Private Equity

- **What is Private Equity?**
- **Is this something for me?**

FN 211 – Thammasat University (BE)

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Regional Director (Asia), NORFUND

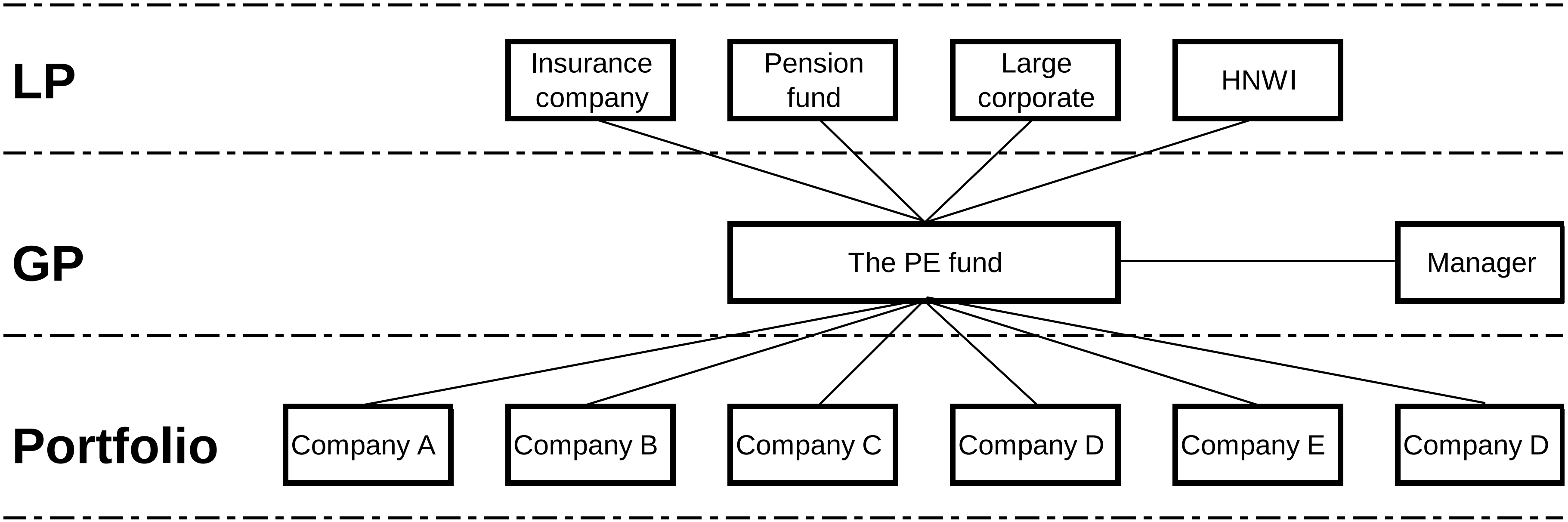
Emerging market private equity funds in 2012 had their best year for raising capital since 2008, pulling in USD 40.3 billion: number of funds raising capital increased to 161 from 148 while the overall dollar value increased by 4.7 percent from USD 38.5 billion in 2011.

Southeast Asia raised the most capital since 2007 with 13 funds pulling in USD 1.4 billion.

Basic

- Asset class representing the companies not publicly traded vs. public equity traded on stock exchange
- Medium to long term investment. Less liquid.
- Venture capital, growth capital, buyout, Sector/ Geographical focus
- PE funds are raised from pension funds, insurance companies, large corporate, HNWI
- Investors in PE funds are called “Limited Partners”
- PE funds are managed by the “General Partners”

Structure of private equity participations



Fund terms – sample

Fund	Xcellent fund
General partner	Xcellent Partner
Objective	Superior returns by investing in high return sectors, add value to leadding local companies through knowledge and techncology transfers, optimize capital structure
Size	USD 100m
Target return	30% , 3-4 x multiple
Commitment period	5 years after first closing
Term	10 years +1
Target closing	2Q 2013
Management fee	2% of committed capital
GP carried interest	20% , after 8% hurdle
GP commitment	USD 5million
Co investment	Across all sectors

Why PE? Reasons to invest

- Attractive track record
- Experienced investment team
- Differentiated investment strategy
- Proprietary deal flow – co investment opportunity
- Sector/geographic focus
- Risk diversification

What do we look for?

NF as fund of fund investor

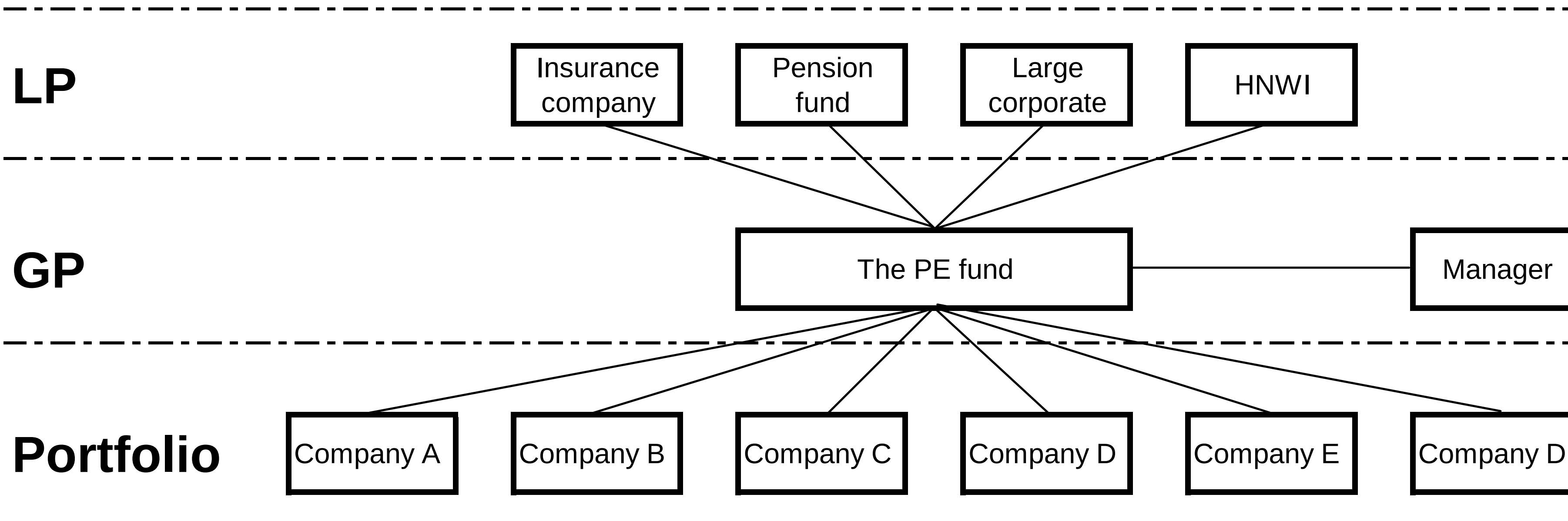
- Right strategy
- Experienced investment team
  - local presence
  - Good mix of skills across the team: deal generation, structure, and exit, + market knowledge, track records
- Is there a team? Team continuity
- Key man/woman
- Skin in the game, alignment of interest

Remuneration – alignment of interest

- GPs receive standard management fee of around 1.5% - 2% per annum
- Other fees may also apply in specific circumstances
- LP agreement (LPA) also sets out carried interest arrangements

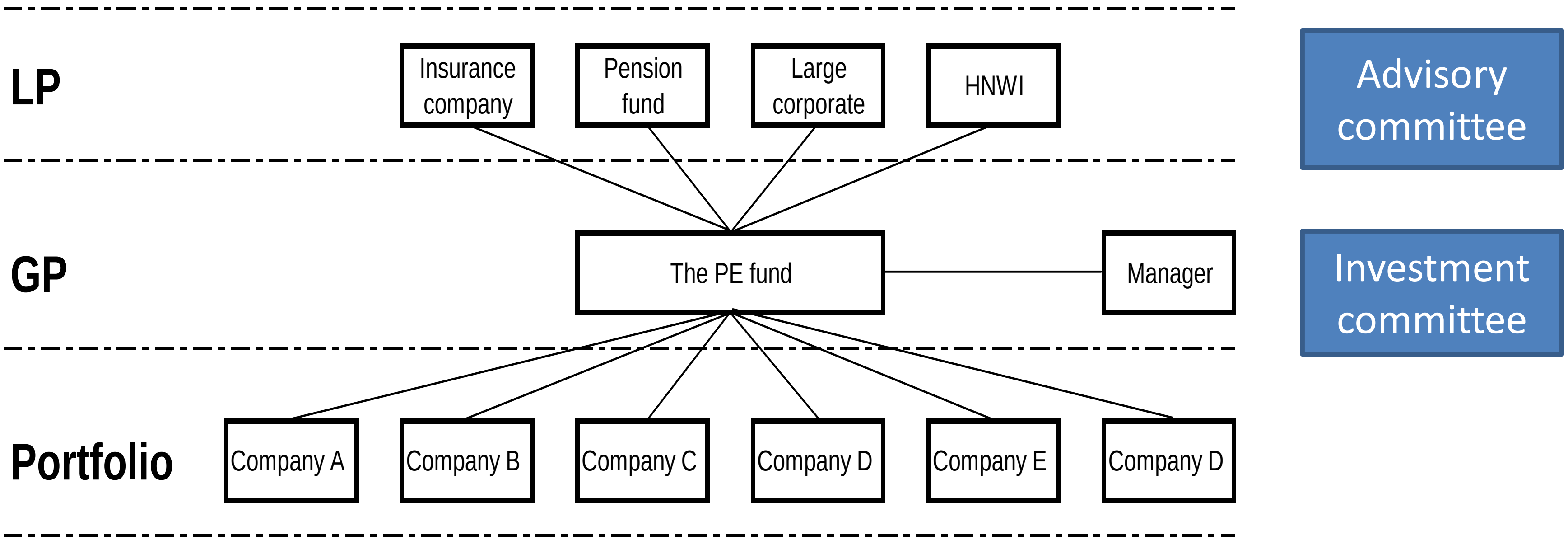
– Carry is when GPs get a share of returns, and is paid after LPs receive a preferred return -- hurdle rate (8%)

Structure – remunerations and returns



Portfolio companies	A	B	C	D	E	total
Investments	10	10	20	25	35	100
EXIT	0	0	40	50	40	130
Profits	-10	-10	20	25	5	30
Distribution						
Return of original invested capital						
8% hurdle to LPs	8					
Profits to be split:	22					
LPs - 80%	17,6					
GP - 20%	4,4					

Governance structure of PE



PE types

	"Angel"	"Venture Capital"		"Growth"	"Buyouts"		"Distressed Investing"	
	Seed	1st Round	2nd & 3rd Round	Emerging Growth	Leveraged Buyouts	Mezzanine Debt	Distressed Equity	Distressed Debt
Age of Company	0 years	0-1 year	1-3 years	3-10 years	10-50 years	10-50 years	10-50 years	10-50 years
Stage of Company	Idea	Prototype	1st generation product	2nd or 3rd generation product	Established, slow growth	Established, slow growth	Stressed	Stressed
Public or Private?	Private	Private	Private	Private or Public	Private or Public	Private or Public	Private or Public	Private or Public
Equity Requirement	\$0.2-0.5m	\$1-2m	\$2-5m	\$5-20m	\$10 - 250m	\$10 - 250m	\$10 - 250m	\$10 - 250m
Return Expectations	70%+	50-70%	50-60%	40-50%	25-40%	20-30%	30-50%	30-40%

Venture capital

- Earlier stage: venture investors provide funds for start-up and early expansion
- Based on innovative business, development of a new product, new patent
- Scalable investments with a lot of failures and few great successes
- Financing in several rounds (round 1, round 2, round 3…) with typically clinical test results as threshold for next round
- Most of the exits are IPO
- Examples: Skype, Google, Apple, Atari, Cisco, Yahoo, YouTube, LinkedIn, Paypal.

Buyout

- Buyout comes after venture and growth capital.
- Taking control of a company through leveraged buyout (LBO).
- Management team of the company is investing alongside the PE fund (alignment of interest)

Distressed funds

- Investment in debt-securities or equity of a company under financial stress
- Loans are rated BB and below by S&P based on usual ratio (debt/EBITDA, EBITDA interest coverage, etc…)
- Distressed debt investors try first to influence the process
- Debt holders have access to confidential information
- Then, as debt holders, they can take the control of the company

Mezzanine

- Debt instrument immediately subordinated to senior loans
- The most risky debt instrument = highest yield
- Returns generated by:
  - cash interest payment: fixed rate or fluctuate along an index (e.g. LIBOR)
  - Ownership: mezzanine financing most of the time include equity ownership

  - Mezzanine suffered before credit crunch as senior debt was easy to access

Infrastructure

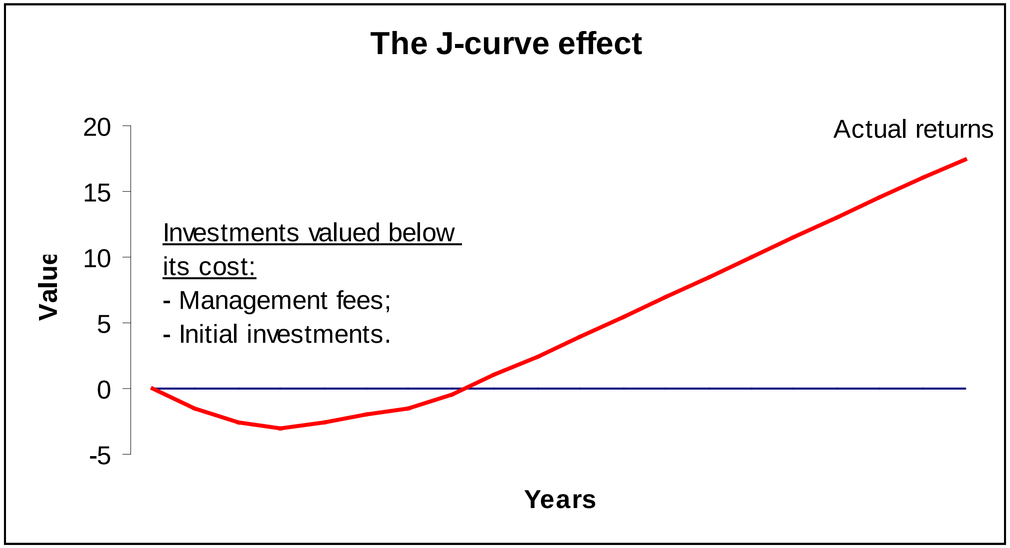
- Global needs for infrastructure assets
- Roads, ports, airports, energy plant, hospitals
- Mix of private investors and governments through PPP (Public-Private Partnerships)
- Longer term investment, lower return, steady cash-flow with regular yield

Geography

- Country – specific fund
- Regional – emerging markets

The J-curve

- In the early years, low or negative valuation due to:
  - Management fees drawn from committed capital;
  - Initial investments to identify and improve inefficiencies;



The J-curve

- Fees are charged based on the fund's entire committed capital;
- Example:
  - Fund size: USD 100 million;
  - Management fee: annual 2% committed capital;
  - Organizational expenses: USD 300,000

→ USD 2,300,000 expenses/fees called regardless of any investment made.

CASE STUDY I

Case study

- What kind of company is this?
- Is this a good company?
- Would you lend your money to this company?
- Would you buy this company?

Norfund

- Invest risk capital to promote economic development and poverty reduction
- Wholly owned and funded by the Norwegian government (USD 1,5 billion under management)
- Key investment areas:

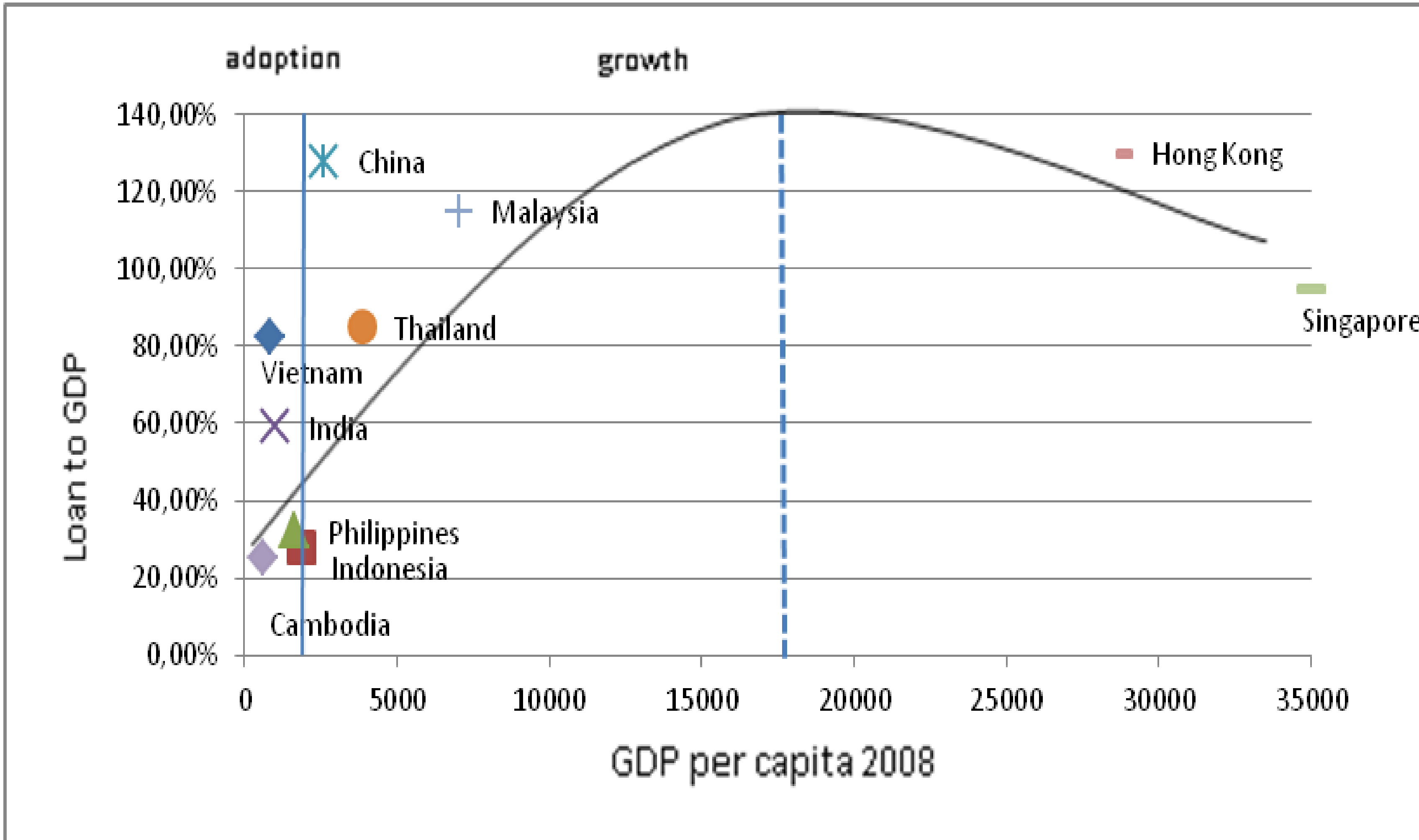
  renewable energy

  agro-business

  financial institutions and funds

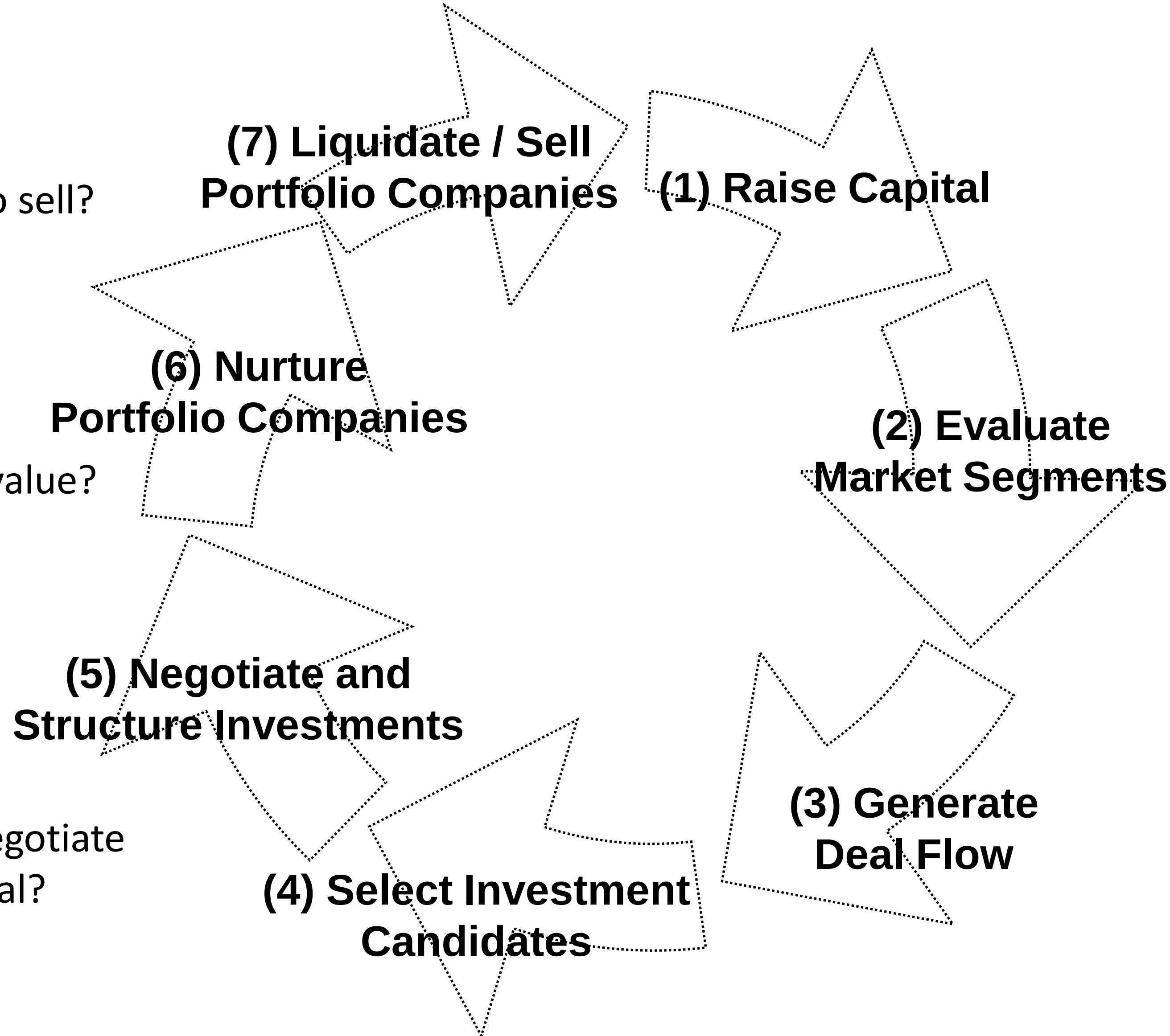
Asia mandate:
Vietnam
Cambodia
Laos
Bangladesh
Myanmar

Case study – why FI?



Growth, risk mitigation as FIs are regulated, Highly developmental – provision of access to finance

Investment Process



When to sell?

How to add value?

How to negotiate
a good deal?

Should we invest?

FI analysis

Capital adequacy

Management – KEY

- integrity and reputation check
- alignment of interest

Earnings

Liquidity

Investment process

Mapping
Preliminary review

- Desk analysis
- Candidates list
- Mkt visits
- Finalization of Targets
- Obtain in principle approval

Due diligence

- Term sheet signed
- Due diligence: CAMEL

Investment

- Final approval from IC
- Negotiate and finalize Agreements
- Sign!
- CPs completion and Disburse

Portfolio management

- Active board seat
- Active SHA

Issues to consider:

Political risk, FX risk
Industry trend, Legal framework
Industry structure

What is the pricing?
What kind of downside Mitigation?
How to communicate?
Do we have the same Expectations?

Should we invest?
Legal and regulatory Risk
How to communicate?

How to put in place Good governance?
How to add value?
How to incentivize Management?
When to exit?

Emerging markets investments

- Political risk
- FX risk
- Macro trend, industry trend
- Legal framework, jurisdictions
- Control and incentivization vs. Growth capital
- Management quality
- Governance

CASE STUDY II

Case study II

You have agreed to invest USD 5,0 million in the Company, giving you a 25% shareholding.

The founder/CEO owns 75% of the company.

What kind of rights do you wish to have as a minority shareholder?

Minority SHA

- Board seat(s)
- Control:
  - Anti dilution: new shares/ pre-emptive rights
    existing shares/rights of first refusal
  - change of business
  - taking on debts
- Tag along
- Provision on SHA deadlocks

The J-curve

- If 5 investments are made the first year for €3 million each:
  - 5 x €3 million = €15 million;
- If 20% of committed capital is called the first year: €20 million;

Capital contributed	€20 million (20% of committed capital)
Assets:	
Investments	€15 million (5 investments at €3 million each, held at cost)
Remaining cash	€2.7 million (20-15-2.3 = €2.7 million)
Total assets	€17.7 million (= 0.89x the 20 million contributed by LPs)

- Interim value is thus: €17.7 million or 0.89x contributed capital;

The J-curve

- Underperforming investments tend to be written down more quickly than successful companies develop;
- Example 2nd year:
  - Another 20% of committed capital : €20 million;
  - Five new deals at €3 million each: €15 million;
  - Two first-year investments are written down/off;
  - Annual management fee: €2 million.

Capital contributed	€40 million (40% of committed capital)
Assets:	
First-year investments	€10.5 million (original 5 investments, one written off, one written down to half its value)
2nd-year investments	€15 million (another five investments at €3 million each, held at cost)
Cash on hand	€5.7 (cash after €4.3 million of expenses(2+2+0.3) and €30 million of investments)
Total assets	€31.2 million (=0.78x the €40 million)

The J-curve

- Companies performing well, held at cost or conservative valuation, understate the value of the portfolio;
- Interim is thus often misleading;
- NAV + cumulative distributions track over time relative to contributed capital: