Venture capital: Structuring a profitable exit

By Priti Suri,
PSA,
Legal Counsellors

PSA

E 601, Gauri Sadan
5, Hailey Road
New Delhi - 110 001
India
Tel: +91 11 4350 0500
Fax: +91 11 4350 0502
Email: p.suri@psalegal.com

Innovative ideas are always warmly welcomed. New and innovative ventures in India have not been an exception and have managed to secure financial assistance in both domestic and global markets. Venture capital is one means Indian entrepreneurs have managed to raise funds.

Venture capitalists (VCs) can give startups access to bigger markets by giving them access to deep pools of funds in exchange for an equity stake.

When the investee companies start yielding good profits, VCs generally move to exit the investment and walk out with the profits from their investment.

Timing is important so a carefully planned exit strategy is an essential and a critical element of the business strategy for the VCs.

The objective of any investor is to cash-out of the investment at the right time and with substantial profits.

In order to facilitate a smooth exit from the investment it is critical to plan for the exit at the time of entry.

There are several ways through which VCs can exit from an investment.

IPO route

Exit options are often included in the charter documents of the investee company when the deal is closed with an investor.

A frequently used exit route is an Initial Public Offering (IPO).

However, structuring a profitable exit via IPO can be difficult. A successful IPO depends on a host of factors, including valuation, prevalent market conditions, the sector in general and the status of the company.

Investors normally expect to exit at the end of their typical cycle or if they believe the company has achieved all that it could.

However, an IPO has to meet parameters prescribed by the Securities and Exchange Board of India (SEBI) and this process can be a tedious one.

For instance, if the investee is a closely-held private company, which is frequently the case for start-ups or other Indian companies, it must convert its status to a public company.

SEBI regulations mandate that a company should have existed as a private and public company for a minimum of three years before restructuring the capital and issuing an IPO.

Other mandatory entry norms for an unlisted company include:

- Net tangible assets of at least US$750,000 for three full years of which not more than half must be held in monetary assets.
- In the preceding three years a company must have distributable profits and the net worth of the company should be at least US$250,000.
- If the company has changed its name, then a minimum 50% of the revenue for the preceding year should be in the company's new name.
- The size of the issue should not exceed five times the pre-issue net worth.

The M&A option

Not all companies choose to go public. Most venture capital investments must generate returns through other means.

Mergers or acquisitions is another viable exit option for VCs.

Valuation is a vital issue here and it is important to remember that structuring an exit through this route requires a certain amount of manipulation.

The company should strive towards achieving key milestones, generating revenue and driving customer relationships, which contribute to enhancing its value and can make it attractive for a potential acquirer.

Strategic sale

Another exit strategy is to sell the equity acquired through the original venture capital investment to a strategic investor.

In this case, the valuation will likely depend on the existing market conditions and financial position of the company.

If the company has a good position in the public and good prospects of growth, the VCs can structure a winning exit by striking a good deal with prospective buyers.

VCs adopt this route when the market conditions are turbulent, meaning IPOs may not produce the anticipated results and M&As may be difficult to structure.

Balance pros and cons

Structuring a profitable exit depends a lot on the business terms of the investment and a sustainable business model.

Intricacies exist in all the exit routes; the challenge lies in identifying the exit route best suited to the needs of the VCs.

The investors must think through the various exit scenarios at different times in the company's evolution and take decisions based on the business prospects at that juncture. The most common exit route, so far, has been IPO. However, companies may fail to qualify for an IPO and this opens the route of merger or acquisition to the VCs with promising returns.

Priti Suri is the proprietor of PSA.