Staged financing reduces investment risks

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Globalization has increased the number of funds and cross-border deals into different geographic areas.

During 2007, venture capital (VC) and private equity (PE) investments touched US$14.2 billion and spanned nearly 400 deals. In 2006 the number was just US$7.5 billion.

According to *Venture Intelligence India*, which tracks VC and PE investments in India and compiles data for the Indian Venture Capital Association, VC investments alone accounted for US$560 million across 100 deals in 2007.

The bulk of this – 70% – went to information technology and IT enabled services while health care, life-sciences, media, telecoms, retail and food and beverages shared the balance.

The structure of the Indian private equity industry was not always transparent. Conditions in India, until recently, were not encouraging for the growth of entrepreneurship.

Bank loans remained the leading source of finance.

The situation changed after 1992 when the Securities and Exchange Board of India introduced a package of reforms including mandatory reporting, buy-back of securities, and a reduction in the minimum percentage of shares required to be listed to 20%. Further reforms – tax concessions, parity for all funds operating in India, and relaxation of requirements for initial public offerings – created a conducive investment climate and a market parallel to that of India's western counterparts.

Staged financing: lower risk

In order to be successful, investors develop risk management processes and risk mitigation strategies to manage the risks associated with their investments at various stages – pre-screening, post-investment and portfolio risk – in both established and developing markets.

Many investors use staged financing in order to reduce their risk when funding companies. Essentially, funding a company in stages means providing the money that has been committed in pieces provided the investee meets pre-established goals.

The investor first invests a small amount of capital and, in subsequent rounds of financing, adds further capital.

While the commitment is to fund the entire amount, the later stages of funding are contingent on the company attaining its goals. Failure by the company to achieve targets releases the investor of his obligation to provide additional funds. Using staged financing, an investor defines goals prior to subsequent payouts at fresh valuations.

Multiple stages

The first stage is "seed financing" which refers to raising money to convert an idea into a working prototype.

Hardest to find, seed money is the most expensive in terms of equity.

The next stage is "start-up" capital which usually is readily available and refers to money raised to modify a prototype into a product to be manufactured at a cost that allows the company to make a profit.

If needed, second and third-tier financing follow to finance inventory and company expansions.

Often a company goes through a couple of rounds of financing before it gains the size and success needed to sell its stock to the public.

Each stage of financing will often reduce the promoters' ownership. If a company does well, its stock should command a higher price in each successive stage of financing. The investors' risk decreases as the company succeeds and meets its goals.

Various options

On one hand, staged financing provides an option to the investor to exit from a venture that is not developing in accordance with the agreed targets or growth expectations. The investor can, therefore, minimize losses.

On the other hand, progressive financing allows the investee to reach a pre-determined goal.

However, critics condemn staged financing due to the possibility that it may slow down development. In spite of this, however, it continues to be popular.

Syndication option

Syndication is another mechanism that permits reduction of investment risk through the participation of a co-investor.

Investment is made when two lenders see potential returns and mutually decide to invest – the willingness of the other to invest in a potentially promising environment can be an attractive factor and influence the decision to invest.

The selection, corporate governance, and issues related to investment management are paramount to VC and PE success.

Crafting specialized and enforceable contracts that allow for different forms of financing with clearly defined targets and expectations are crucial and requires consideration of foreseeable future contingencies.

Priti Suri is the proprietor of PSA.