RISK FINANCE

Venture Capital and private equity finance

Private Equity Capital is much in the news these days. A leading magazine had termed 2004 as the Year of the Venture Capitalist. This article focuses on various facets of private equity financing, which is of a fairly recent origin in India but nonetheless of great topical interest.

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Venture Capital is finance given to entrepreneurs with novel ideas for untried and emerging technologies. VC funding is not the normal tangible security-based financing with expectation of regular income flows like interest or dividend. It is risk capital, invested with an expectation of capital appreciation over 3 to 5 years. The points of distinction between Venture Capital and conventional financing by a banker/lender are tabulated below:

Sl.No.	Points of Difference	Conventional Financing	Venture Capital
1)	Primary Focus	Debt Servicing capacity of the investee co.	Growth Potential of the Project
2)	Collaterals	Secured against movable/ immovable property	No Security/ Guarantee; relies on the project and its promoters.
3)	Risk	Very Less	Very High
4)	Target Return	15% - 16% p.a.	30% - 40% (50% to 100% in some cases)
5)	Exit	Only through retirement of debt	Disinvestment options.
6)	Period of Investment	Can be short term or long term	3 - 5 years
7)	Bureaucracy bottlenecks	More	Less
8)	Participation Level	Does not take active interest in the project	Extends support at all the stages of the project

Venture Capital & Private Equity Finance: Venture Capital refers to early stage financing given to young or fledgling companies. It bridges the gap between an idea and the first trickle of revenues. This includes the following:

(a) Seed Capital: This is the finance provided to companies when the business is still in the conceptual stage. It includes R&D financing for product development and for testing the technical feasibility of the product.

(b) Start-up Capital: This is the finance provided for manufacturing and commercializing the product including initial marketing expenses.

Private Equity Financing is a broader term. Besides Venture Capital, it includes later stage financing

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given for expansion of companies that have already demonstrated their business potential but do not have access to the public securities market or to credit oriented institutional funding sources. It includes finance given in buy-out and turnaround situations. Thus while venture capitalists invest in the early stages of business growth, private equity funds invest in the entire life cycle of the investee company.

Some of the top deals recently made

	Name of the VCF	Amount of Investment Rs. in crores
1.	Newbridge capital & Temasek Holdings (direct investment co. of Singapore Govt., the second largest foreign private equity investor in India) in MATRIX LAB, Hyderabad based pharmaceutical co. for 14% stake @ Rs.1500 per share.. P/E ratio 15	607
2.	ICICI Ventures 50% stake in Tata Infomedia.	115
3.	Warburg Pincus, India's largest private equity investor in Radhakrishna Food Land, Mumbai based fast food chain.	230
4.	CDC (Now called Actis) in Punjab Tractors, a state govt. owned co.	262
5.	ICICI Ventures 15% stake in Samtel Colour, India's top colour picture tube maker (for future capacity expansion programme)	50
6.	ICICI Ventures Subhiksha Trading (Retail Sector)	38
7.	ICICI Ventures Glaxo Real Estate (Real Estate Sector)	30
8.	ICICI Ventures inWelspun India (Textile Sector)	75

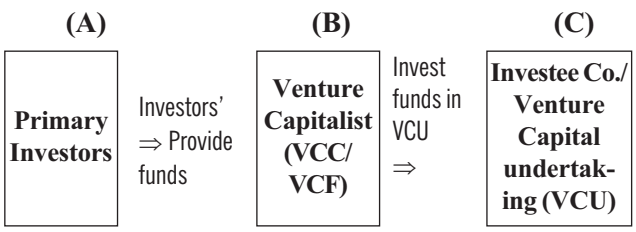
Genesis of Venture Capital

Venture Capital originated in United States of America in the mid fifties. General George Doroit, a French born military man, who founded American Research and Development Corporation (ARD) in 1946, is considered to be the 'Father of Venture Capital'. In U.S., Apple Computers, Federal Express, Compaq, Intel, Sun Microsystems, Genetic and Microsoft are famous examples of companies, which received Venture Capital in the early stage of their development. In India, Venture Capital industry had its formal introduction in the budget speech of Dr. Manmohan Singh, the then Finance Minister and the present Prime Minister. in 1988. A cess of 5% was levied on all technology import payments to create a pool of funds.

The Venture Fund that was created out of this cess was to be administered by the Industrial Development Bank of India. In November 1988, guidelines were issued for setting up of Venture Capital Funds/ Companies (VCFs/VCCs) for investing in unlisted companies. India's first private sector Venture Capital Fund was set up by ANZ Grindlays Bank.

How Venture Capital Works

Venture Capitalist is a financial intermediary, that raises funds from several investors (called primary investors) and then invests it in growth – oriented new companies.(called the venture capital undertakings or the investee companies.



From the point of view of fund raising, funds are of the following three types:

(a) Captive Fund: This is an in-house private equity arm funded by a company and/or its clients.

(b) Semi – Captive Fund: This fund is similar to a captive fund but a portion of the money is raised from third party sources.

(c) Independent Fund: this is a VCF which raises money wholly from outside investors

(A) Primary Investors are the following:

- Financial Institutions (All India Level/State Level)
- Commercial Banks
- Insurance Companies
- Corporate Sector
- Mutual Funds
- Multilateral Development Agencies such as World

Bank.

- Foreign Institutional Investors.
- Non-Resident Indians
- Public and others

The primary investors have a large risk appetite as they contribute to venture capital companies/ funds, which invest in companies that have no major collateral security to offer as security. Since they assume great risk, their return expectation from investment in venture capital companies/funds is also high.

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(B) Structure of the Venture Capital Industry:

There are broadly four categories of venture capital companies -

1. Venture Capital Funds sponsored by All India Development Financial Institutions
   Eg. (i) ICICI Ventures (sponsored by ICICI)
   (ii) Risk Capital Fund (sponsored by IDBI)
   (iii) Risk Capital and Technology Finance Corporation Ltd. (sponsored by IFCI)
2. Venture Capital Funds promoted by the State – Level Development Financial Institutions:
   Eg: (i) Kitven Fund (Karnataka Information Technology Venture Capital
   Fund) promoted by KSIIDC, KSFC & SIDBI.
   (II) Andhra Pradesh Venture Capital Limited promoted by APSFC.
3. Venture Capital Funds sponsored by public sector banks or their subsidiaries such as Canbank Ventures and SBI Caps.
4. Venture Capital funds set up by Indian or foreign private sector institutions

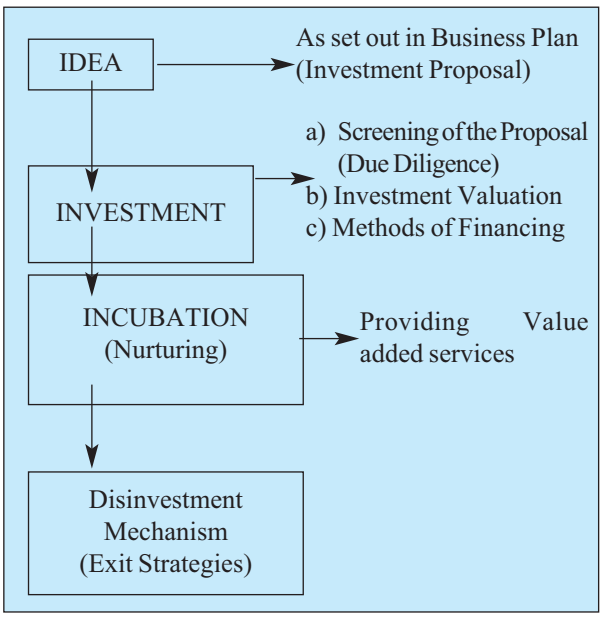
Private Funds have expectations of higher returns than funds promoted by banks or financial institutions. According to a survey, the return expected by foreign and private investors from information technology businesses is a minimum IRR of 43% as against 30% expected by public financial institutions. However, the bottom line is that if the deal succeeds a VCF gets a very high return on its investments. If the financed venture fails, the investment has to be written off. Some instances of such doomed investments are:

i. e-ventures wrote off its $10 million investment in Chaitime:
ii. Citibank Private Equity and Edelweiss Capital shut down Icleo, a portal for women and wrote off Rs.1 crore.
iii. Chryscapital wrote off $ 2mn invested in Avigna, - $1 mn each invested in Broadcast India and Cheecoo.

Like mutual fund, a Venture Capital Company may develop a portfolio of funds. Each fund may have a focus on different sector. Some funds finance early stage deals and some funds finance later stage deals. Funds, which invest in various industry sectors, across various geographical locations and in various stages of a company's life, are called generalist investors. Specialist venture capital companies invest in only a particular geographical area and in one or two sectors only. The size of the deals considered for investment by different funds may also vary.

The Indian Venture Capitalist Association (IVCA) is the association of premier venture capital companies in India. The association was founded in 1992 to coordinate the activities of its members and has been building up a database on the venture activity in the country. It publishes an annual report every year.

Typical stages in an Investment Cycle



(a) **Business Plan**: The first step in procuring Venture Capital is the preparation of Business Plan. A business plan should normally cover the following points:

- Full details of the project concentrating on the four basic elements – people, product, market and competition.
- Detailed Bio-data of the promoters and the key personnel.
- Cost of the project and means of finance, duly supported by the related plans, detailed estimates, proforma invoices, quotations etc.
- Details of market studies, projected demand and supply.
- Projected Financial Statements for 5 years with assumptions underlying the figures.
- In case of an existing company audited financial statements relating to the preceding 3 years and estimates for the current year.
- Competitors in the field and competitive edge of the applicant-company in terms of product features, pricing, quality etc.
- Details of all Government and statutory clearances/approval required for the project and copies of approvals/clearances already obtained from the authorities.
- Schedule of implementation of the project.
- The exit route and the year in which such exit is proposed to be offered.

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(b) **Screening of the Proposal:** The Venture Capitalists do not finance all the ventures for which proposals are received. They invest only in a small percentage of business proposals, which they review. It is said that it is as hard to convince a VC that a business is sound as to get a first novel published. Proposals are subjected to due diligence process. The venture capitalist assesses whether the applicant has the passion, commitment and ethical values to turn his idea into a business.

What one should look for in a Venture Capitalist if he/she has the luxury of selecting a Venture Capitalist:

- Make sure that the VC approached has domain knowledge of the space you hope to be in.
- Find out if his existing portfolio of investments matches the type of business you hope to build.
- Match the stage of your project with the funding pattern of the VC
- Choose between a domestic fund and an overseas fund based on what your business demands – dollar or rupee inputs.
- Track the VC's network of contacts and affiliations and judge if they can add value to your business.
- Find a fit between the returns your VC expects and what you see as the potential scalability of your business.
- Listen to your instincts – if the chemistry is right, sign with the VC.

(c) **Valuation Methods:** After having decided to finance a project, the next questions addressed by a venture capitalist would be how much to finance and how to finance.

How much to invest? To determine the percentage of ownership to be acquired in a VCU, the VCI normally adopt the following valuation methods:

(a) Conventional Venture Capitalist Valuation method.
(b) The First Chicago method
(c) The Revenue multiplier method

Conventional Valuation Method: Eg. B Ltd. has developed a prototype that needs to be commercialized. B needs Rs. 4 million to establish production facilities and set up a marketing programme. The company is expected to go public in 5 years and is expected to have revenues of Rs.100 million and a PAT margin of 10% on sales. Assume for the sake of convenience that there would be no further addition to the equity capital of the company.

The VC has a hurdle rate of return of 75% (discounted) over a 5 years period. Firms with comparable sales and profitability and risk profile trade at 15 times earnings on the stock exchange.

What is the valuation of the company at the time of raising capital? Determine the percentage stake required by VC in B Ltd.

In order to get a 75% return p.a., the initial investment of Rs.4 mn must grow to 4 x (1.75) 5 = 4 x 16.4 = 65.6 mn. on disinvestments in year 5.

B's market capitalization in five years is likely to be 100 x 0.1 x 15 mn = Rs.150 mn.

Percentage ownership that is required to yield the desired accumulation will be (65.6/150) = 44% approximately.

The valuation of B at the time of raising capital = $\frac{100 \times 4}{44}$ = 9.09mn

Pre-money valuation = Post money valuation

Less Cash being brought in by the venture capital investor.

Pre money valuation = 9.09 – 4 mn = 5.09 mn.

Steps to be followed for valuation of the investee company:

1) Evaluate future revenue and profitability at the time of exit.
2) Forecast likely future value of the firm based on expected capitalization or expected acquisition proceeds depending upon the anticipated exit from the investment.
3) Obtain the present value of the investee company using a suitable discount factor.
4) Target an ownership position in the investee firm so as to achieve desired appreciation on the proposed investment. The appreciation desired should yield a hurdle rate of return on a discounted cash flow basis.

The weakness of this method is that it over – emphasizes the stream of earnings for the year of exit only.

The First Chicago Method: This method considers the entire earnings stream between the starting point and the exit point of the investment. The sequence of steps in valuation and the determination of the percentage share ownership of the VC are:

i) Three alternative scenarios namely SUCCESS, SIDEWAYS SURVIVAL and FAILURE are considered;
ii) Each one of these is assigned a probability rating;
iii) Using a discount rate, the discounted present value of the VCU is computed.
iv) The discounted present value is multiplied by the respective probabilities.
v) The expected present value of the VCU is equal to the total of these in the three alternative scenarios.

Eg: If the expected present value of the VCU is Rs.5 crore and the fund requirement from the VC is 2.5 crore, the minimum ownership required is 50%.

Daksh-e-services, taken over by IBM, was estimated to have revenues of about USD 50 million and net profits of USD 10 million for financial year 2004. The value of the deal estimated to be between USD 130 to 170 million works out to a sales multiple of 3 and earnings multiple of 15.

Revenue Multiplier Method: This method can be used in the case of early stage/start-up venture capital investments when after-tax profits may be low/negative. Value is estimated by multiplying the revenue with a revenue multiplier. A revenue multiplier is calculated as follows:

$$M = \frac{V}{R} = \frac{(1+r)^n \times a \times p}{(1+d)^n}$$

Where

a = expected after tax profit margin percentage at the time of exit.

p = expected price/earnings ratio at exit time.

r = expected annual rate of growth of revenue.

d = appropriate discount rate for a venture investment at this stage, risk and other relevant factors.

R = annual revenue level

V = present value of the VCU

It may be difficult to estimate the revenue multiplier as

it requires a lot of data like expected growth rate in the revenue stream.

(d) **Structuring of the Deal/Methods of Financing:** The structuring of the deal refers to the financial instruments through which venture capital investment is made.

These could be any one or a combination of the following:

i) Equity Instruments: Normally not more than 49% of the total equity is issued to private equity investors as the promoters like to retain control over the company.

ii) Cumulative Convertible Preference shares.

iii) Conditional Loan: No interest is paid on these loans. A royalty or (a very high interest rate) of 2% to 15% on sales is paid after the VCU is able to generate sales. In some cases, instead of royalty, certain share of post-tax profits may be paid.

iv) Income Notes: These are hybrid instruments where VCU pays both interest and royalty at low rates.

v) Partially Convertible Debentures.

e) **Value Addition and Nurturing:** A private equity investor adds value to the investee company at every stage. Suppose the promoters of a company raise Rs. 10 lakhs from savings and personal bank loans and invest it in 10 lakh equity shares of Re.1 each in their company. Further suppose the entire amount was fully spent on design and testing of the product. The Balance Sheet at this stage would be as follows:

Balance Sheet

(market value Rs. in lakhs)

Original Equity held by entrepreneurs	10	Intangible assets	10

As there are no tangible fixed assets at this stage, a traditional banker/lender would not touch the proposal even with a barge pole. But, suppose, the promoters are able to convince a venture capitalist that the business is a good investment opportunity which has a potential to generate capital appreciation and the VC invests 10 lakhs in the company for a 50% stake. By making such investment, the VC has implicitly valued the company at Rs.20 lakhs. The Balance Sheet after this first stage financing would look like this:

First Stage Balance Sheet (Market Value Rs. in lakhs)

First Stage Balance Sheet

(Market value Rs. in lakhs)

Original Equity held by entrepreneurs	10	Intangible assets	10
New Equity from Venture Capitalist	10	Cash	10
Total	20	Total	20

This cash is again fully utilized and the company asks for more money from the VC for pilot production and test marketing of the product. The VC agrees for a second round of financing for 40 lakhs. It revises upward the value of the intangible assets by 10 lakhs marks up its investment in the company to 15 lakhs. The promoters also note an additional paper gain of Rs.5 lakhs in their original investment. The Balance Sheet would now look like this:

Second Stage Balance Sheet

(Market Value Rs. In Lakhs)

New equity	40	Cash	40
Original equity held By entrepreneurs	15	Intangible Assets, as revalued by the VC	30
First stage VC funding Funding	15		
Total	70	**Total**	70

This value addition goes on with every stage of investment. The paper gains made by the VC and the promoters will turn into fungible wealth once the company goes public.

The Venture Capitalist does not stop at providing finance. It is not a passive investor - there is a substantial degree of active involvement in the investee company by way of providing managerial support, technical know-how, marketing expertise, customer contacts, financial structuring. VCI tries to create synergies between the various companies they have invested in - a company that has a great product but does not have a distribution network may be paired with another company in the venture portfolio that has a better distribution technology.

Exit Strategies

The following are the disinvestments mechanisms open to a VC:

(1) Mergers and Acquisition: Ex: IBM's 100% acquisition of Daksh – e- services, a leading BPO services provider gave an exit opportunity – to private equity investors – Citigroup Venture Partners, Actis and General Atlantic Partners.

(2) Sale to other Venture Fund: Ex: Actis brought another VC viz.,Baring's stake in Mumbai based Jyothy Laboratories.

(3) Initial Public Offer: Biocon's IPO gave an exit route to ICICI Ventures, AIG and GW Capital.

(4) Buyback of VC's stake by the promoters

(5) Sale on the OTC market

(6) Management buyout of the VC's stake

Legal and Regulatory Frame work

(1) Salient Elements of SEBI (Venture Capital Funds) Regulations, 1996

According to these regulations, a VCF means a fund established in the form of a trust or a company and registered with SEBI. A VCU means a domestic company whose shares are not listed on a recognized stock exchange in India and which is engaged in providing services/production/manufacture of any article/thing/activities/sectors except those mentioned in the Third Schedule of the Regulations.

(1). Registration

(a) All VCFs must be registered with SEBI and pay Rs.25,000/- as application fee and Rs.5,00,000 as registration fee for grant of certificate.

(b) The applicant should be a company or a registered trust. In case of a company, the M/A should prohibit invitation to public to subscribe to its securities.

(2) Investment Conditions and Restrictions:

(a) Each scheme launched/fund set up by a VCF should have a firm commitment from the investors for contribution of at least 5 crore before the start of its operation.

(b) The minimum investment in a VCF by an investor must be Rs.5 lakh.

(3) Restriction on Investment by VCFs:

(a) The VCF should disclose the investment strategy at the time of their registration.

(b) They cannot invest more than 25% corpus of the fund in one VCU.

(c) At least 66.67% of the investible funds of the VCF should be invested in unlisted equity shares, equity linked instruments.

(d) Not more than 33.33% may be invested by way of:

(i) subscription to IPO of a VCU whose shares are proposed to be listed

(ii) debt instruments of a VCU in which the VCF has already made an investment by way of equity.

(iii) Preferential allotment of equity shares of a listed company subject to a lock-in period of one-year, the equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed.

(iv) Special Purpose Vehicle, which are created by a VCF for the purpose of facilitating or promoting investment according to these Regulations.

(4) Prohibition on Listing

No VCF shall be entitled to get its units listed on any recognized stock exchange till the expiry of three years from the date of issuance of units by it.

Third Schedule (Negative List) of the SEBI Regulations which prohibit a Venture Capital Fund from giving finance

To an NBFC (excluding those NBFC which are registered with RBI and have been categorized as Equipment Leasing or Hire Purchase Companies.)

For Gold Financing (excluding those companies which are engaged in gold financing for jewellery).

Relevant Income Tax Provisions

I. Any income of a Venture Capital Company or VCF set up to raise funds for investment in a VCU is totally exempt u/s.10 (23FB) provided it is registered under SEBI and has satisfied the conditions specified by SEBI.

II. Chapter XII F:Special Provisions relating to tax on income received by the primary investors from VCC or VCF:(Section 115 U)

(1) Such income shall be chargeable to Income Tax in the same manner as if it were the income received by such person had he made investments directly in the VCU

(2). It is deemed to be of the same nature and the same proportion in the hands of the person receiving such income as if it had been received

by or had been accrued to the VCC or the VCF as the case may be during the previous year.

A statement of distributed income, details of the nature of such income (Capital gain, dividend, interest etc.) in Form 64 duly verified by a Chartered Accountant shall be furnished to the investor and the Income Tax Department by 30th of November of the year following the previous year.

Conclusion

Kiran Mazumdar the Chairperson and Managing Director of Biocon and Padmashree awardee, in an interview published in the *Economic Times* discussed the financial and other problems she faced initially in setting up her business in 1978 when biotechnology sector was still in its infancy.

She had stated that at that time the bankers demanded all sorts of guarantees from her father and others. She had to wait for over a quarter century to reach the position in which she is today. With the coming of age of private equity capital in India, the technocrat – entrepreneurs may not have to wait for such a long period to taste success. In fact, in the current scenario of bull run on the stock markets, the target company promoters have turned greedy and their expectations are becoming tough to meet by the private equity investors.

Due to stretched valuations, fresh round of funding have been kept in abeyance and the venture capitalists are waiting for more realistic ask prices as per ET report (dated 01.10.2004). And, since Venture Capitalist are beginning to evince interest in small and medium scale enterprises across diverse sectors, fresh opportunities have been thrown open to more and more chartered accountants. They can advise and assist prospective entrepreneurs in areas like the preparation of business plans, short-listing of suitable VCs, negotiating with the VC etc. ■

For the kind attention of members in Part-time practice

The Council at its 241st meeting decided that effective from 1.04.2005, any member in part-time practice (namely, holding certificate of practice and is also engaging himself in any other business and/or occupation) is not entitled to perform attest function, and that the resolution passed under Regulation 190A, which is currently in force and appears as Appendix 10 to the Chartered Accountants Regulations, 1988 (Appendix No. 9 in 2002 Edition), be reviewed by the Executive Committee, in the light of the above decision:

The Council at its 242nd meeting noted the recommendations made to it by the Executive Committee in this regard and accordingly passed the following resolution as a part of and in continuation of the existing resolution under Regulation 190A which appears as Appendix no. 9 to the C.A. Regulations, 1988 (2002 edition)

IT IS FURTHER RESOLVED that the general and specific permission granted by the Council is subject to the condition that –

i) any member engaged in any other business or occupation, in terms of general or specific permission granted as per Appendix No. (9) shall not be entitled to perform any attest function except in the following cases.
   a. Authorship of books and articles
   b. Holding of Life Assurance Agency Licence for the limited purpose of getting renewal commission.
   c. Attending classes and appearing for any examination.
   d. Holding of public elective offices such as M.P., MLA & MLC.
   e. Honorary office-bearership of charitable, educational or other non-commercial organizations.
   f. Acting as Notary Public, Justice of the Peace, Special Executive Magistrate and the like.
   g. Part-time tutorship under the Coaching Organisation of the Institute.
   h. Valuation of papers, acting as paper-setter, head-examiner or a moderator for an examination.
   i. Editorship of professional journals – (not in employment)
   j. Acting as surveyor and Loss Assessor under the Insurance Act, 1938 (not in employment).
   k. Acting as Recovery consultant in the Banking Sector (not in employment)
   l. Any coaching assignment organized by the Institute, its Regional Councils and Branches of Regional Councils.
   m. Engagement as Lecturer in an University, affiliated college, educational institution, coaching organization, private tutorship, provided the direct teaching hours devoted to such activities taken together do not exceed 25 hours a week.
   n. Engagement in any other business or occupation permitted by the Executive Committee from time to time.

ii) A member who is not entitled to perform attest function shall not be entitled to train articled clerks.

iii) The decision (of the Council) taken at its 223rd meeting held in February,2002 prescribing the criteria for individual cases of articleship shall continue to be in operation, mutatis mutandi."

The Council in this connection also clarified that the Attest function for the purpose of this Resolution would cover services pertaining to audit, review, certification, agreed upon procedures, and compilation, as defined in the Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services published in the July, 2001 issue of the Institute's Journal.