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)

1. MEANING OF PRIVATE EQUITY (PE)

Private equity is the capital brought in by the Private Equity firms (simply called as 'PE firms') into the enterprise as part of equity capital. PE firms are the investment fund companies who take strategic stake in the enterprise once the enterprise is established as a successful cash generating unit. This is
the basic difference – the PE would come in post the Venture Capitalist (VC) - a typical example will be of a PE firm replacing a VC interested to exit out by repaying off its investment debt, and taking a position in the equity capital of the firm. PE firms are in a broader sense, the long term investors into the enterprise and act like ‘mentors’ to the management.

Industry Overview

Private Equity (PE) is the alternate 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 in order to amplify the returns, the PE firms use a leveraged approach of using debt as the funding instrument. PE firms target a return based on IRR or the ‘multiple based’ approach.

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 marked increase in regulations in both US and Europe. In 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.

The below table gives us an insight into the largest Private Equity-Backed Buyout Deals in 2016:

<table>
<thead>
<tr>
<th>Portfolio Company</th>
<th>Investment Type</th>
<th>Deal Date</th>
<th>Deal Size (mn)</th>
<th>Deal Status</th>
<th>Investor(s)</th>
<th>Bought from/Exiting Company</th>
<th>Location</th>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supercell Oy</td>
<td>Buyout</td>
<td>Jun-16</td>
<td>8,600 USD</td>
<td>Announced</td>
<td>AVIC Capital, CITIC Capital, Pagoda Investment, Shanghai Pudong Development Bank, Sino-Rock Investment Management, Tencent**, Zheng Hong Capital</td>
<td>Softbank Capital</td>
<td>Finland</td>
<td>Gaming</td>
</tr>
<tr>
<td>MultiPlan, Inc.</td>
<td>Buyout</td>
<td>May-16</td>
<td>7,500 USD</td>
<td>Completed</td>
<td>GIC, Hellman &amp; Friedman, Leonard Green &amp; Partners</td>
<td>Ardlan, Partners Group, Starr Investment Holdings</td>
<td>US</td>
<td>Healthcare IT</td>
</tr>
<tr>
<td>Team Health Holdings, Inc</td>
<td>Public-to-Private</td>
<td>Oct-16</td>
<td>6,100 USD</td>
<td>Announced</td>
<td>Blackstone Group</td>
<td>-</td>
<td>US</td>
<td>Healthcare</td>
</tr>
<tr>
<td>Cabela’s Inc</td>
<td>Add-on</td>
<td>Oct-16</td>
<td>5,500 USD</td>
<td>Announced</td>
<td>Bass Pro Shops**, Goldman Sachs Merchant Banking Division, Pamplona Capital Management</td>
<td>-</td>
<td>US</td>
<td>Retail</td>
</tr>
<tr>
<td>Playtika Ltd</td>
<td>Buyout</td>
<td>Jul-16</td>
<td>4,400 USD</td>
<td>Announced</td>
<td>CDH Investments, China Minsheng Trust, China Oceanwide Holdings Group, Giant Interactive Group, Hony Capital, YT Capital</td>
<td>Caesars Entertainment Corporation</td>
<td>Israel</td>
<td>Gaming</td>
</tr>
<tr>
<td>Ultimate Fighting Championship Ltd</td>
<td>Buyout</td>
<td>Jul-16</td>
<td>4,000 USD</td>
<td>Announced</td>
<td>KKR, MSD Capital, Silver Lake, William Morris Endeavor Entertainment, LLC**</td>
<td>-</td>
<td>US</td>
<td>Media</td>
</tr>
</tbody>
</table>

Source: Preqin Private Equity Online
The concept of alternate investments has slowly gained a steady trajectory in India. An excerpt from The Economic Times dated Mar 11, 2017 on the PE industry in India - ‘The year 2016 turned out to be a mixed bag for India in term of private equity and venture capital investments. The volume and value of these investments in 2016 decreased by 25% and 39% respectively compared to the year before (2015). This decline was expected as the flurry of investments in 2015 was shouldered by a high volume of startup deals during the year. In 2016, the political and economic turmoil in Europe, including Brexit, rising oil prices and increased risk premium for technology/internet sector investments affected the sentiments of foreign investors.

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 the 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 more riskier approach of investing in startups exhibiting ‘raw potential', whereas later stage would mean the less riskier way of investing in firms having proven their business viability and are wanting to expand their operations.

Who stand 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

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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 Business Model for a VC

So, what is the business model for a VC? The first and the 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 are able to 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 looks into the possibility of how much can a startup 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 have 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 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 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. Startup funding
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 fund 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 the recent times, there are ‘incubators’ who have specialized into this type of funding purely for seed capital, and seek to exit out once other investors find value.

2. **Startup funding**: This funding is given usually for the purposes of executing sales orders, in terms of product development and sales, doing sales promotional activities and the like.
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. 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 managements 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 at least 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 for adding further variety to their developed shelf of products and services.

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

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2.1.4 Angel Investor

An angel investor is a multi-millionaire who has the funds, usually idle with him or her, and wants to take a share of risk to promote a startup by investing into 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 knowhow of the particular 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 definitely approach for an assessment of a particular enterprise together. This has also given rise to a new concept called ‘equity crowd sourcing’ – online social media like Facebook, LinkedIn have been fuelling this concept of crowd sourcing or crowd funding, however given the fact that the gullible investors can fall prey to fly-by-night operators;US has brought the JOBS Act (the acronym JOBS is abbreviated for ‘Jumpstart Our Business Startups Act’), which has been conditionally adopted by the US regulatory authority which is Securities Exchange Commission (SEC).

2.2 Buyouts for a PE

A PE would have a horizon estimate put to its investment. However, usually they are actively assessing for obtaining a good value informally within their business circles, at times, even a year before the planned exit date. There are two popular ways of buyouts getting executed – Leveraged Buyouts (LBOs) and Management Buyouts (MBOs).

2.2.1 Leveraged Buy Outs (LBOs)

The increasingly complex nature of commerce and its applications have given rise to a new category of 'strategic investors' – private equity (PE) firms who scout for enterprises in the 'rough', acquire the same using a clever mix of debt and equity (typically at 70:30 debt to equity), and then targeting to sell the same within a medium term period, say 3 to 5 years. In the process, they leverage on 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.
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 into 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 the PE brings in the 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 chose 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 sharing of profits start. In other words, the hurdle rate is the minimum guaranteed return for the 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 in excess of 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 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 VC will have two types of fee income it earns – a management fee that is based on a fixed percentage, and a ‘carry’. The management fee will vary from 1% to as high as 5%, the normal standard being 2% of the total invested funds in the particular venture. It is not unusual to also find a tapering clause in the fee structure after a specific period, say three years, post which the fee percentage starts shrinking to the harvest year. On the other hand, a ‘carry’ clause would mean a
'carried interest' in the profits of the venture either for a certain pre-determined number of years, or till harvest. The GP (General Partner) usually stands to earn a portion of both management fee as well as carry. Carried interest gets payable after the hurdle rate is achieved.

(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 the 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) -

<table>
<thead>
<tr>
<th></th>
<th>Number of Shares</th>
<th>Per share</th>
<th>Value</th>
<th>% holding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>600,000</td>
<td>1.00</td>
<td>600,000</td>
<td>60%</td>
</tr>
<tr>
<td>Series A investor</td>
<td>400,000</td>
<td>1.00</td>
<td>400,000</td>
<td>40%</td>
</tr>
<tr>
<td></td>
<td><strong>1,000,000</strong></td>
<td><strong>1.00</strong></td>
<td><strong>1,000,000</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>Number of Shares</th>
<th>Per share</th>
<th>Value</th>
<th>% holding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>300,000</td>
<td>0.60</td>
<td>180,000</td>
<td>30%</td>
</tr>
<tr>
<td>Series A investor</td>
<td>200,000</td>
<td>0.60</td>
<td>120,000</td>
<td>20%</td>
</tr>
<tr>
<td>Series B investor</td>
<td>500,000</td>
<td>0.60</td>
<td>300,000</td>
<td>50%</td>
</tr>
<tr>
<td></td>
<td><strong>1,000,000</strong></td>
<td><strong>0.60</strong></td>
<td><strong>600,000</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

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 –
<table>
<thead>
<tr>
<th>Common Stock</th>
<th>Number of Shares</th>
<th>CP</th>
<th>Value</th>
<th>% holding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Series A investor</td>
<td>400,000</td>
<td>0.60</td>
<td>240,000</td>
<td>40%</td>
</tr>
<tr>
<td>Series B investor</td>
<td>500,000</td>
<td>0.60</td>
<td>300,000</td>
<td>50%</td>
</tr>
<tr>
<td><strong>1,000,000</strong></td>
<td><strong>600,000</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(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 IN PRIVATE EQUITY

The cost of investment for a PE will be economically the same as seen for a VC, barring for the capital cost in specific cases. However, given that the PEs are strategic equity holders, they would always prefer to hold the investment using a holding-subsidiary company structure. This would help them to exercise the control from outside without involving in the day-to-day operations of the subsidiary as well as in maintaining arm’s length as there can be more than one strategic investor too. As per the Companies Act 2013, the holding company will enjoy a majority status if it has more than 50% of the total share capital of the subsidiary or exercises ‘control’ over the composition of the board of directors.

### 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.

(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 hand-shake 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 had made an over-estimate of expected returns, or a particular idea behind the venture hasn't really taken off, or 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 Rs. 10 each. X, a VC, has shown interest to do 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:

$\text{New Investment Amount} \times \left( \frac{\text{Total shares post investment}}{\text{Shares issued in new investment}} \right)$

In the example, the post-money valuation will as –

<table>
<thead>
<tr>
<th>Number of shares</th>
<th>Face Value</th>
<th>Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-money</td>
<td>1000</td>
<td>10</td>
</tr>
<tr>
<td>Post-money</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Existing</td>
<td>1000</td>
<td>10</td>
</tr>
<tr>
<td>New Investment</td>
<td>400</td>
<td>10</td>
</tr>
<tr>
<td>Post-money shares outstanding</td>
<td>1400</td>
<td>10</td>
</tr>
<tr>
<td>Post-money Valuation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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.

(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 fund by VC over and above preferred and common stock holders 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 the 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 also determine the ‘capital commitment’ by the LPs.

For e.g.: 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.

**Conclusion**

We have seen that venture capital funds and PEs fill in the capital requirement gap of new emerging technologies and innovations. In matured 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 have to follow the established rules and procedures for equity sourcing and funding.