



PRIVATE EQUITY: CONCEPT & PROCESS

PRESENTED BY

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Private Equity (“PE”)



- PE is the capital infused by the private Investors .
- PE can be obtained from Private Equity Investors and Venture Capital Funds.
- PE is obtained through a negotiated process between the parties.
- PE involves meticulous financial planning.
- PE requires considered management decision.
- PE may have conditions to control or restrict the powers of the shareholders and/or the board.
- PE involves complex legal documentation.

Major Acts/regulations/policies applicable to PE/VCF:

SEBI

- SEBI Act, 1992
- SEBI (FII) Regulations, 1995
- SEBI (AIF) Regulations, 2012
- SEBI (Custodial of Securities) Regulations, 1996

FEMA

FEMA (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000

FDI Policy

- Consolidated FDI Policy

Income Tax

- Income Tax Act, 1961;
- DTAA

TYPES OF PE INVESTORS:

PE INVESTORS

DIRECT INVESTORS

The Investors who directly invest in companies as per their stated objectives.

FUND OF FUNDS INVESTORS

The investment company invests in a portfolio of private equity funds who invest in target companies.

STAGES OF PE FUNDING:

1. Seed stage :

PE funding can be obtained for research and development, an initial concept or an idea before a business has reached the start-up phase.

2. Start-up stage:

PE investors provide financing during product development and initial marketing.

3. Expansion stage:

PE funding can also be obtained for growth and expansion of a company.

4. Replacement of capital i.e. refinancing of existing debt.

PE funding can be obtained for replacing existing high cost borrowings.

IMPORTANT ISSUES RELATING TO PE FUNDING

1. Financial Issues

2. Managerial Issues

3. Legal Issues

IMPORTANT FINANCIAL ISSUES:

1. Adequate financial planning to meet the exit liabilities as per T&C of PE fund investment.
2. Proper evaluation of conversion value of Foreign Currency Convertible Bond(“ FCCB”) or Preference Shares into equity shares of the company.
3. Maintenance of ideal Debt Equity Ratio after raising of PE fund.
4. Liability for any dividend on Foreign Currency Convertible Preference(“FCCP”) Shares.
5. Commission to Intermediaries, **For Ex. Commission to fund arrangers or agents involved in the transaction.**

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6. Cost to cover hedging of foreign currency;
7. Legal expenses for drafting, vetting and execution of legal documents;
8. Cost levied by bank for remittance of fund;
9. Fee charged by Escrow Agent appointed to comply the Drag-on clause;
10. Cost for not achieving financial targets- **For Ex. T&C prescribe additional cost for not achieving specified EBITDA margins.**

MANAGERIAL ISSUES:

1. Assess the business growth targets proposed by the PE Investors;
2. Operational difficulty on change of Board- **For Ex. PE Investors will appoint one or more directors in the board of the company;**
 - The Chairman of the Board and exercise of casting vote by the Chairman;
 - Mechanism to overcome deadlock situation;
 - All major decision will be taken with the consent of PE directors; and
 - Quorum for the Board and Committees: **The quorum of Board and committees shall not be complete without presence of PE Directors;**
3. Issues related to Ratchet Mechanism- **For Ex. No dilution in equity holding ratio of the PE Investor.**

4. Exit options for the PE Investor:

- **Floating of IPO/FPO;**
- **Buy Back of equity from PE Investor voluntarily as per terms of PE investment or on exercise of Put option by PE Investor;**
- **Enforced selling of the equity by other shareholders under Drag- along clause.**

5. Valuation of IPRs and rights after exit of PE Investors; and

6. Material Adverse effect – **For Ex. PE Investor may exit from market on unfavorable market conditions.**

LEGAL ISSUES:

- 1. Potential difficulty in specific enforcement of certain provisions of Investment Agreements/Shareholders Agreement.**
- 2. Burdensome Non Disclosure and Confidentiality Clause.**
- 3. Ratchet mechanism – interplay with applicable laws/ regulations.**
- 4. Difficulty in enforcement of drag along clause and other share transfer restrictions.**
- 5. Difficulty in enforceability of IPO exit clause.**
- 6. Inclusion of operational terms & conditions of agreements in Articles of Association.**

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- 7. Penalty under indemnity clause for breaches of representations and warranties;**
- 8. Enforceability of Promoters' guarantees for incorrect representations , warranties and undertakings by the investee company;**
- 9. Use of escrow structure to meet the condition of drag-along;**
- 10. Difficulty in assigning specific role and responsibility to PE Nominee Director/s;**
- 11. PE Investor/ VC Fund may require key persons or important technical persons to enter into non-compete agreement with the company. The non-compete agreement may be held void under Section 27 of Contract Act,1872 being restraint in practicing trade and profession.**

12. Detailed and onerous representation and warranties- **For Ex. legal existence of the company, financial statements, liabilities, material contracts & litigation.**
13. Applicability of Governing Laws of other countries- **For Ex. English Law.**
14. Applicability of rules of outside bodies for disputes settlement mechanism and fixation of seat of arbitration out of country- **For Ex- Applicability of ICC rules for arbitration and fixation of seat for arbitration at London.**

PROCESS OF “PE” INVESTMENT

Deal Origination or Deal Sourcing:

A potential deal can either come through promoters or from an intermediary who will try to bring both parties (Company and PE Investor) to negotiate and conclude the deal. In some cases, PE Investors approach the companies having higher growth potential for PE funding.

STEP-1

Preliminary Proposal(For a going on concern):

The proposal for PE funding is floated to potential investors with following documents:

- 1. Brief Project Report- for Ex- 10-15 pages;**
- 2. Background of the promoters including information on key personnel;**

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3. Information on promoters' other businesses;
4. Stage wise requirement and utilisation of the fund;
5. Audited accounts summary of last 2 years of present company showing current profitability and debt conditions;
6. The confirmation from promoters that there has neither been default nor delay in payment of any installment of existing debts;
7. 5 years detailed P&L and B &S forecast for the proposed project; and
8. Details of tie- ups or arrangements relating to proposed project.

On being satisfied, the PE Investor shall issue a Non Binding Letter expressing its intent to proceed in the transaction.

STEP-2**Due Diligence(“DD”):**

DD you could call ‘doing your homework’. Before starting detailed negotiations, investor try to make sure everything is fair and secure. Although Auditors and Consultants are appointed to conduct the Financial, Tax, Legal and Technical Due Diligence – but PE investor also work side by side to understand the investee company and its proposed project. All the information collected during DD are used during negotiation between the PE investor and promoters of investee company.

STEP-3**Deal Negotiation phase:**

PE investor set out the terms and conditions (covenants, representations and warranties) to the promoters of investee company. Parties negotiate the T&C mutually and thereafter seal the transaction.

STEP-4**Issue of Term Sheet:**

PE investor issues a 2-3 pages term sheet defining all terms and conditions of the proposed transaction. **For Ex- Amount of PE Funding, mode of disbursement, conditions precedent and subsequent and exit options etc.**

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STEP-5**Execution of Legal Documents:**

In general, the following kinds of legal agreements are executed:

Investment Agreement-

Agreement covers T&C for acquisition of stake in the investee company and include:

- Valuation of subscription or purchase of Equity;
- Conditions precedent;
- Representations and Warranties - absolute and qualified;
- Material Adverse Events; and
- Walk away rights & termination etc.

Shareholders Agreement("SHA")-

SHA governs relationship between the PE Investor and shareholders of the Investee company and include:

- **Rights and obligations PE Nominee Director/s – For Ex. Affirmative Actions/Veto etc powers of Nominee Director/s;**
- **The proposed management structure of the company;**
- **Information rights of the PE Nominee Director/s;**
- **Anti-dilution mechanisms;**
- **Share transfer restrictions on the promoter shareholders ;**
- **Exit Mechanisms- put-option, drag-along, strategic sale and IPO;**
- **Breach and consequences; and**
- **Termination and consequences.**

STEP-6

Remittance of fund by the PE Investor as per the T&C of legal documents.

STEP-7

Post compliances and monitoring:

- **Appointment of PE Nominee Director/s on the board and committees of the company;**
- **Amendment to Articles of Association to insert all operational features of executed agreements .**
- **Periodical Furnishing of information to PE Investor and/or nominee director/s.**

ADVANTAGES OF PE FUNDING:

- 1. Easy mode to obtain capital, which otherwise not available thorough conventional routes;**
- 2. Availability of capital to under- capitalised companies;**
- 3. Relief from compliances of transparency standards applicable to public companies;**
- 4. Relief from constraint of reporting periodically to Regulatory bodies/authorities;**
- 5. Freedom from the burden of regular payment of instalments;**
- 6. Higher growth on capital;**
- 7. Bring operational efficiency in Investee Company;**

8. Adoption of best management practices;
9. Contribute to the growth of economy;
10. Opens up avenues to obtain additional capital by investee company.

DISADVANTAGES:

1. Difficult in accessing for small & medium companies;
2. Channelization of fund in few sectors;
3. Enforce Illiquidity in capital;
4. Lengthy and cumbersome process;
5. Loosing of partial control over the company;
6. Operational Interference by PE Investor.

**THERE IS NO SCARCITY OF CAPITAL
FOR
A VIABLE BUSINESS PROPOSAL**

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