After all it's their own funds, as compared to VC funds who manage other's funds. It is not uncommon to find angel investors having common segment interest to team together, such as two investors having a liking for e-retailing space would approach for an assessment of a particular enterprise together.

## 2.2 Buyouts for a PE

There are two popular ways of buyouts getting executed – Leveraged Buyouts (LBOs) and Management Buyouts (MBOs).

### 2.2.1 Leveraged Buy Outs (LBOs)

Leveraged buyout is a series of actions that include investment, divestment, and restructuring. In an LBO, the acquirer uses a significant amount of debt to finance the acquisition of a target and then pursues restructuring actions, with the goal of exiting the target with a sale or public listing.

In the process, they leverage the debt and create value (both perceived and real) and then they either spin off the management control to another entity for a price or go for an outright sale.

Some of the examples of a successful LBO deal include the buyout by Tata Steel of UK's Corus, and the acquisition of SLI Sylvania by Havells India.

### 2.2.2 Management Buy Outs (MBOs)

The classic MBO represents the buyout made by the entity's managers themselves. The logical reasoning is that they are best placed to run the operations efficiently. However, the other side to this is that the managers of the entity may not be the best of the lot to bring in additional clients. Similarly, they may be on the conservative side when it comes to risk taking.

The MBOs are often funded to management by private equity firms i.e., private equity firm contributes capital to the management to initiate MBO.

However, with changing times, MBOs are also getting attention from PEs themselves. In an article published in *The Hindu Business Line* print edition dated July 10, 2008, explaining on the emerging features of MBOs - 'Traditionally, Management Buy Outs (MBOs) involved the management wanting to purchase a controlling interest in the company and working along with financial advisors to fund the change of control. Today, MBO activities involve promoters divesting their stake in a firm by selling out to PE players willing to finance the asking price.'

The PE players are flexible enough to enter a partnering relationship with the existing management. This sort of arrangement is basically just a stake buyout and not a classical MBO. It is common in scenarios where owners want to hive off entities with poor results and the management lacks funds to hold on to the entity (and their jobs) and are, in turn, bailed out by the PE firm'. This means that PE brings in finance as well as their clout in the market to attract additional business lines. Once the expected IRR is achieved, or the estimated cash-on-cash multiple is attained, the PE may also choose to exit out. One of the good examples of MBO in India is the purchase of Intelenet Global Services by Blackstone.

## 2.3 Hurdle rate

The minimum rate of return that is required by the investor before the sharing of profits – for e.g., a hurdle rate of 15% would mean for the PE that this should be the minimum return to be generated before the sharing of profits starts. In other words, the hurdle rate is the minimum guaranteed return for Limited Partners before sharing the gains with the General Partners, as per the carried interest arrangement. Carried interest or simply stated as 'carry' is the share of profits of the General Partner more than the investment made by him in the portfolio.

## 2.4 Paid in Capital

Paid in Capital is the amount of capital contributed by the shareholders. It is the amount of capital "paid in" by investors during the issue of equity shares to the public, including the par value of the shares themselves. Paid in capital represents the funds raised by the business from equity, and not from ongoing operations." "Paid-Up Capital" is shown in the 'equity' section of the balance sheet. It represents the amount of money shareholders have paid into the company by purchasing shares. It basically involves two accounts, the par value of the shares and the excess over par value.

## 2.5 Term Sheet

The term sheet is the agreement copy that the VC hands over to the management, which contains the terms and conditions, fee structure, payout terms, liquidation rights, anti-dilution provisions, pre-emptive rights, exit terms etc.

### Critical Terms that appear in a Term Sheet:

- (i) **Fee structure:** The standard fee structure of a PE fund is made to balance the financial interests of the fund's investors and the PE firm. The "2 and 20" fee structure in PE describes how a fund's investment manager and general partner (GP), and consequently, its PE professionals, are paid: the "2%" refers to the management fee paid by the LPs annually to a fund's investment manager while the "20" represents the percentage of net fund profits, also known as carried interest or "carry," paid to its GP. Pro rata distribution of a fund's profits, or 80% of them, is made to the LPs. If carried interest is the primary financial incentive for PE experts, their attention will.
- (ii) **Harvest year:** The year projected to be the exit year for the PE/VC.
- (iii) **Down round:** This would mean that the investors pay a lower per share price than what previous investors paid, which indirectly implies that the investors have valued the VC at a lower value in the current round than the previous round. This decline is called as 'down round'. For example, if the initial round of financing earned INR 1 Crore for an entity, and round two has obtained

a value of INR 0.7 Lacs, then this means that the investors have valued the entity lower in the second round, causing a ‘down round’. Down round causes a dilutive effect of original investor rights.

**(iv) Methods for computing anti-dilution rights:** To avoid a possible dilution to a ‘down round’ situation, the term sheet will usually contain an anti-dilutive clause. This is achieved either by a ‘full ratchet’ method or a ‘weighted average’ method, and the preferred method is mentioned in the term sheet. In a rare case where it is not explicitly stated, the weighted average method is usually adopted.

#### Illustrative example on the application of anti-dilutive clause:

The position of holding in a VC before the second round (Series B) -

	Number of Shares	Per share	Value	% holding
Common Stock	600,000	1.00	600,000	60%
Series A investor	400,000	1.00	400,000	40%
	<b>1,000,000</b>	<b>1.00</b>	<b>1,000,000</b>	<b>100%</b>

Now, in Series B an investor has given a down round value of only INR 6, 00,000 with 50% stake after down round. Without an anti-dilution clause, the revised stake-holding would be as:

Common Stock	300,000	0.60	180,000	30%
Series A investor	200,000	0.60	120,000	20%
Series B investor	500,000	0.60	300,000	50%
	<b>1,000,000</b>		<b>600,000</b>	<b>100%</b>

You would note that the share of Series A investor has gone down, whereas the late entrant Series B investor has an upper hand.

Now, say if there was an anti-dilutive clause which stated to protect Series A investor against a down round – the revised sheet would look as below –

	Number of Shares	CP	Value	% holding
Common Stock	100,000	0.60	60,000	10%
Series A investor	400,000	0.60	240,000	40%
Series B investor	500,000	0.60	300,000	50%
	<b>1,000,000</b>		<b>600,000</b>	

**(v) Up round:** The opposite of down round where the successive round of investment has valued the venture at a value higher than the earlier round.

(vi) **Break Fee:** A fee typically payable to the investor if the company declines the investment described in the Term Sheet or if the company or founders breach exclusivity or other binding provisions in the Term Sheet.

(vii) **Exclusivity Agreement:** A kind of non-compete period during which the company cannot negotiate for investments with outsiders for additional investments in the company. This is to protect the holding rights of the PE.



### 3. COST OF INVESTING FOR PRIVATE EQUITY

The cost of investment for a PE will be economically the same as seen for a VC, barring the capital cost in specific cases. The cost of investing in PE would typically be equal to the weighted average cost of capital for the amounts raised by PE for the purpose of investing in the venture. This is based on the expectations of the investor as well as fund management costs including the commission etc. payable as mentioned above.



### 4. EXIT ROUTES FOR A PE

There are four ways to exit out of a PE investment once the horizon period is met, or otherwise by management decision.

(i) **IPO (initial public offer):** This represents a highly successful exit strategy, riding on a strong business model. The payback can be instantaneous through selling the own shares immediately on listing on the stock exchange. However as per regulations there are restrictions and regulations for the exit planned through IPO which are notified by Securities and Exchange Board of India.

(ii) **Strategic Acquisition:** The share of the PE is acquired by a larger company, usually in the same business segment. Thus, a small IT company into a niche testing technology line may get acquired by a bigger IT company, which is often seen in India. Another example can be the acquisition of Instagram by Facebook. This is perhaps the most commonly used exit route and is usually a win-win situation for both the exiting investor as well as the management of the enterprise.

(iii) **Secondary Sale:** The investor PE exits by transferring its share to another PE. Such an exchange is seen either when a larger PE finds value in the venture thereby giving a sweetened deal to the smaller PE, or, where the business may require more money which is not in the capacity of the current equity fund.

(iv) **Repurchase by existing management (founder members):** This is an ideal scenario type where the founders get back to owning the majority stake in their entity, and a golden handshake to

the exiting PE. This is also referred to as 'Management Buyout' (MBO). The exiting PE may, in rare cases, also get to earn a trail fee for the next  $n$  years as may be mutually agreed to by the parties, usually a % of EBIT, or a multiple based terminal value.

(v) **Liquidation:** This is the least preferred method of exit, where the investor leaves out at a cash loss on capital invested. This usually happens where the investor cannot take further losses, or has made an overestimate of expected returns, or a particular idea behind the venture hasn't really taken off or was well received in the market. The term sheet usually provides financial safeguards to the VC against drastic losses.



## 5. VALUATION OF PRIVATE EQUITY TRANSACTIONS

There are certain terminologies that are intrinsic to valuation exercises performed by VCs / PEs, these includes:

(i) **Pre-money and post-money valuation:** Simply put, pre-money valuation is the value of the enterprise before the investment; and post-money is the valuation after the investment by the VC. For example – assume a startup has a share capital of ₹ 10,000 represented by 1000 equity shares of ₹. 10 each. X, a VC, has shown interest in doing an initial funding of ₹ 4000 worth represented by 400 equity shares.

In this case the pre-money valuation is INR 10,000 (before investment). The post-money valuation will be the fully diluted impact on the equity which will be computed using the following formula:

**New Investment Amount\* (Total shares post investment ÷ Shares issued in new investment)**

In the example, the post-money valuation will be calculated as follows:

	Number of shares	Face Value	Valuation
<b>Pre-money</b>	1000	10	10,000
<b>Post-money</b>			
Existing	1000	10	10,000
New Investment	400	10	4,000
<b>Post-money shares outstanding</b>	<b>1400</b>	<b>10</b>	<b>14,000</b>
<b>Post-money Valuation</b>			<b>14,000</b>

**Note:** The above illustration is a simplistic representation of how pre and post money valuation works in mathematical terms. In real life, the VC would perform a valuation based on due diligence and the value would either be at a premium or discount.

Assume in the above example the fresh capital is introduced at ₹ 20 per share and the amount invested is 8,000 by purchasing 400 shares.

The post money valuation would be  $(8000/400)*1400 = 28,000$  (basis formulae above)

**(ii) Ownership dilution:** Each additional investment from the VC will end up diluting the ownership control of the management of the enterprise. In the example above, the effective ownership control of management has gone down from 100% to 71.43%. If there is a further round of investment, the management control even will well go below 50%. Anti-dilution clauses are mandated in the term sheet to help overcome this problem. The number of shares to be issued will be adjusted to maintain the ratio of holding.

**(iii) Liquidation Preference:** It is an important term associated with Private Equity financing. This term provides preference to receive funds by VC over and above preferred and common stockholders in the event of liquidation or deemed liquidation.

**(iv) Series A and B:** Series A will be the initial round of funding, whereas Series B are the subsequent rounds of funding, which are usually after the enterprise achieves certain pre-determined milestones.

**(v) ROI:** The rate of return that the enterprise would offer to the investor (VC) on the investment.

**(vi) Terminal Value:** The value of the enterprise that would be at the end of the time frame of the investment cycle of the VC, used at the time of acquisition / sale to a third party. An Exit Multiple would be used, usually calculated as on Enterprise Value (EV/EBIDTA), that the VC has been expecting to obtain at the exit through selloff.

**(vii) Tranches:** The investor (PE or VC etc.) will bring the funds only based on certain agreed 'milestones'. The funding is, thus, made in parts or 'tranches'.

**(viii) Deemed Liquidation:** This term implies in addition to liquidation, it includes change of control, acquisition, amalgamation etc., sale of a company or sale of most of its assets. As mentioned above deemed liquidation normally are considered trigger events for liquidity preferences.



## 6. PRIVATE EQUITY FUNDS (DISTRIBUTION OF RETURNS IN GENERAL PARTNER AND LIMITED PARTNERS)

The terms General Partner and Limited Partner are generic to PE world and represent the way the stakeholders and their rights are structured within PE. The PE fund is structured as a liability partnership; and General Partner (GP) is the one who represents the PE firm in terms of raising the

capital from a basket of pension funds, angel investors, HNIs (high- net worth individuals), and the Limited Partners (LPs) are these investors (pension funds, angel investors etc) who have invested with the GP. The GP acts like the investment / fund manager and will formulate the investment portfolios (the enterprises where the PE will invest funds) and determine the 'capital commitment' by the LPs.

**For example:** a PE looking to fund an enterprise into e-retailing (portfolio) will have its GP approaching its pool of LPs and, say, if a couple of LPs agree to investing the sum required, then this becomes the capital committed from the LPs end. One practical scenario will be that the investments are not required in one go – it will be in tranches –and hence there will be 'calls' raised by the GP for fund requests from the designated LPs (two in our case). Suppose if one of them doesn't honor the call, the GP normally has the right to forfeit the amount invested by the LP to that point of time, unless the agreement specifically states otherwise, or allows for a 'replacement' by another LP who would purchase at a discount the existing share. The GP will usually stand to earn through 'management fee' which will be a % fixed on the deal amount and through 'incentive fees' – called hurdle rates.

Generally, 5% of the entire fund is also contributed by General Partners so that they have a fiduciary relationship with Limited Partners. Limited partners participate in the returns after fund relates expenses, hurdle rate and other admin cost of the fund is reduced. The returns for the fund are calculated by determining the fair value of the underlying investment. This can be realized or unrealized as well.

## Conclusion

We have seen that venture capital funds and PEs fill in the capital requirement gap of new emerging technologies and innovations. In mature markets like US, PEs does play a significant role in funding such segments. In India, VCs and PEs are still in evolving stages though e-commerce companies have certainly progressed due to their innovative entry and exit strategies. VCs work towards short and medium term goals, whereas PE funds stay put for the long run. However, both have well defined exit strategies, typically through acquisitions or IPO mode. In India, they come within the ambit of SEBI and must follow the established rules and procedures for equity sourcing and funding.

## TEST YOUR KNOWLEDGE

### Multiple Choice Questions (MCQs)

1. Private equity uses funds raised from which sources.
  - (a) Initial Public Offer
  - (b) Mutual funds, HNIs, Insurance etc
  - (c) Taxpayers' money
  - (d) Follow on Public Offer
2. Once investment is initiated by private equity then:
  - (a) Exit of investment happens when life cycle or term sheet is completed.
  - (b) Expert is appointed to the board of directors.
  - (c) Next series funding is not allowed.
  - (d) a and b are correct
3. A company is floated with authorized shares of 10,000 @ ₹ 10 each as face value. Promoters have invested into 5000 shares as paid-up capital. After 5 years of running the business, they got an offer from Private Equity for a 40% stake at ₹ 80,000 capital. Please calculate the gain to promoters once this valuation is accepted and the deal is executed.
  - (a) ₹ 70,000
  - (b) No gain or loss
  - (c) ₹ 50,000
  - (d) Cannot say.
4. The purchase of a stake in a target company by substantially borrowing the funds is regarded as
  - (a) Management Buyout.
  - (b) Leverage Buy out.
  - (c) Management Buy in
  - (d) Leveraged buy in

5. Private equity refers to investment in business and issuance of shares under circumstances other than:
  - (a) Initial Public offer
  - (b) Follow on public offer.
  - (c) Private issuance of shares
  - (d) Both a and b
6. While doing financial due diligence which among the following a private equity may not consider before investing?
  - (a) Off-balance sheet financial instruments
  - (b) Weakening working capital trends
  - (c) Dependence on powerful suppliers or a concentrated customer base
  - (d) Accounting adjustments to obscure actual performance
7. Which among the following is not a disadvantage of IPO in the exit strategy of private equity?
  - (a) Risks of going to market
  - (b) Strategies require a majority stake
  - (c) Lock-up
  - (d) Uncertainty of returns

## Theoretical Questions

1. Who are venture capitalists? Who stands to gain from venture capital funding?
2. Briefly explain the business model for a venture capitalist.
3. Discuss the difference between Leveraged Buy Outs and Management Buy Outs.
4. Explain the critical terms that appear in a Term Sheet.
5. Discuss the various exit routes for a PE.

## Practical Questions

1. PQ Ltd, a PE firm, purchases ₹ 1 crore EBIDTA company having an EBIDTA multiple of 10 times. The purchase is funded by 50% debt. After 5 years EBIDTA is expected to grow by

- 20% on a constant annual growth basis. However, the EBIDTA multiple is expected to come down to 9 after 5 years. Compute the EBIDTA numbers appearing after 5 years?
2. Continuing the facts above, please compute the gain to PE firm after 5 years assuming all the debt is repaid in 3<sup>rd</sup> year?
  3. A VC firm is looking at an investment of ` 20 crores in a start-up company today. Exit will be in 5 years at a revenue multiple of 10 times and Year 5 revenue of ` 150 crores. No debt is required. No additional equity to be raised. Cash flow profile:

Year	0	1	2	3	4	5
Cash Flow	(2)	0	0	0	0	120

IRR is 70%. You are required to calculate the post money valuation and the equity % of the company the VC may ask for.

## ANSWERS/SOLUTIONS

### Answers to the MCQ based Questions.

1.	(b)	2.	(d)	3.	(a)*	4.	(b)	5.	(d)
6.	(c)	7.	(b)	8.					

\*(80,000/40%\*60%-50,000)

### Answers to the Theoretical Questions

1. Please refer paragraph 2.1.1
2. Please refer paragraph 2.1.3
3. Please refer paragraph 2.2
4. Please refer paragraph 2.5
5. Please refer paragraph 4

### Answers to the Practical Questions

1. EBIDTA current = ₹ 1 cr

$$\text{EBIDTA 5 years} = ₹ 1 \text{ crores} * (1.20)^5 = ₹ 2.48832 \text{ crores}$$

2. Investment value in current year = 1 cr \* 10 \* 50% = 5 cr  
Investment value after 5 years =  $2.48832^*9*100\% = 22.39488$  cr  
Gain to PE firm = ₹ 17.39488 cr
3. Exit Value = 10 x ₹ 150 crores = ₹ 1500 crores.  
Post money valuation =  $1500/1.70^5 = ₹ 105.64$  crores.  
The equity percentage of the company the VC may ask for  
= ₹ 20 crores/₹ 105.64 crores = 18.93%