

1. Why Private Equity?

We have seen that the Private Equity as an investment asset has its roots in the post World War II era. What are the other factors which enable the PE industry to flourish in today's scenario? There are several reasons to answer this question. The answer contains a mix response of macroeconomic parameters, firm level variables, and other requirements of the firm or its owner. Referring to the firm level variables, it may be the case that the owner of the firm would wish to exit the firm due to old age or that he discovers that a private equity firm brings him adequate returns and value to his business. A successful investment from a PE investor before an IPO may serve as a faith reinstating factor for the public to invest in the IPO. Thus, PE investment has a significant influence on the IPO response and its pricing. Infact, PE funding is one source in the new age industries to make a start without having sales or profit record to back the borrowings. Also, the new business start-up or a venture may not have access to the best of the institutional investors. In such cases, the PE comes in as a timely investor that remains with the firm for a fairly longer period and helps in strategically guiding the company towards profits. Even if a start up firm has grown in size, it may have financial constraints to expand its capabilities or to acquire some other entities. Thus the PE investment can help cover the gap between scaling up and reaching public issue size. Interestingly, unlike a firm which is a single entity, a PE investment firm or a fund is an entity that has investments in several firms. Hence, with its portfolio companies, the PE investor also brings about an operational and sales enhancement besides the capital availability. Unlike the hedge funds that are relatively short term investors and who believing in exiting the venture as soon as the firm makes profits, the PE investor stays invested for a longer time in the company and avoids short term performance. Infact, the PE investor has a planned exit strategy that also takes into account the post-exit scenario of the portfolio company. And more importantly, while a technological start-up has its expertise in development the technology further, the PE investor is skilled at managing finances of the portfolio company and hence, it makes an attempt to enhance the financial strength of the company and thus enhance the shareholders value. Most of the PE firms across Asia today open ended, which means that the funds periodically issue additional partnership interests. Some PE firms are also involved in taking directional calls, or you may say bets, in case of

bullish markets. This is mainly to gain returns in shorter duration. Most PE firms in Asia look for arbitrage opportunities and seek an exit option.

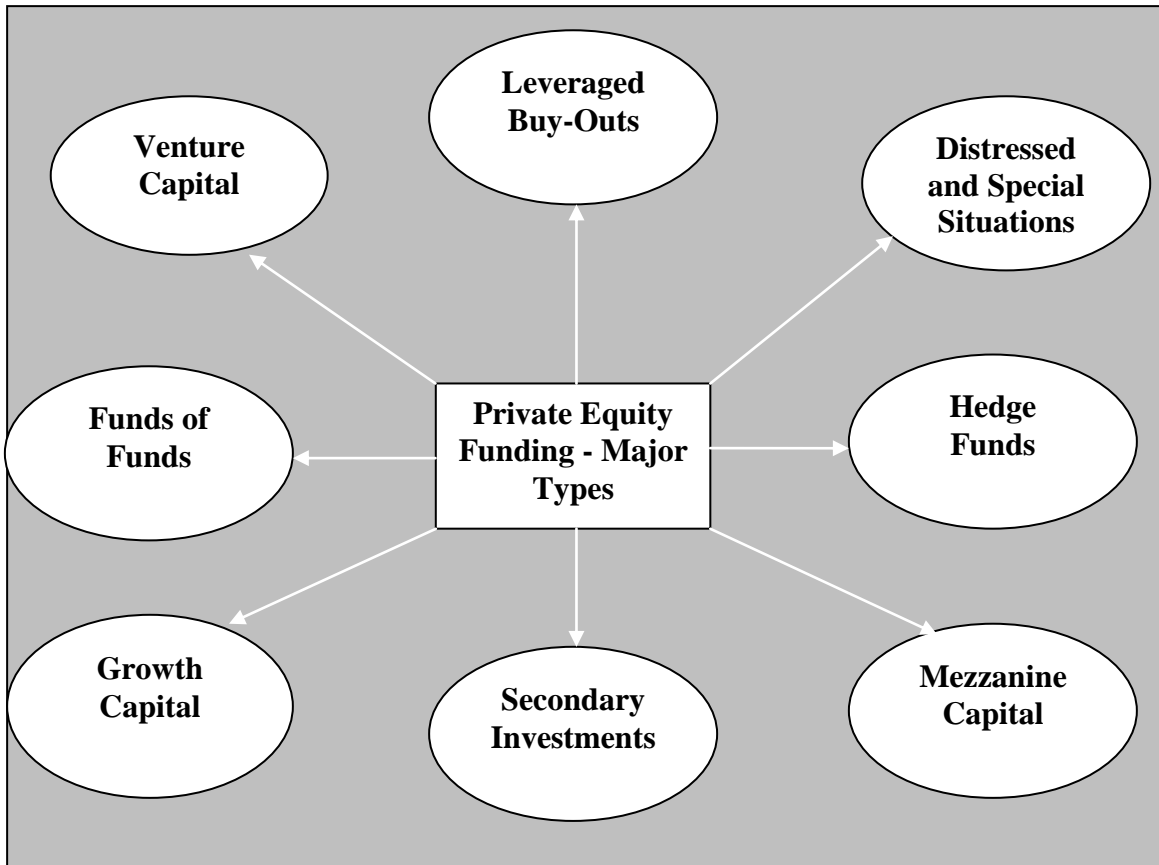
Now let's have a look at what motivates the PE firms to actively seek investment in portfolio companies. Firstly, the current trend shows that the PE investors who invest in firms prior to their IPO, consider the IPO as one of their exit option. This is because with the investments the company grows and when it goes public, it can easily sell its shares at a premium during IPO. This earns them returns on their investment. Secondly, they may see a value in a business prospect in near future that drives them to invest in the firm. For instance, A PE firm is likely to invest in a firm that has several molecules lined up in the pipeline. This is because they believe that the molecules shall earn revenue for the firm and themselves as investors from the market. Thirdly, they may be attracted by the deals in the secondary market. This means they would help an investee firm or a portfolio company to grow to a certain extent and then sell its stake to another PE investor which could possibly take the firm to the next level. Another option that a PE investor views is helping the firm grow and selling it to another operational entity in the same sector which would value the stake in the portfolio company at a premium to consolidate its position in the given industrial sector. In bull markets, the expertise of investments and the flipping activity reaps higher profits for PE funds. So these are some of the parameters that drive the investors and general partners to form an investment fund that generates returns which are then redistributed. Thus, the PE investment activity is an example of financial engineering that mainly involves creation of new and improved financial products (or portfolio of companies) through strategic investment and drive up the business and hence the valuation of the investee firms.

2. Private Equity Features and Forms

The PE investments exits in different forms, including venture capital funds, buyout/LBO funds, mezzanine debt funds, and international private equity funds. These funding strategies produce significantly different returns than traditional investment classes. The investments may be in the listed securities or unlisted securities. The PE firms tend to increase investment returns by “selling” unneeded liquidity to capital needy businesses and diversify by investing in businesses or industries that are not represented fully in the public security markets. By investing in the private firms, the PE investment firms also intend to reduce

volatility of its investments. Unlike the hedge funds in specific, the PE investors do not focus on short term performance but are long term investors. The long term investment may be about 5-7 years.

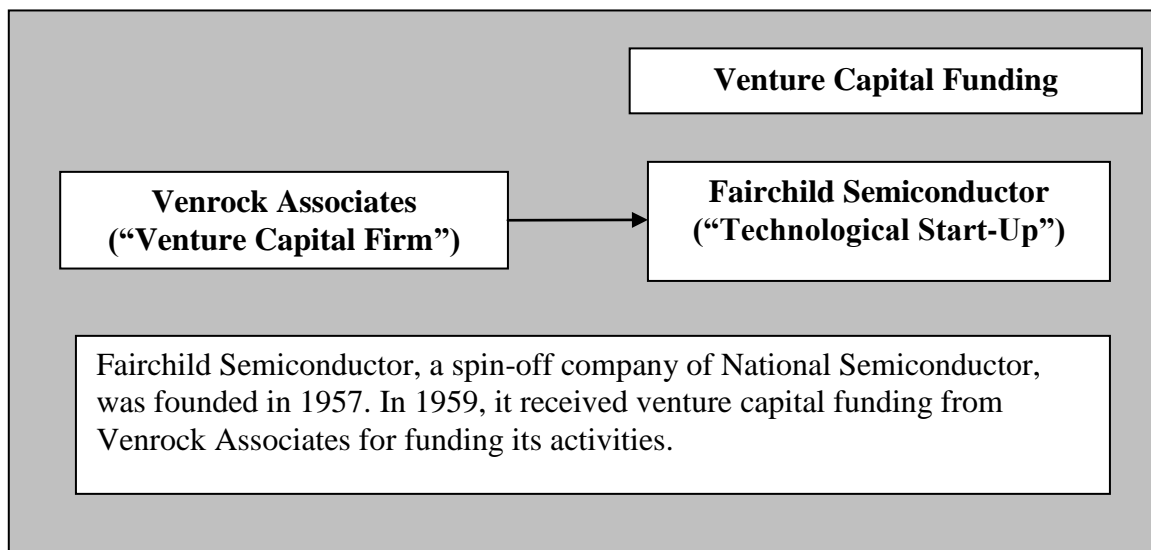
The following are some of the basic types of PE funding forms:



Venture Capital (“VC”)

- It refers to equity investments that are made in less mature companies, which includes funding for the launch of the business or early development, or expansion of a business.
- This kind of funding is most often found in the application of new technology, new marketing concepts and new products that are yet to be proven. An early stage PE firm evaluates the strength of the business proposal to succeed in the market which is also known as “proof of concept” to invest, however at a later stage PE funds may bring in money that supports other activities such as expansion of business which for e.g. expanding the multiplex chain from 2 multiplexes to 30

- This kind of funding is most suitable for businesses with large up-front capital requirements but cannot be financed by cheaper alternatives such as debt
- The VC firms may be specialized in investments in specific technological domain, or the geography of the business
- They are seed- stage firms that act as “incubators” and provide “seed” capital and infrastructure to entrepreneurs and assist with financials and business plans
- Private equity in Asia has moved away from VC type funding to either pre IPO funding or even established companies. Mezzanine or pre-IPO-stage PE investment influences the IPO pricing and the PE investors may consider IPO or immediate trading as an exit option.
- For instance, today’s one of the leading semiconductor companies in the US – Fairchild Semiconductor had venture capital funding in its early days in 1959 by VC firm – Venrock Associates. The funding by the VC supported the technological expertise at Fairchild resulted into a successful venture over a period.



Growth Capital

- It refers to equity investments in relatively mature companies that are looking for capital to expand or restructure its operations or enter new markets or finance a major acquisition without a change of control of the business

- In this type of funding, the investee company is able to generate revenue and operating profits but unable to generate sufficient cash to fund major expansions, acquisitions or other investments.
- The investments are typically made in the form of a convertible or preferred security that is unregistered for a certain period of time

Distressed and Special Situations

- This type of PE investment refers to investment in form of equity or debt securities of financially stressed companies
- The Loan-to-Own strategy in this kind of funding refers to restructuring of the company with PE investments and following restructuring the PE investor expects to control the company through its equity stake
- The hedge funds often make investments in such companies by actively trading the bonds and loans issued by the distressed companies

Mezzanine Capital

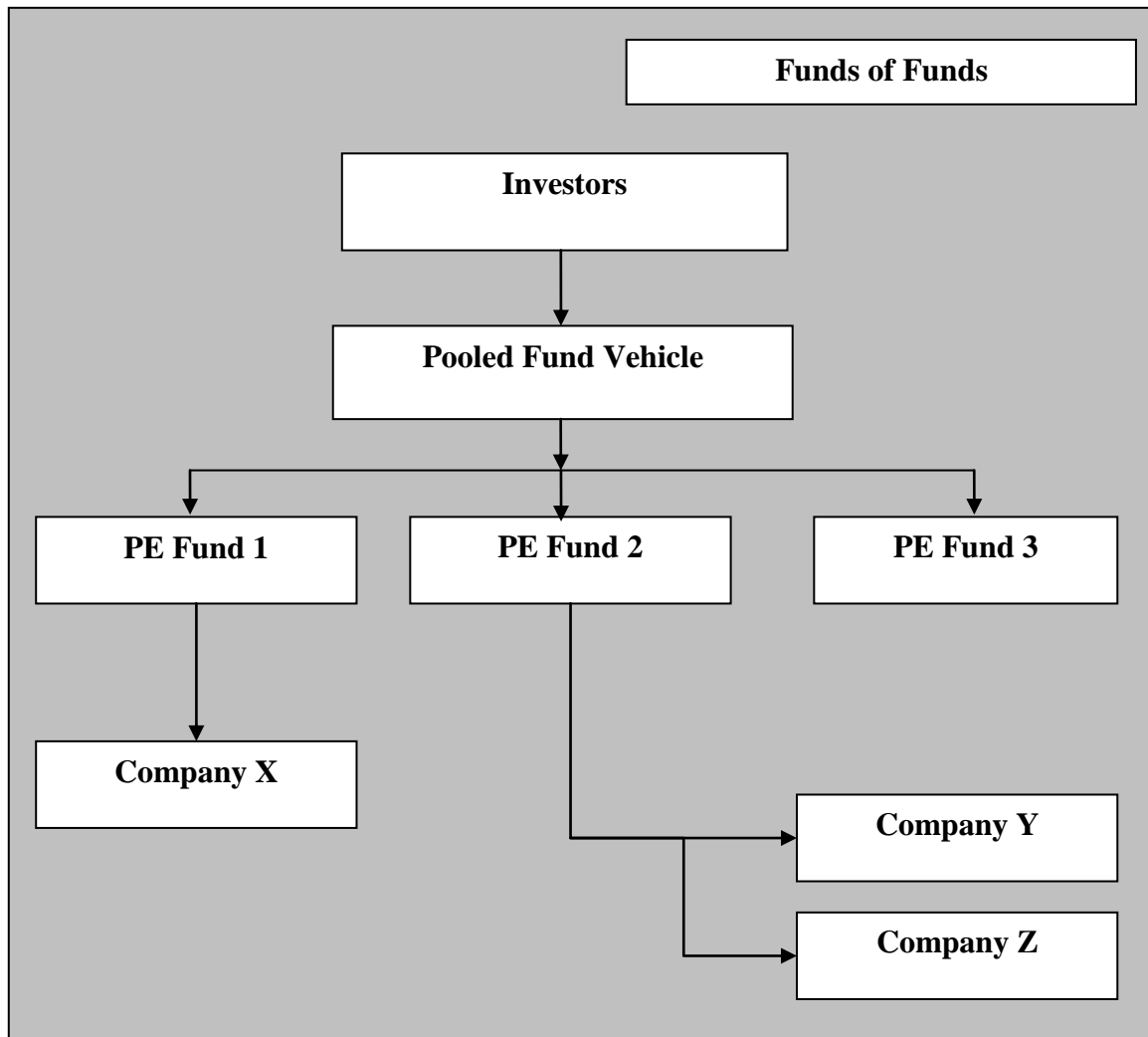
- This form of financing refers to subordinated debt or preferred equity securities that generally refers to the most junior portion of a company's capital structure that is senior to the company's common equity. This form is often used by PE to reduce the amount of equity capital required to finance an LBO or a major expansion.
- In compensation for the increased risk (lower rank in the capital structure), mezzanine debt holders require a higher return for their investment than secured sources of funds
- The PE invest is acknowledged either in form of warrants or equity which are unsecured
- PE firms may buy junk bonds or debt to raise the desired capital
- Sometimes the PE investors who invest in this formation convert the debt to equity and then work on getting the company back in the black or force reorganization, liquidation, etc.
- Similar to a VC funding, the pre-IPO mezzanine funding influences the IPO pricing and the PE investors may consider IPO or immediate trading as an exit option

Secondary Investment

- Secondary investment refers to investments made in existing PE assets. These transactions can involve the sale of PE fund interests or portfolios of direct investments in privately held companies through the purchase of these investments from existing institutional investors

Funds of Funds (“FoF”)

- It is a multi-manager investment. It is a collective investment scheme that has a high minimum investment level compared to traditional investment funds or individual funds
- It involves investing through PE managers who can deliver higher returns on the fund
- However, this type of investment involves two layers of fees and leaves little for investors. An additional fee by the external manager of the funds of about 1% of assets managed and 10% carry fees in addition to a 1% actual fund fee and 20% carry at the PE fund level takes away a major pie of the profits generated
- One of the major advantages of this investment strategy is that the experienced fund of funds managers have ability to access top-performing, direct-equity partnerships which are inaccessible by the fund on its own
- Diversification is another key characteristic of this type of investment. The fund may be a mix of venture capital, buy-out funds, and mezzanine funds, etc.



- Once a pool of funds is created, then several FoF partnerships with a variety of PE funds can be made so that the investments are diversified across several industrial sectors. For instance, in the above diagram, the funds from the pooled fund vehicle are distributed among three PE fund managers namely, PE Fund 1, PE Fund 2, and PE Fund 3. Now the PE Fund 1 that has investments in biotechnology companies such as the Company X, whereas the PE Fund 2 has investment in the software and semiconductor companies namely - the Company Y and Company Z and hence the funds are diversified into different industrial segments.

Leveraged Buy-Out

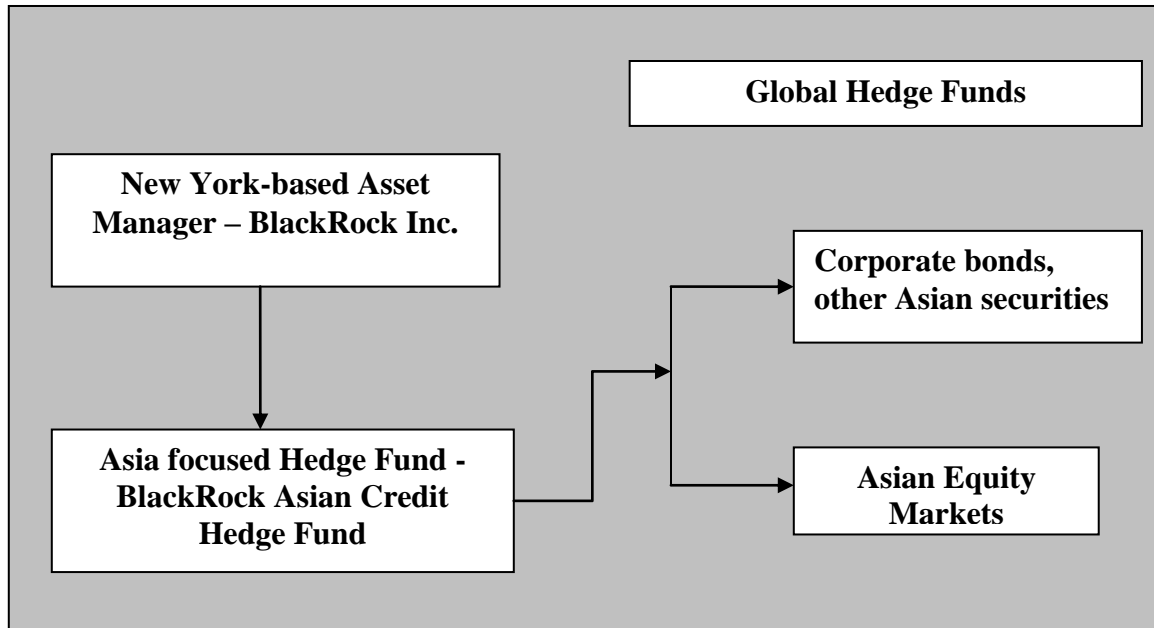
- It is a debt dominated financing option. It is usually exercised in situations where the cash flows of the investee companies are strong enough to meet the working requirements of the firm and repay the debt amount
- Thus, it involves a small amount of down payment to purchase the business and the rest of the purchase is financed by debt
- The assets of the target company are used as collateral for the loans and the cash flow of the target is used to pay off the debt
- Since the debt is repaid from the cash flow of the target company, LBO firms work on improving the acquired company's profitability, growing the business organically or inorganically
- However, this strategy does not work well in bull markets where the valuations are high and also higher returns in short term are available in the market.
- The goal of the LBO firms is to ensure increased profitability of the acquired company and then re-package the deal that fetches higher valuation

Hedge Funds

- In recent times, the demarcation between the hedge funds and PE investors has become hazy. Depending upon the market activity, both the funds double up as both. However, the most essential difference between a PE investor and hedge fund is the time duration of investment and level of control that an investor seeks in the target company
- Private-equity investors like the Blackstone Group or KKR invest for a relatively longer time than the hedge funds and they intend to control stakes in the investee companies and are involved in strategic decision making level of the investee companies, which is often not the case with the hedge funds. While PE managers come from relationship-driven investment-banking side of the business, hedge fund managers usually come from trading side of the business
- The hedge funds are active in shareholder activism and often go after badly run companies or management with low shareholder focus
- The hedge funds pool money from wealthy individuals and institutional investors in order to invest in stocks, bonds, foreign currency and derivatives. Some funds also pursue an

aggressive strategy by investing in highly leveraged instruments that have high risk in order to gain a higher rate of return. A few other hedge funds employ a traditional approach in order to balance the risk and returns

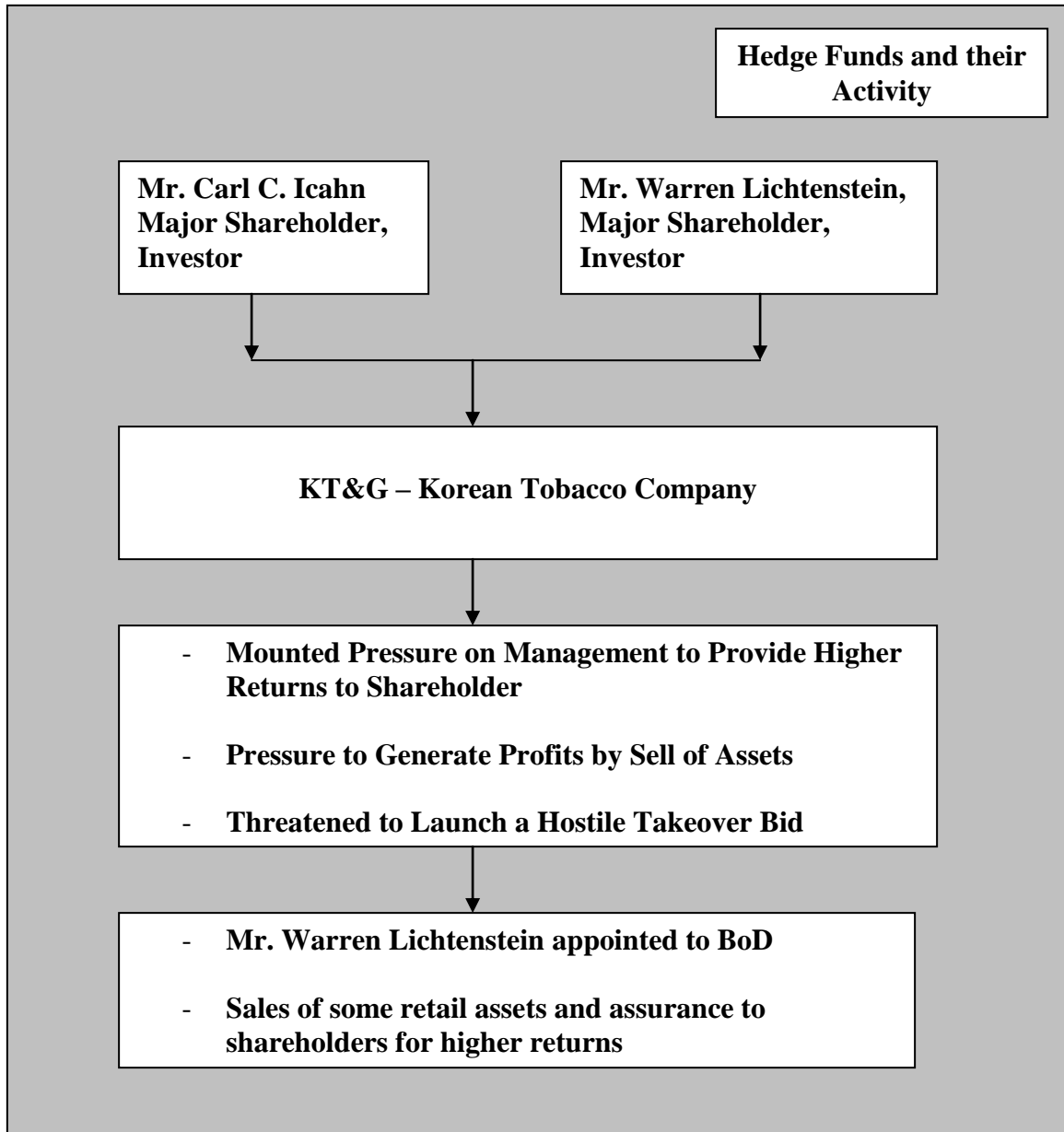
- If in a short term frame the overall industry outlook appears positive and there's a firm that is operationally effective but financially weak, it is most likely to be targeted by the hedge funds as they tend to capitalize on the positivity in the industry outlook, the operational efficiency of the firm and get enhanced returns in a short duration
- Relative-value hedge funds, a type of hedge funds, seek to generate profits by identifying irregularities or discrepancies in the pricing of stocks, bonds or derivatives. They take a position on forward interest rates, the spread between different yields and the price differences between related securities. Since these funds exploit the pricing inefficiencies, they are also known as "market neutral" or arbitrage funds
- Another type of hedge funds which are event-driven hedge funds seek to profit from specific events such as mergers or acquisitions, stock splits or buy backs
- The macro or global hedge funds take directional bets on market prices of securities, foreign currencies, commodities or derivatives. They profit from the change in the interest rates and prices that are influenced by the macroeconomic outlook of each of the countries where the investments are made. For instance, one of the world's biggest asset managers – Blackrock Inc., decided to launch a hedge fund in the Asian market called BlackRock Asian Credit Hedge Fund. The fund shall trade in Asian corporate bonds, including investment grade and high yield securities and options. The fund is also expected to invest in the equity markets.



- The hedge funds may be bullying in case if they do not realize the desired returns in the short period of time. They may threaten or even attempt to launch a proxy fight for board seats and seek a change in company's management or policies if they do not get the desired returns on their investment. An example of such activity by a hedge fund that owned a private equity in a Korean company is the case of Korean Tobacco Company – KT&G.

KT&G and PE Investors - Mr. Mr. Carl C. Icahn and Mr. Warren Lichtenstein

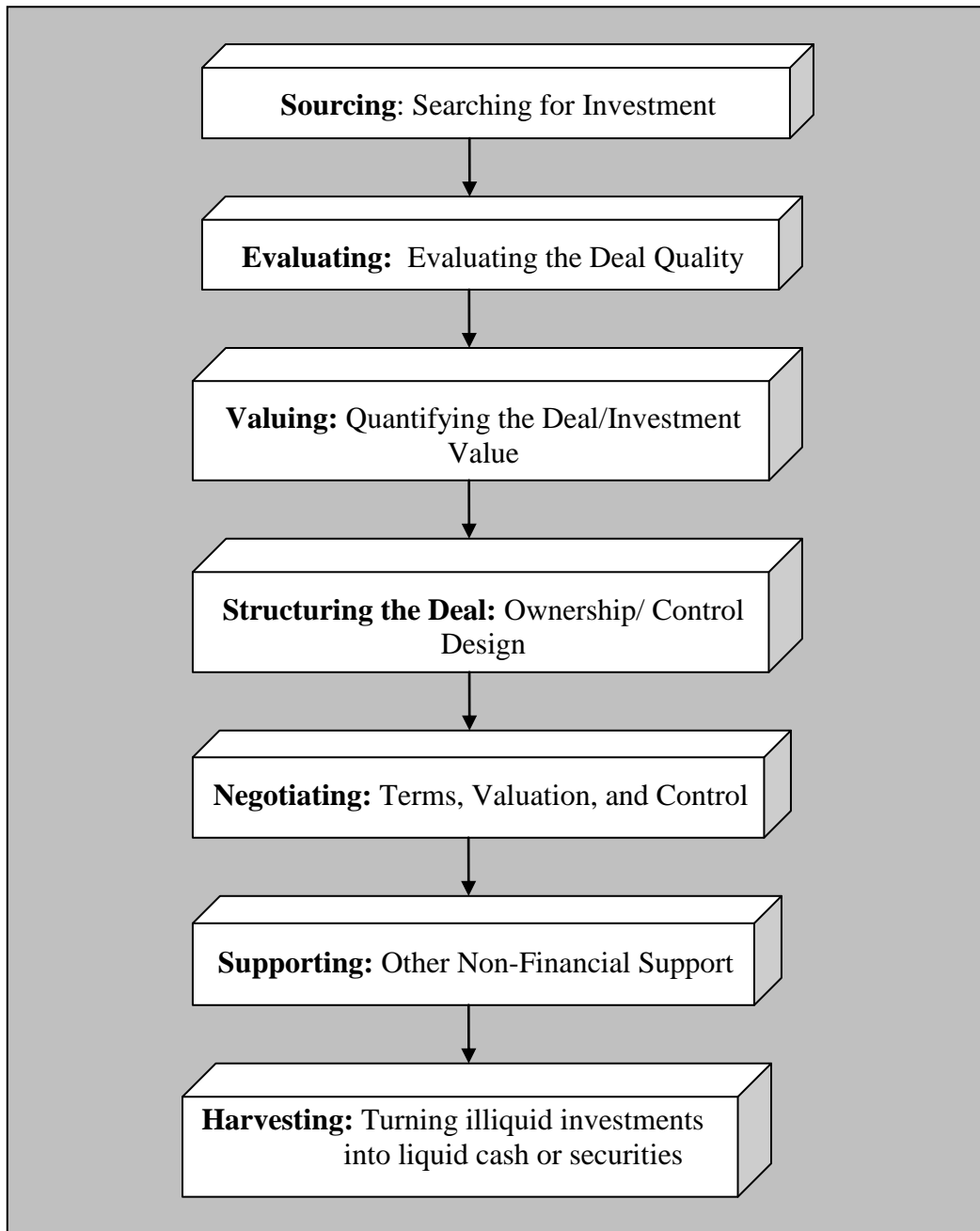
- The US-based PE investors and hedge fund owners Mr. Carl Icahn and Mr. Warren Lichtenstein owned a significant stake in the Koran Tobacco Company - KT&G Corp (“KT&G”)
- Prior to Mr. Icahn and Mr. Lichtenstein’s stake holding, KT&G was a state owned company that was run by the government of Korea. Following the acquisition of the stake, they mounted a campaign against KT&G for higher returns on the shares by sale of assets of the company and threatened to take over the company if the company management did not heed to their advice of giving higher returns to the shareholders of the company.
- Mr. Icahn accused that the company assets were under utilized and hence the returns to the shareholders were not adequate.
- Mr. Icahn also pressurized the company management to sell off these so-called “under-utilized assets” to enhance the shareholder returns.
- The billionaire investor – Mr. Icahn also threatened of possibility of launching a \$10bn takeover bid if KT&G failed to meet his demand.
- However, KT&G refused to bow to their demands to sell off the real estate and ginseng divisions.
- Following this, Mr. Carl Icahn and Mr. Warren Lichtenstein with their combined holding managed to get Mr. Lichtenstein on the board of the company.
- Finally, KT&G sold a small retail chain and announced that it would return up to \$3bn to shareholders in the subsequent three years in the form of share buy-backs and higher dividends.
- The news on higher shareholder returns created huge demand for KT&G’s shares in the market and the prices soared by about 34%. However, with the reports in the late December 2006, which suggested that Mr. Icahn had sold his stake in the company, the stock prices plunged by 4.1%.



- The hedge funds are likely to garner public and media attention to publicize weak financial performance and/or highlight other shortfalls of the target company management. They may also force a company to leverage its assets for profits

3. PE Investment Process

As referred earlier, a PE investment in today's world is an asset class and an investment opportunity. From the following graph, the PE investment process may appear linear and streamlined but isn't the case. This is because a PE investor deals with a number of companies and each one is at a different stage in the private equity process.



Sourcing

Deal sourcing or deal origination is the first step towards PE investment. It involves either a company approaching the PE investor or a PE investor approaching a potentially attractive company. An intermediary may also be involved in introducing the parties to each other. A PE investment forms may receive numerous applications in a year, but only a few are selected as a potential party to the investment.

Evaluation

The evaluation of several applications received by the PE investor is done based on criteria such as the business proposition, the economic outlook, sectoral status, etc. The PE investor assesses the investment model in the proposed company and the management of the investee company. The due diligence is also involved at this stage where before starting the valuations and negotiations, the implication of the investment in the investee company is assessed. Financial, Tax, Legal and Technical Due Diligence are conducted at this stage to understand the investee company and the industry better. All the information that is segregated at this stage is then compiled into a report which forms the basis negotiation.

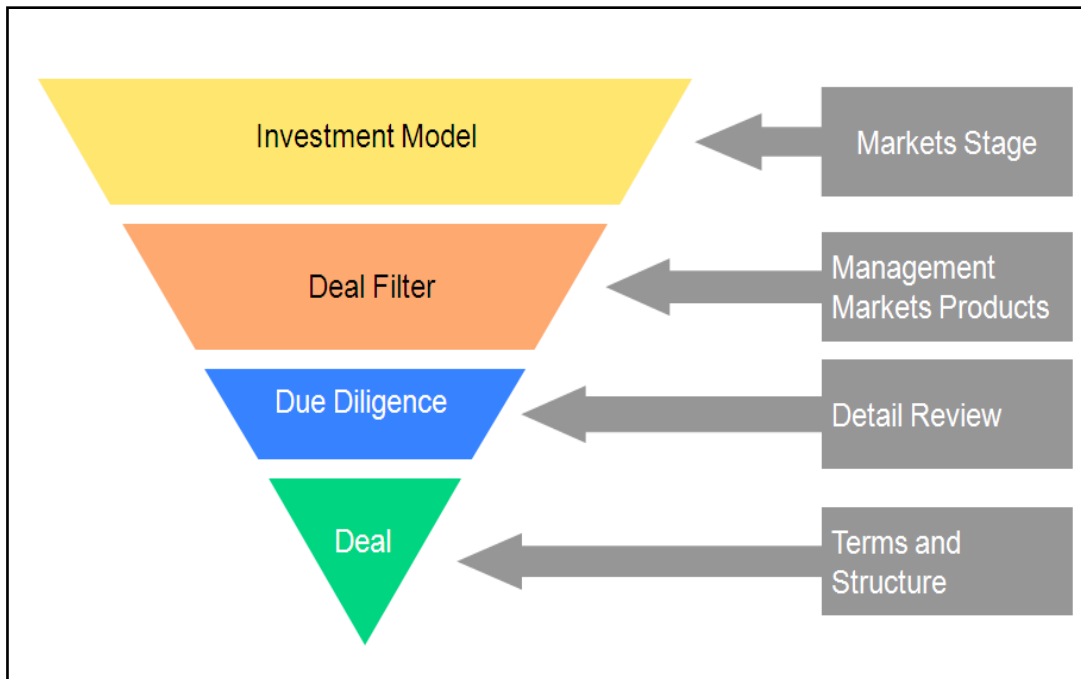
Valuation

The deal valuation stage involves use of valuation techniques like comparable company analysis or precedent transaction analysis or the DCF method. The PE investor ensures that it obtains realistic cash flow projections for the coming years and discounts it by the expected growth rate projections to estimate the present value of the investment. In the valuation stage, the PE also investigates into the risk of the investment and assessing what levels of business shall ensure the sustainability of the investment in the firm. The PE also evaluates the investee firm's ability to innovate and sustain the market competition. An exit strategy and the duration of the investment are also the components of assessment at this stage.

Structuring and Negotiating

Negotiating a deal and structuring a deal are two different activities and both complement each other. This is because it is with the negotiations that both the parties arrive to consensus over a structure of the deal. The deal cannot go through unless both the parties agree to a given specific condition. The term structuring refers to the ownership and control pattern in the investee firm and the modes of funding. On the other hand, negotiations are often based on the contents of the evaluation stage and the data on deal valuation. Thus, negotiations addresses the “what” question of the due diligence and valuation, whereas the structuring refers to “how” part of the contents. In specific, structuring involves the mode and the timeline of allocation of capital, the extent of control that a PE investor shall have in the investee company – whether it would involved in making operational decisions, the mechanisms of governance, etc. Based on the negotiations, the PE investor can freeze upon the mode of raising capital to invest in the company. This includes debt, equity or a hybrid structure. Even within equity, what kind of shares shall be allotted to the PE investor – preferred or ordinary, convertible or non-convertible, or other a contingent equity in form of options and warrants is decided. Typical valuations may not work under such instances because the deal structure may not be cash flow, revenue or assets. Instead the structure may be such that the PE investor invests in the company over a stipulated period of time and not at a single shot. The parties also discuss upon the contents of the term sheets, which is a summary sheet detailing the terms and conditions of an investment opportunity. Several agreements such as Investment Agreement, Share Purchase Agreement, Management Agreement, Advisory Agreement etc. are drafted to include all the elements of the deal on record.

The successful negotiations results into closing of the deal that is marked by signing of the agreements that are put forth during the negotiations. Several other administrative functions including the updating the shareholding pattern, the Articles of Association, etc is completed. The overall approach to closing the deal can be described by the following graphic:

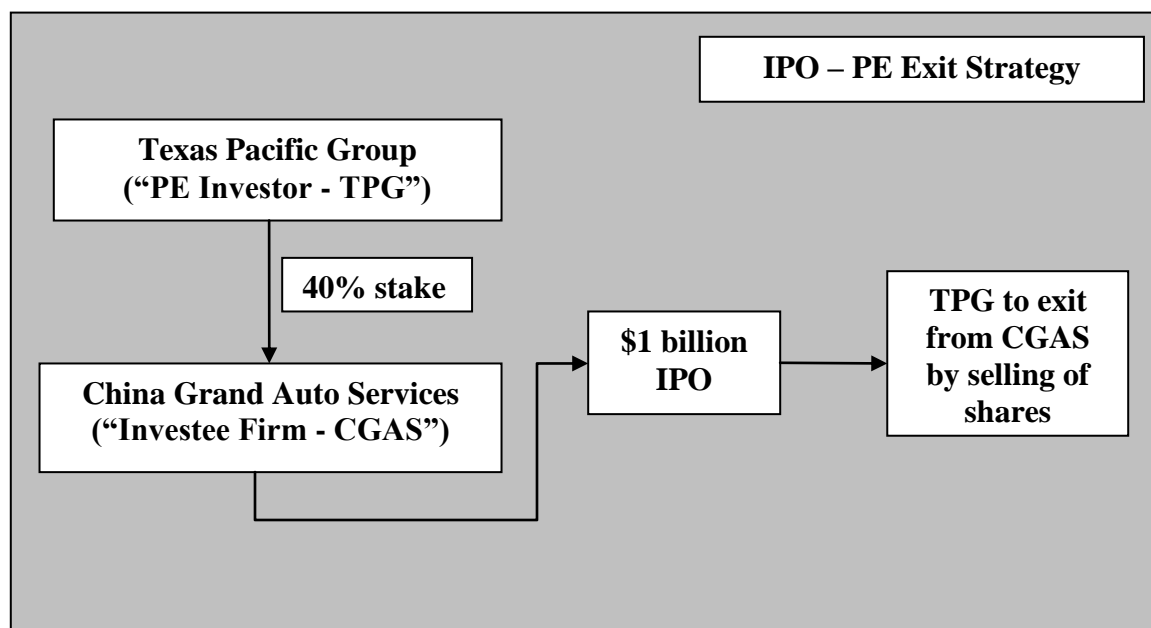


Supporting and Post Acquisition Monitoring

If both the parties to the deal agree to the valuations and the structure of the deal, it is only then that the deal can go through. However, the successful investing activity does not mark the end of the PE investment cycle. Conversely, it is the successful exit with desired returns is the end of the PE investment cycle. The supporting (non-financial) and post acquisition step monitoring is the element that leads to a successful exit. At this stage, having invested in a company, the PE firm requires its team, mainly comprising of the people who are involved with the deal making process, to closely monitor the company. The monitoring of the company is done from the operational point of view and the financial point of view. It monitors these parameters in view of the expansion plans, budgets or any other future plans set by the investee firm while it was into the negotiation process. Improvements to business, from the point of view of corporate governance, financial reporting, and information flow to strategy are monitored by the PE investor's team. Usually, the team gets a representation on the board of the investee company through which it monitors the internal processes.

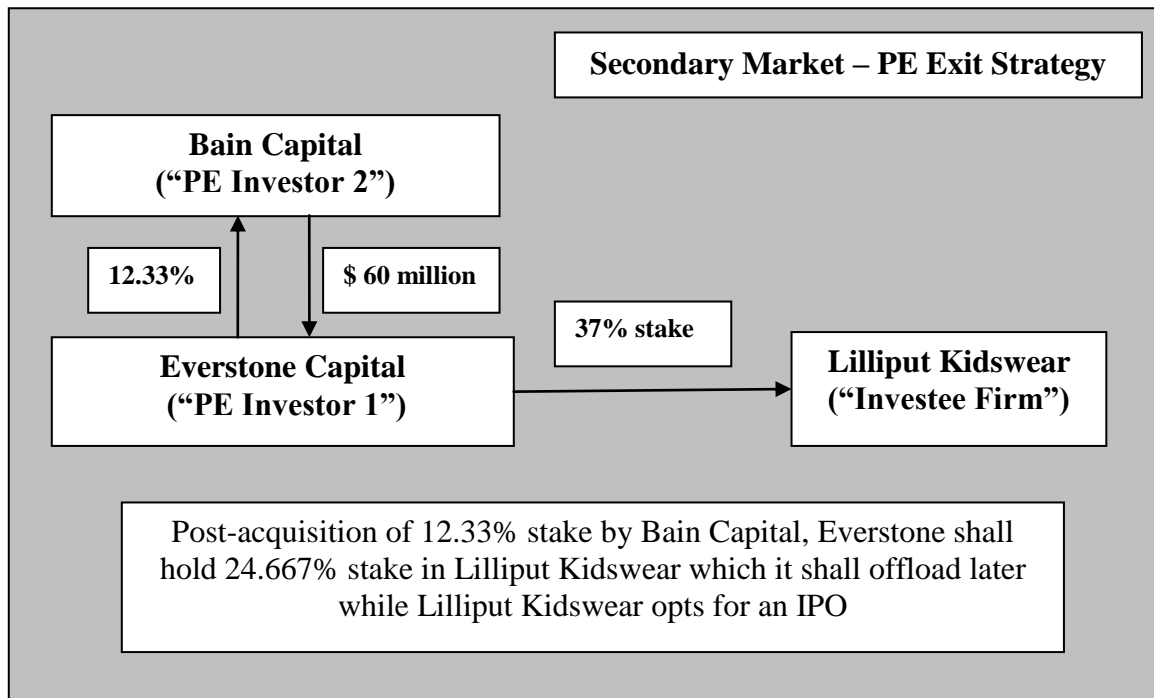
Harvesting and Exiting

In common parlance, harvesting can be defined as reaping the benefits of investment in a privately held company by selling the company for cash or stock in a publicly held company. It can also be referred as one of the exit strategies of the PE investor. Turning illiquid investments into liquid cash or securities is one of the alternatives under harvesting. The illiquid assets could include, for example, shares in private companies, long term CDs, real estate, etc. They are referred as illiquid because unlike listed shares or bonds they do not have a market for trading and it often takes sometime to encash such investments. Another strategy which is often employed is exiting through IPO. An example of such strategy is Texas Pacific Group's ("TPG") decision to exit the Chinese dealership network – China Grand Auto Services ("CGAS"). TPG had initially secured 40% stake in CGAS which it intends to sell while CGAS goes public in the second-half of 2010 or early 2011. The TPG Group has also appointed Goldman Sachs Group Inc. and China International Capital Corp. to manage the issue to manage the \$ 1 billion IPO through which it intends to sell the stake.

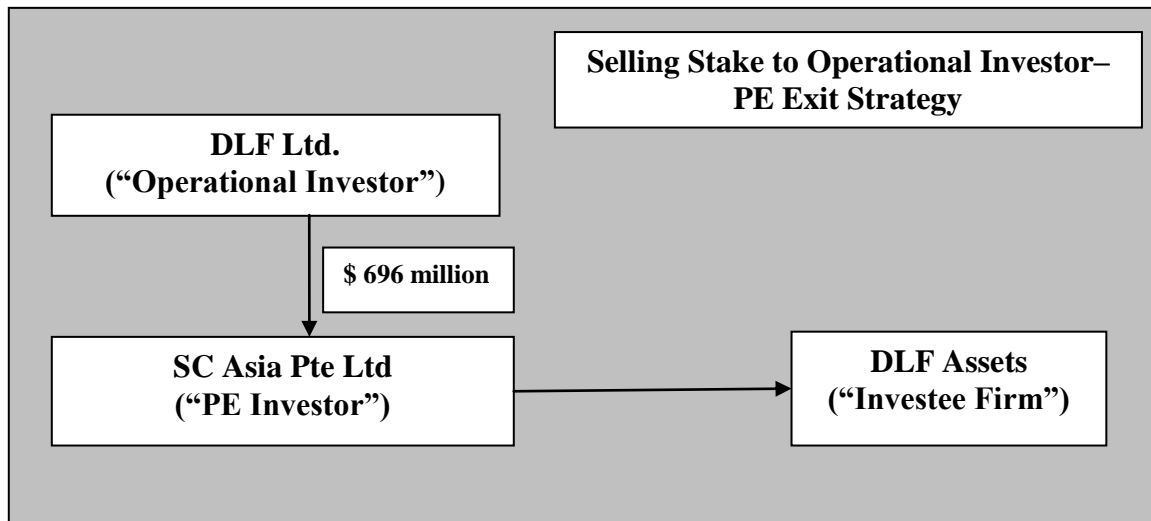


In a bearish market scenario where IPO is not likely to get a favorable response, a PE firm may exit a particular venture in the secondary market by selling off its stake to some other PE investor. For instance, the US-based PE firm Bain Capital is set to acquire 12.33% stake in the Indian kids wear company – Lilliput Kidswear for \$60 million from another PE investor Everstone Capital. Everstone's share sale is part of its agreement with Lilliput

Kidswear to sell one third of its stake before an IPO, and one-third during the public offering and the remaining on-third after the public issue.



A spinoff of an investee company can be another alternative to monetize the investments. The exit strategy may also involve selling of stake to another operational entity or an investor, not necessarily a PE firm. DLF Ltd, India's largest-listed real estate firm, bought 245 million compulsorily convertible preference shares in a group company, DLF Assets, from private equity firm SC Asia Pte Ltd for \$696 million. For DLF, the buying of shares from SC Asia Pte Ltd was in line with its strategy of consolidating shareholding of DLF Assets, whereas for SC Asia Pte Ltd, it was an opportunity to exit the venture.



Another option which is rarely used in case of failure of the investee company is write-offs. In this option, the value of the portfolio asset is written down to zero, with the result that the private equity investor or investors go without proceeds upon disposition or in case of bankruptcy, the PE investor may choose to liquidate the business.

The following chart summarizes the overall PE investment scenario in Asia:

