Legal Compliance for Incorporating Startup
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Lecture – 17
Raising fund through Private Equity and Venture Capital

I welcome you in lecture 17 regarding Legal Compliance for Incorporating Startup and I am in the module of financing and legal compliance, and specifically I am going to talk with you regarding raising of fund through private equity and venture capital. Now, in my previous lecture I talked, I referred this particular two word; private equity and venture capital and possibly you might also heard this particular two word because this is commonly used whenever we talk about the startup. Now, private equity are generally small abbreviation is PE and venture capital, small abbreviation is VC.

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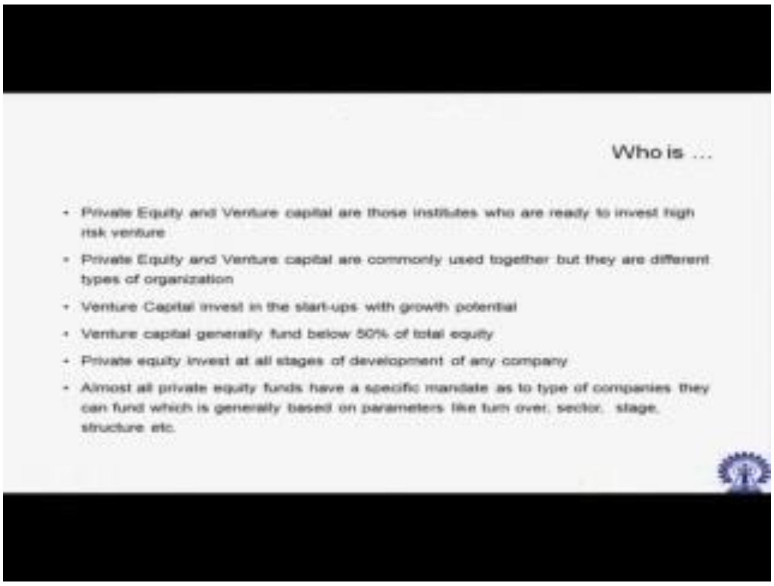

As I have wrote here that these people are ready to invest in high risk venture and please remember, most of the startup are high risk venture because it is developed on certain idea either it is technologically entrepreneurship or it is some kind of a process refining, or you are trying to bring in some kind of a new market process to solve the problem.

So, whatever it is, it is basically high risk in the sense because even though you have done all the due diligence before you start your startup, but you are not sure how the market is going to react or how the consumer is going to react. So, naturally if people make an investment in these particular startup, people are not sure that they are going to get return out of this particular investment and I believe you might have heard also that in most of the cases, the success story in case of the startups are less, very few of them are very successful, but at the same time there are numerous number of startup incorporated everyday in India.

So, you might have a very bright idea, there is a proper due diligence done. You might thought that your business will take off, but at the end of the day you find that well, there is some kind of issue and because of that this particular business is not really taken off the way you wanted. Now, private equity and venture capital you will find their use commonly to have that, but they are actually not the same type of organization. They are bit different from each other and generally in case of the venture capital, you will find they basically invest in the startup with growth potential element. They want to see that if found, convince themselves that well this particular startup as a growth potential, they can be put for this investment.

Next thing you will find in case of the venture capital, they generally do not make a 100 percent investment with the startup. So, depending on the appetite or the potential of the business, the venture capital makes the assessment and generally they keep their investment below 50 percent of the entire capital of this particular startup. Now, please remember that whenever the venture capital brings the money they can brings the money in different form. It can be the equity or it can be in the debt also or they can bring it in convertible debentures and many of the time it is. So, happen that when this particular startup is in the growth path and decided to go for IPO, they basically convert this particular debenture into equity, so that they can really capitalize their investment when these IPO is successful.

Now, whereas, in case of the private equity they basically make an investment in all stages of the company and it is not necessary that they will only invest in the beginning of the startup, but they can even make an investment when the company is in the growth path to put it in other way round there can be a sequencing that means, when you start your startup, the venture capital may make an investment and later on the venture capital might exit from the startup maybe after 5 years and at that particular point of time, equity investor, private equity investor might comes in.

So, the venture capital I mean it can be the subsequent approach that means, venture capital might be the first person to bring the fund to your startup and subsequently it is the public equity who takes over and this is for your information most of the time even you will find that private equity can go even 100 percent investment like we have seen in many of the cases, where you will find the industry is slow or the growth is not happening in a particular industry, even the private equity target a new innovation or a new startup and they make 100 percent investment to that, so that they can address their own growth or their capital growth to this particular startup.

So, almost all private equity funds have a specific mandate as the type of company they can fund which is generally based on a parameter like turnover, sectors, stage and structure. So, private equity might be dedicated for a particular type of venture or particular segment or even it can only make an investment when they are convinced that they are going to get a particular percentage of return and even there is a particular type of structure the organization is following that means, it can be either a public listed company or maybe private company or maybe public unlisted company. So, whatever they have to put it into their mandate type of the structure, they can invest, they can go and make an investment.

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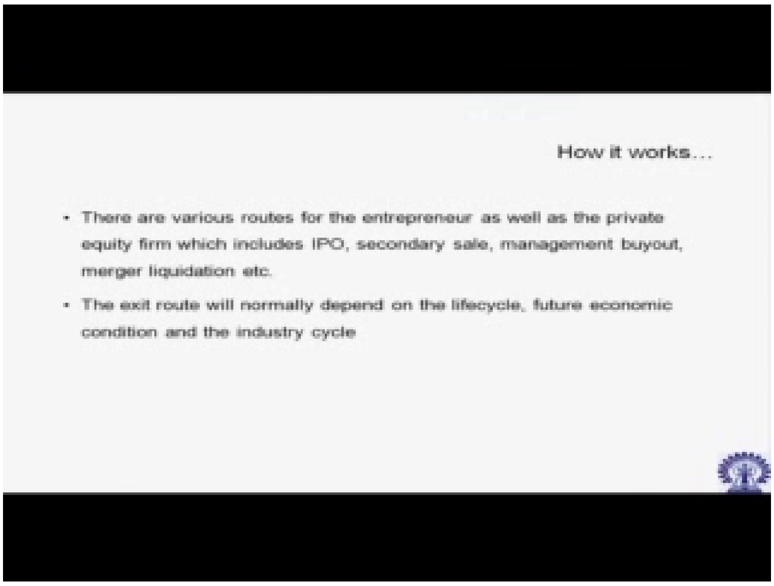

Now, there are various routes for the entrepreneur as well as the private equity firm which includes the IPO, secondary sale management buyout and manager liquidation. Now, let me explain all these particular term because these are the mark, standard or market terms. So, I just put it like when you talk about the IPO, it is basically the initial public offer and in the initial public offer you basically access the primary market and when the you are accessing these primary market, you can talk with the private equity or if you are doing the private placement, you can talk with the private equity to make an investment into the capital of your company, or if you are issuing debt instrument then you can also convince the private equity to subscribe the debt instrument which you are issuing.

Now, it can be the secondary sale that means, somebody want to dilute their stake who are already holding in your start up and they wanted to exit like as I was telling you that venture capital might exit after some period of time 5 years period of time. So, at that time the private equity can purchase this particular share through. So, this is basically known as a secondary sale.

Now, marathon buyout might be private equity; might find that this is a potential organization to grow and as I was talking about that they can go for 100 percent investment. So, they can do it through this particular management buyout that means, they basically purchase that much of instrument or acquire that much of equity which will given them a management right over this particular organization that means, you might have started this startup, but you will basically lose your right to manage that particular startup and you give that particular right to that private equity holder, but it is not necessary that we have to exit from that particular startup.

You can still continue as a member, but you are going to be a minority in that particular startup and you might not have any say relating to the management of that particular startup itself and there is another thing like there can be a merger, there can be a liquidation that means, you can go for merger with some kind of subsidiary of a private equity which has been created for this particular purposes, or there can be a special purpose vehicle which has been created for this particular purpose and you go and merge and if each this circumstances, pretty common in case of a triangular merger where you will find that special purpose vehicle is created just to acquire another organization or if you find that well something was not really going well then you can go for liquidation.

So, in case of private equity or the venture capital, the exit route normally depend on the life cycle then future economic conditions and the industry cycle life cycle means you might have incorporated the startup based on a particular technology and as I have discussed with you before that every technology as a life cycle that means, you can really do a great with that technology for a couple of years and after that you find the technology, which has come which is redefined the entire industry.

So, your technology even though it is very efficient, but no more good for a consumer choice like I can give example of Blackberry; Blackberry one point of time used to be treated as something called best smart phone because they used to claim that it is going to give you a wireless email because at that time the concept of email was to receiving it only in your personal computer and the personal computer need to be connected with the wire, but Blackberry said that they are going to give you something called wireless email and that was a sort of a market standard and they have really made a good fortune for a long period of time in the market.

But the day, iphone has come, you will all android the phone has started coming or the mobile is started developing around the app based system the Blackberry is basically gone for down circle. So, it is basically life cycle because that technology is no more appeal to the people and people do not like to use any more that particular technology. Now, future economic condition may be such that people there might be inflation or there might be financial crisis or there might be some kind of a collapse in somewhere. So, that the source of earning which was there into that particular market and no more in that particular way and because of that it is going down like, we might find that those particular country who are depending on the oil and their economy were depending on the oil.

Now, facing the trouble because the oil price has really come down, invested in all time at that particular condition it might be going to hit your this business or the startup or maybe you can refer to this global financial crisis when the market was pretty bad and at that time it might hit a particular startup or the business because it might be directly related to the economic condition of that particular point of time.

This sometime industrial circle you will find industrial circle as such, wherein you will find a particular industry even wiped out with passage of time like you are aware about the jute fabric, jute was used to be one of the highly demanded the natural fabric for packaging of, or transportation of the goods and today you will find the jute industry is really in trouble. So, there might be industrial cycle and that might create havoc for your startup.

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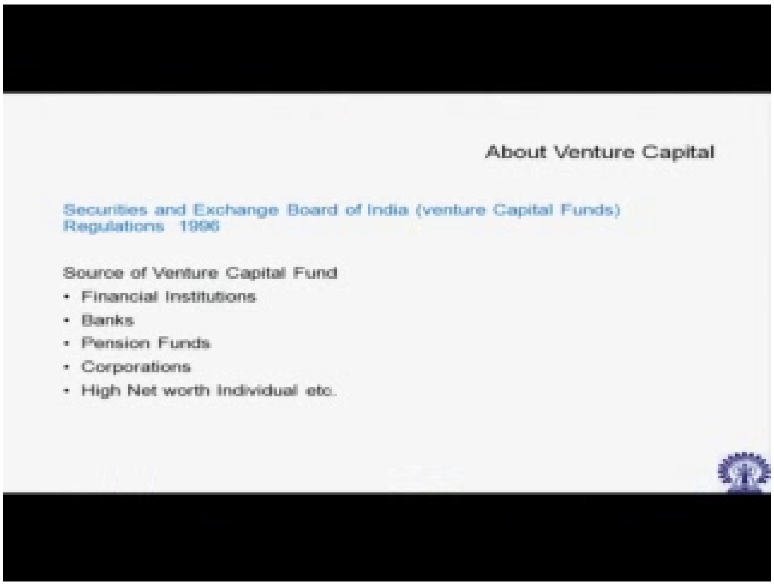

Now, let me talk little more about venture capital. Now, venture capital is actually governed by the relation which has been framed in 1996 by Security and Exchange Board of India and they have detailed out that from which places the venture capital can raise the fund and for which purposes, and how much percentage they can use this particular fund, in what type of instrument; please do remember whenever you are talking of the venture capital, venture capital is a body corporate either it is a company or it is a trust and the venture capital cannot be a listed company in a stock exchange.

Now, it is also prescribed that venture capital is generally make an investment into those particular instrument which are non-market instrument or non-listed instrument that means, it might be the equity of a private limited company or it might be a debenture from the private limited or public unlisted company or an equity of a public unlisted company. They cannot make an investment more than 30 percent in a listed company that means, around 66 percent of their entire investment has to be in the unlisted companies either a public or private.

Now, the source of venture capitals are generally the financial institution from there they can raise the fund or the banks or the pension fund or the corporation or the high net worth individual. Now, I believe all other institution I have discussed one or other point of time with you in my previous lecture, but I did not mention about the word high net individual; it is basically many of the industry, many of the people who are individual, but who has a like, who has created a huge fortune for them like, in case of India we can say it is Mr. Ratan Tata, who has really created a huge fortune or maybe Mr. Nandan Nilekani, he who has created a huge fortune for them and they can make an investment in this particular venture capital.

Now, venture capital in generally take the investment in the form of a units and then they decide that in which are the fund and which are the companies based on their potential they are going to make an investment. So, venture capitals are basically regulated institution or regulated body of investors and they are basically regulated by the market regulator; SEBI.

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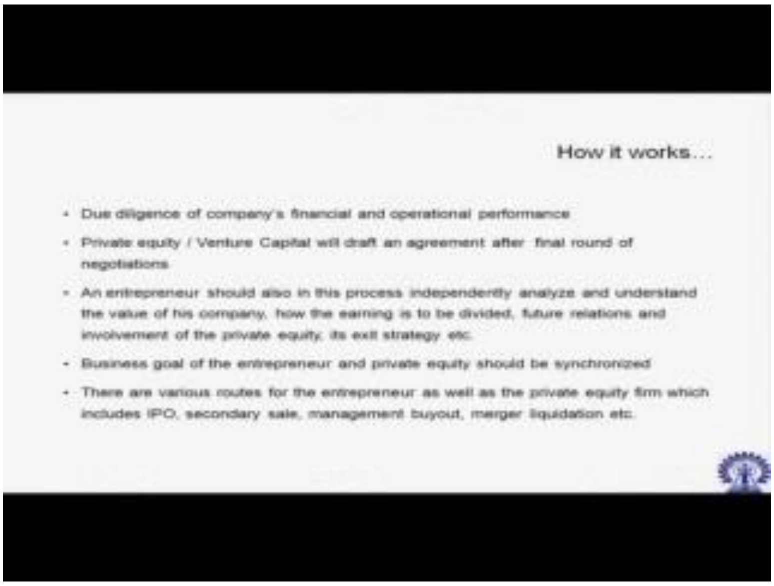

Now, how it is worked either in case of a private equity or in the case of venture capital? The company generally do the due diligence for financial as well as operational performance of the startup and then, they try to understand the potential of this particular startup have for the growth or to address the growth and then you will find, the private capital, private equity or venture capital is generally draft an agreement after the final round of negotiation and these particular negotiation is very important because the negotiation after relating to the amount of the investment, relating to right of the management, relating to the major policy issues, relating to the business or maybe how to, if there is a change in the business, or if you need to adjust the different contract which you have entered with the different people or the creditors and the negotiation even might be relating to the exiting or diluting the form, diluting the stake either by the entrepreneur or by this particular private equity or the venture capital.

So, the negotiation is very, very important and whatever you do negotiate, you basically put that particular matter into the agreement itself which is created by this particular private equity or venture capital. Now, in the process of this process I suggested being an entrepreneur, you should take the advice of all professional. It should be the legal professional; it should be the auditors or the financial guy who might talk about the financing risk. It might be the other professionals who can talk about the growth in the market or the marketing person because this is a very complicated and you should know that what you are getting against what you are giving and the entrepreneur, this the reason entrepreneur should also process to analyze and understand the values of his companies and how to earn; how the earning is divided now future relation and involvement of the private equity and its exit strategy.

So, sometimes it might so happen that you have taken a venture capital or you have taken a private equity and you have ambition to or you have quite attached with your startup, but condition becomes such that you have to exit that because that is what they were looking for replacing the management and they wanted to put the new management. So, you should be careful what you are getting and what you are negotiating and how much you are giving, how much you are getting in return and if there is exit policy over the change in management policy or they want a management to keep with them or appointment of the manager kept with them, then in what terms and condition they are doing that.

Now, please remember you should align your business goal that means, being an entrepreneur you should align your business goal with the private equity holder because many of the time you will find, once you go ahead with your business you do to create a tussle with this particular business goal. So, it is important that you should align realign your business goal. Now, there are various routes through which private equity firm go out and I think I have discussed with you relating to this thing in my previous slide.

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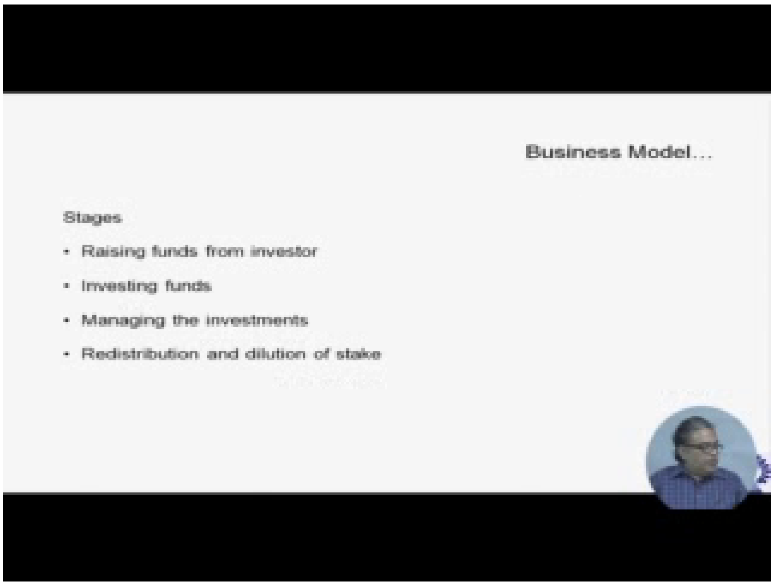

Now, the stages or the business module in case of a private equity can be divided into a four broad category; the first one is that they basically decide to make an investment into a particular venture either private equity holder or the venture capital, then they raise the fund from the investors and I have talked with you, told you that who are the investor for this particular fund then they generally invest this particular fund and it is invested according to the contract or according to the agreement, which they have entered into with you and whatever we have discussed just before.

Then they might also closely monitor the investment management of the investment, many of the time; please do remember they might create a special division within their organization that means, venture capital might create special division within their organization or a private equity create a special division in their organization or they might even create fund manager or they might create a portfolio for the investment, and there will be a specific person who is going to monitor this particular investment, how this particular investment is doing and during this process; please remember they have also high stake in these organization.

So, if there is a major decision you are taking as an entrepreneur relating to the business you need to inform them or they might even sometime reject your plan. So, whatever it may, it should be governed by the agreement which you have entered with them and then there can be a stage where there is a redistribution or dilution of the stake redistribution means, they might go out or they might reallocate this kind of a fund or the equity among themselves and then they might dilute the stake and they can go out of this particular venture itself.

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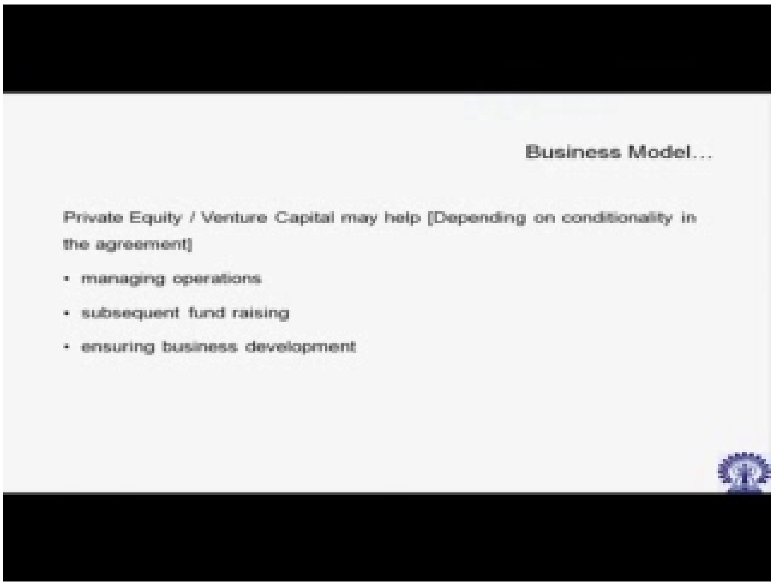

Now, even private equity or the venture capital may help depending on the conditionality in the agreement relating to management operations, and as I told that many of the time even they might undertake, takeover the management because if they find that well, being an entrepreneur you are unable to address the complex market scenario or you do not have that kind of capacity then they can take over the management, or even they can also help you relating to subsequently raising the fund.

That means, you need a more further funding for the growth and you are not ready now to go for a primary market that raising the fund from the primary market or go for private placement then in that case they might be frustrated to raise the further fund for your business organization and they might even ensure the business development in all way that means, the funding or the market for you, finding out the arranging the clients network, arranging the distribution network you know supply chain for you. So, whatever is relevant for your business they can all providing the expert advice whatever is required for your steady growth they can do that.

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Now, in general you will find that these are the sectors which are listed. There the venture capitalists can make an investment or the private equity make an investment and these are basically IT and IT related issues, software and wireless telecom, semiconductors. Then you will find media and entertainment, biotechnology and bioinformatics, pharmaceutical, electronic, manufacturing and retail. So, in these particular sectors which we have found that venture capitalist and the private equities are very active. So, if your startup falls within these particular categories; be sure that you are going to be a lucky to get a kind of funding from these particular venture capitalists.

Now, apart from all these particular discussion possibly you are aware of the fact that under this particular government scheme, the government has created a fund for the venture capitalists, at this entire different organization or different government organization are taking a venture capital fund like private equity fund like railway has created something like that I have seen that multinational bank also created a venture capitalist. So, there are many organizations who are successful PSU’s or who are the government arms they are creating the private equity or venture capital firm, so that they can make, they can finance this particular startup at the sometime you will find in India different industrialist.

Now, creating a venture capital fund or they are making investment through the venture capital like you will find Mr. Ratan Tata made a lot of investment through the venture capital. Then I have seen Mr. Nandan Nilekani who has made the investment, even other industrialists, big industrialists they also make a lot of investment through the venture capitalist in the startup. So, startup nowadays, there is a lot of opportunities for the startup day to day funded through the venture capitalists on to the private equity.

Thank you.