A typical investor's portfolio could be classified under a number of different asset classes, depending upon the investor's risk appetite.

A TYPICAL INVESTOR'S PROTFOLIO

Equities, Fixed income and cash are some of the traditional and known forms of investment options that the investor exercises. The Alternative asset class is a relatively newer form of diversifying the investor's portfolio and has gained acceptance and prominence in the recent past. Alternative asset class includes investing in real estate, hedging and private equity. We shall discuss and understand a little more about private equity in the accompanying paragraphs.

PRIVATE EQUITY FUNDS generally make high risk, potentially high return, privately negotiated investments including investment in and as growth capital, venture capital, leveraged buyouts, distressed debt instruments and mezzanine instruments. Investors in a private equity fund include company pension plans, trusts, banks, insurance companies, family offices, high net worth individuals, various classes of offshore investors - and all of them allocate a portion of their assets towards this asset class. This class of investors are generally able to allocate a portion of their assets towards private equity

a. Because of their ability to take risks or higher exposure than normal

b. Look at a long term horizon (private equity funds normally are close ended and could return investment over 6 to 10 years)

Evolution of Private Equity

Private Equity was predominantly an American phenomenon and was prevalent since the dawn of the industrial revolution - wealthy individual financing and advising industries that they believed had an attractive market. However, the industry gained momentum post the Great Depression of 1930s, when the existing ways of financing fast growing and start ups companies through bank funding was considered inadequate and webbed with complicated paper work and regulations. Laws like the Small Business Investment Company (SBIC) came into being in the 60s to moderate the flow of capital to small and medium scale industries. Through the decades leading to the 21st century, private equity investments moved from the traditional venture capital funding to buyouts and distressed assets purchase. The industry attained some form of maturity and the concept of limited partnership gained credence.

In India however, this industry gained its roots in the late 90s and over the last 15 years, the industry has seen its share of ups and downs. Over $ 56 bn have been invested across 2500+ deals in India since inception across sectors. The private equity industry is regulated by the Securities and Exchange Board of India (SEBI) and recently SEBI had introduced the Alternative Investment Fund (AIF) Regulations 2012 to streamline the working of this industry.

Limited Partners (LPs) and General Partners (GPs)

The limited partnership structure is the most preferred form of link between the suppliers of capital (Limited Partners) with the individuals who make and manage the investments (General Partners). This structure ensures that the LPs liability is limited to the extent of the invested amount. The GPs on the other hand are solely responsible for sourcing deals, executing the deals and managing the portfolio companies. The LPs investment is pooled in a common entity, which could be limited liability corporation, managed and operated by the GPs.

Various kinds of LPs exist in the market place and they are predominantly institutional investors like pension houses, bank and insurance companies, trusts and foundations, wealth funds, angel investors and high net worth individuals. To de-risk their overall asset allocation, LPs look at private equity as another asset class and therefore invest a portion of their wealth.

GPs on the other hand are a breed of well informed, networked and resourceful set of professionals with an uncanny ability to identify, track and invest in companies looking for capital.

The LPs investment as mentioned above is pooled in a common entity controlled by the GPs - the entity is formed for the specific purpose of investing the LPs investment in portfolio companies (the Investment Process as detailed below). The time horizon of the investment and the eventual exit is between six to ten years. The GPs are remunerated through recurring yearly fees from the common entity. At the time of the exit of the investment, the gains from the investments along with the capital amount invested by the LPs are transferred to them. The GPs are normally allowed to retain ~ 20% of the gains as their reward for their services.

The Art of Fund Raising

Once the LPs have made up their minds to look at investing in private equity, they source and screen for potential GPs. LPs investing appetite could be specific in their interest levels - they might be sector specific or geography specific. Some of the criteria that the LPs normally would employ include: - GPs skill sets, expertise, background, past performance and team - The fund macro factors including past performance, competition with other funds, fund strategy in relation to the economic environment - The investment criteria of a LP - within the current portfolio, tenor of the fund, expected returns - Strategy and approach of the of the GPs differentiated, sourcing opportunities The LPs would then conduct a "fund due diligence" to evaluate the GPs. The diligence would cover the GPs track record specifically past performance, ability to invest and manage portfolio companies, team and soft skills, their comparison with other similar funds. Based on the results of some of these criteria, the LPs would weigh their decision with their investment criteria and decide on their investing plans.

Various kinds of private equity funds exists - each fund is unique in its approach and is managed by capable GPs. Some of the familiar types in the market include - Venture Capital and start up - Buyout- Growth capital - Distress debt funds - Mezzanine - Real estate - Sector specific

The Investment Process

Once the LPs and GPs have reaching an understanding and a fund is in place, the next step involves the investing process. Investing process is normally the domain of the GPs, however, in certain cases, key or anchor LPs do have the authority to decide on a particular investment.

The steps in an investment process include

- Deal sourcing, identification Deals are normally sourced through third parties like investment bankers, advisors, commercial banks and service providers. GPs also indulge in proprietary deals or proactive deal sourcing through industry networks, research reports, corporate database and friends and family. - Deal evaluation. Once a deal is identified and there is mutual interest in pursuing a discussion, the GP's team would then engage in understanding the business, market dynamics, internal and external factors impacting the business, competition, financial information, promoter background and experience, regulations and a host of other factors influencing the business. - Valuation After analysing and studying the business model and the comparative data of the business, the GPs would be in a position to discuss valuation of the business with the company. There are a number of valuation methods that are used by the GPs to determine the accurate value of the business. Some of the methods include • The comparable method • The simplified valuation method • The net present value method • Adjusted net present value method However the most commonly used method is the comparable method - wherein data based on similar companies are reviewed and appropriately discounted or given a premium. The net present value method is also popular valuation tool used to estimate the value of the business. However assumptions around the terminal value and discounting rates could influence the number. Valuation of a business depends on a number of factors - the key ones include the market potential, competitive advantage, differentiated offering from the business, the company management, capital efficiency and ease of exit. Once an agreement is in place in terms of the valuation, the company and the fund sign a term sheet broadly explaining the following tenets that will get incorporated in the main agreement: • Value of the business and revised shareholding structure • Rights of the new investor and composition of the Board • Conditions precedent • Warranties and indemnities • Closing conditions -

Diligence and business model Once the term sheet is executed between the company and the fund, the fund takes steps to conduct the financial and legal due diligence of the company. This process would involve verifying the books of accounts and legal documents of the company to get comfort on the financial health of the business and an assurance on the compliances. Red flags raised in the course of this process would have an effect on the investment. However, the magnitude of the differences is measured and decision on investment is taken accordingly.

Of late, funds also conduct a commercial due diligence and a back ground check on the company and its promoters. The commercial diligence process helps the fund to get an assurance on the market condition, competitor behavior, customer feedback, key industry metrics and exit options. The promoter background checks helps the fund to get assurance about the promoter and key management employees - their family background, professional standing, social status, past and present litigation and financial standing.

- Structuring the investment The fund investments in the company are normally structured in one of the following forms: • Issue of Equity shares • Issue of convertible preference shares preference shares are converted at the time of exit into equity shares at a pre-determined price • Issue of convertible debentures - debentures are converted at the time of exit into equity shares and pre-determined price. The debentures would continue to earn interest during such period till its conversion to equity • Issue of warrants - warrants are converted into equity shares at a predetermined price and date.

- Board Responsibilities The fund's entry into the company is formalised through a Shareholders agreement and a Share Purchase agreement. This agreement covers in detail all the rights, duties and obligation of the fund and the company. The agreement would detail out certain key decisions that would always require the approval of the fund. Some of the key decision areas would include - new acquisitions, fund raising either through debt or a new investor, hiring and firing of key employees, approval of business plan, major capital spends etc.,

Exit Process

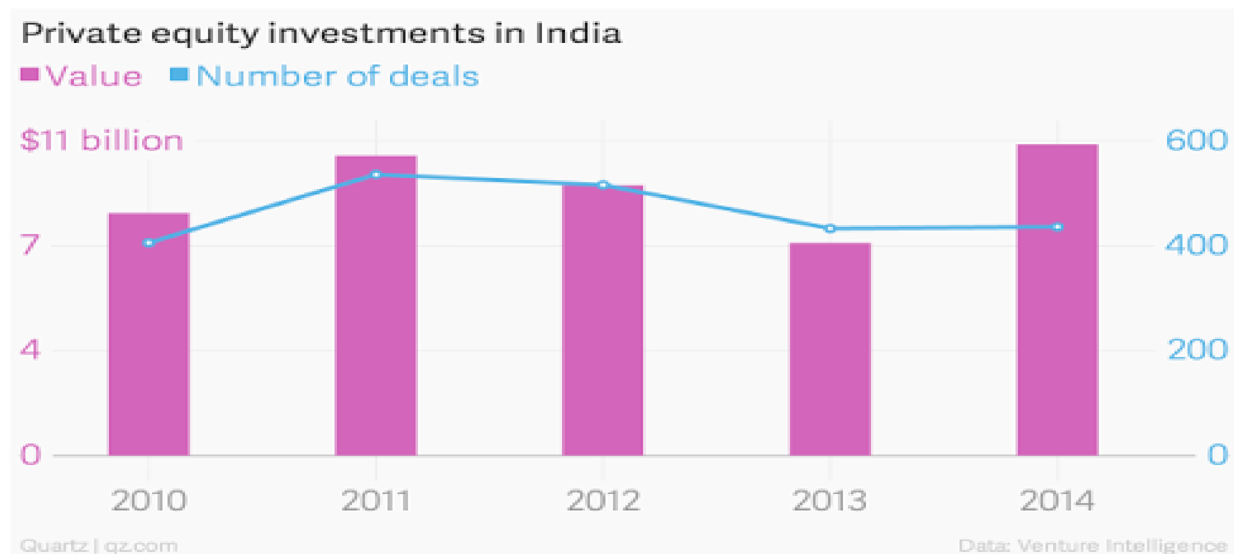
LPs investing in private equity as an asset class usually have a long term view. The life of a fund is normally between six to ten years - right from the fund raising process to investing and the eventual exit from the investments.

The fund would look at exiting their investment in the company at an appropriate time depending on a number of factors like macro market conditions, company position and standing, board and company alignment towards exit and potential suitors keen to invest or acquire the company.

The exits could be through a number of different routes for the fund depending on the size of the company, the market for the company's product, the promoters plan to either stay or exit their shareholding etc., The exit options are therefore dependent on these factors - the most commonly used exit options are: - Through an Initial public offer (IPO) - Sale to a strategic investor - either a partial sale or a complete buyout - Sale to a financial investor, which could be another fund - Promoters buy back - in case the promoter wishes to consolidate the holding or assuming no buyers are interested in buying the fund's investments.

In conclusion, investing in a private equity fund would require immense patience, faith and understanding of the process. While the financial returns and gains could be disproportionately high, the ability to find the right portfolio to invest is challenging and requires a lot of research and study.

PRIVATE EQUITY IN INDIA: A MIXED BAG STORY



Till around a couple of years back, India was the favorite child of most private equity funds across the world. A large number of private equity funds had earmarked substantial funds for investment in India. In terms of investments and bullish sentiments, the Indian PE story was second only to China. However, the private equity story hasn't quite panned out as expected.

Success stories for private equity funds in India are Flipkart, Pipavav Shipping, Bharti Airtel, ABG, Punj Lyod, Pantaloons, and Snapdeal among others. Private equity funds that invested in sound growth companies around 2000-2002 earned handsome returns on their investments. However, this sector in India in recent times is facing many challenges. including inability of PE funds to raise capital from LLPs, declining interest from foreign investors in the India growth story, promoter- private equity discord, experienced private equity professionals venturing out on their own, inability to exit investee companies, low returns on investment and a glut of me-too private equity funds flooding the capital markets.

However, there is no doubt about the fact that for India to grow at more than 9% private equity investments are indispensable especially in sectors such as infrastructure, education , healthcare, IT. Private equity has a big role to play in helping companies grow, increasing employment, raise productivity, improve corporate governance in small and midsized firms; foster growth and encourage innovation and entrepreneurship.

However, for PE to realize its full potential, important regulatory hurdles like uncertainties in India's tax regime and limited investment opportunities for foreign investors in several regulated sectors such as multi brand retail need to be addressed. Going forward the Indian private equity investor still has faith in the long term growth potential of the Indian economy and is cautiously optimistic.

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