# CHAPTER IV

**EXIT STRATEGIES OF VENTURE CAPITAL FIRMS**

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CHAPTER IV
EXIT STRATEGIES OF VENTURE CAPITAL FUNDS

4.1 REASONS FOR EXIT

A venture capitalist partly owns the investee company because of his equity investment but is not interested in retaining his ownership. He is interested in converting the ownership into cash at the earliest opportunity when he can receive a bonus on the realization of the investments. Such realization is called “exit”. The scheduling of “time” and “route” for the “exit” is known as “exit strategy”.

A venture capitalist seeks to liquidate his investment in an investee company for two reasons:

1. The venture capitalist’s money belongs to other investors who may be owners or creditors or contributors of the venture fund. Such money is meant for investment for a limited period and thereafter should be withdrawn and reinvested in other ventures depending upon the objectives of the fund. Such exit is from a profitable situation.

2. The venture capitalist may wish to save his investment and come out of a difficult and disappointing situation with minimal loss using the pre-agreed exit option. Such exit is from a loss-making situation.

The objective behind venture capital investment is, therefore, to help the investee enterprise establish itself, after which it is not necessary for the venture capital fund to remain invested, because on liquidating the investment the fund can be reinvested in other challenging and profit-bearing opportunities. A venture capital
investment is for a short duration. Predetermining the timing for realization of the investment is essential and as such even unquoted equity investments are attempted to be realized. There may be planned, predetermined exit strategy for every investment. There would also be unplanned exit strategy for unforeseen circumstances which may occur at the macro or micro level – natural calamities like earthquake, drought etc., or man-made situations like political change, social disturbance, war – any of which might adversely affect the stock market, depress price mechanism for new issues, discourage initial public offering (IPO).

The price that an investment can fetch depends upon the value of the company, which in turn depends upon the stage of development of the company. In order to obtain a good price a venture capitalist will refrain from selling short if he foresees that the worth of the enterprise is likely to increase.

4.2 EXIT ALTERNATIVES

The following exit alternatives are available for a venture capitalist in normal circumstances depending upon the exit timings, stages of development of the enterprise or geographical location:

- Initial Public Offering (IPO)
- Buy-back by promoters or the company
- Sale of the enterprise to another company
- Sale to new investor
- Self-liquidating process
- Liquidation of the investee company.
4.2.1 INITIAL PUBLIC OFFERING (IPO):

The ideal exit route for venture capitalists is through the stock market following the listing of the investee's company's equity stock. This route is available when the investee company has successfully implemented its project and has started generating income. The main reason for a venture capitalist to choose this alternative is to obtain a higher price. If the stock market is developed, it is likely that the equity shares of the investee can be sold at a higher price than in a private placement.

With initial public offering, the stocks of the company get listed at the stock exchanges and are traded in the secondary market. This creates liquidity for any shareholder but makes it easier for a listed company to raise additional equity capital from the public. In some circumstances it may not be feasible or prudent for a venture capitalist to opt for IPO as the exit route. These circumstances arise when:

- Disclosures and transparency required for public offerings might not be in the interests of the investee company for retaining its monopolistic position in the market and barring the entry of competitors.
- Compliance with increased formalities for a public and listed company under different corporate laws and regulatory enactments.
- If the stock of the company is quoted in the stock exchanges and if the earnings of the company do not increase, quantum of dividend it pays remains the same; the market price of the share will drive down bringing disrepute to the company in the eyes of the investors.
❖ The expenses of going public are very high in terms of underwriters' and brokers' commissions, statutory and other legal fees, publicity expenses, etc. which the company might not be able to afford.

❖ Trading at stock exchange may be sluggish and shares may become totally illiquid in a slow moving market. In a bearish market it is difficult to unload the shares at prevailing market prices.

4.2.2 BUY-BACK BY PROMOTERS OR COMPANY:

Buy-back of its own shares by a company is permitted in India under the Companies Act, 1956 through a recent amendment to the act. Promoters generally enter into buy-back agreement with venture capitalists agreeing to buy a definite number or percentage of shares held by venture capitalists on the expiry of a particular time limit or on the completion of the investee's project. The price at which the deal will be struck will either be predetermined with put option or may be negotiated at the time of exercise of put option by the venture capitalist. Some venture capitalists abroad welcome put option but if the enterprise is not interested in accepting the sale then he is required to put his shares together and offer sale. Such offers are attractive to big industrial houses that may purchase the entire block.

A venture capitalist may invest the funds in an enterprise in the form of convertible bonds or loans that are converted when the company is listed on the stock exchange. On failure of the investee company to seek enlistment within a
stipulated period, say five years, the venture capitalist may get back money with interest and penalty rates.

4.2.3 SALE OF THE ENTERPRISE TO ANOTHER COMPANY:
Under this alternative both the entrepreneur and the venture capitalist may sell their holdings in the enterprise to another individual or company interested in purchasing the venture. The venture capitalist gets his investment back. A sale may be in one of the following forms:

 ✓ Sale of equity may be for cash
 ✓ Sale of equity may be against notes instead of cash
 ✓ Sale of equity may be against equity in another company
 ✓ Sale may involve assets of the investee company instead of equity against cash and may be against equity shares in rather than cash
 ✓ Sale of assets may be against equity shares in another company or in any combination of the above arrangements.

In India such sales will attract the provisions of corporate laws, for example, the Companies Act 1956 where sale or acquisition amounts to merger, amalgamation and takeover. They also attract the provisions of listing agreement if the company is listed on any stock exchange. The provision of SEBI (takeover regulations), 1997 will also be applied in certain situations.

4.2.4 SALE TO NEW INVESTOR:
Venture fund companies sometimes sell their investments to other venture funds that may have just begun to invest or to passive investors who are cash-rich and
interested in buying ownership position of the venture capitalist. This exit route is used when the enterprise wants to get rid of the venture capitalist or the venture capitalist wants to liquidate his own investments.

This mode of exit involving the induction of another venture capitalist is in the form of third-or-fourth-round financing. It is not necessary that the sale will be against cash; it may be in different combinations, covering both loan and stocks.

4.2.5 SELF-LIQUIDATING PROCESS:
This method is rarely used in India. Suez Apec Management (s), a well-known international venture capital firm, have used this exit route in certain projects. Investment made in a development project, buying, renovation and commissioning of a building, or renovation of a ship are some examples. Once the planned programme is completed, the asset is sold and the proceeds are distributed to the shareholders through the liquidation of Investee Company.

4.2.6 LIQUIDATION OF INVESTEE COMPANY:
When a business performs poorly it may be easier to liquidate the company and sell off assets like land, buildings, machinery and equipments. This exit route is not desirable. The investee company does not operate well and there is demand and pressure to pay off its liabilities in cash. The company becomes insolvent, is unable to continue operations and is forced into liquidation.
4.3 THE CASE OF EQUITY INVESTMENT:

This exit strategy for equity investment will differ for each stage of investment. Equity investment made in early stages may be multiplied by financing the subsequent rounds if the project is developing and approaching successful completion. On completion of the project the venture capitalist may avail himself of the option of setting the company to list its stock and then sell off his holdings in the secondary market. This is possible when the enterprise has been making significantly maintainable earnings and its stock can fetch a premium. However, if the project is not making earnings, the venture capitalist can compel the promoters to buy back the shareholdings as per the terms of the mutual agreement.

4.4 THE CASE OF DEBT-FINANCING:

The venture capitalist might provide finance in the form of debt and on successful completion of the project or on its failure may insist on repayment of the loan as per the terms of the loans and other agreements executed by the parties.

4.5 THE CASE OF MIXED-FINANCING:

In the case of mixed-financing with equity and loan instruments both being used by venture capitalists, the exit route is in the mixed form too. For the equity part, any one of the alternatives – IPO, listing for secondary market dealing, buy-back – can be followed. For the loan part, the type of loan or debt instrument and agreement covering the debt arrangement will suggest the exit route – outright payment, installment payment of conversion into equity etc.
For successful ventures, then, the exit route could be as per predetermined norms but if the enterprise does not succeed, the venture capitalist also stands to lose. Nevertheless, the exit strategy has to be planned in both the cases depending upon the prevailing market conditions, business circumstances of the enterprise, relationship between the venture capitalist and the assisted company and any other relevant controllable factor. Many venture capitalists like to hold the investment when the company is listed and market price of the share is on the increase on account of a bullish trend in stock exchanges. It may be noted that Indian venture capitalists consider the exit strategy they each adopt to be a business secret and are wary of any disclosure that could jeopardize their business.

4.6 VENTURE CAPITAL BUY-OUTS:

In exceptional cases, venture capital investors withdraw from the venture enterprise by employing devices such as management buy-outs and management buy-ins. Management buy-outs (MBOs) have assumed importance in venture capital market place for several reasons:

- They encourage smaller-scale enterprises based on new technology
- MBOs help smaller enterprises to adapt to technological changes
- They provide opportunities for common identification of goals by managers and owners where managers become owners
- MBOs provide opportunities to managers to become entrepreneurs
- For venture capital investors buy-outs offer lower-risk investment than early stage investments
Venture capital buy-outs are generally differentiated from mainstream business buy-outs. First, venture capitalists consider aspects which lay greater stress on active aftercare and due diligence than on financial engineering or capability. Second, venture capitalists consider high risk and higher reward with lower price considerations, and lay greater stress on investment in product and process development, by maintaining flow of funds through adequate cash being recycled into the system. Product competitiveness in the market place is the investment objective. Third, venture capitalists also consider longer exit routes to achieve maximum returns on investments.

In the USA and the UK, buy-outs are known respectively as leverage buy-outs and management buy-outs, and are common tools of corporate financing and most rewarding investments for investors. In Europe too a wide range of opportunities is available for venture buy-outs.

Venture buy-out situations generally cover the following:

- **Turnaround from unprofitable situations** where venture capitalists enter into buy-out deals with unprofitable businesses and turn them into profit-earning enterprises.
- **Restart of closed business**
- **Technological innovations** involved in the business to take up a new product as substitute for an old and outdated product
- **Situation of demergers or split in family business**
- **Corporate sell-outs**
Based on the above listed situations, buy-outs can be classified into two broad
two types:

Corporate disposals or “hire-downs”. This form of buy-out envisages 100 per cent
sale of the business. Such sale may be that of the business entity or the product
alone or assets alone. The existing management initiates the buy-out and retains
a minor stake, but starts an independent enterprise. Such buy-outs are common in
the UK.

Family splits/demergers or shareholders repurchases: The management team
buys from the owners a part of the undertaking or family interest and becomes a
controlling shareholder of a part of ongoing business. Another form of buy-out is
acquisition through receivership disposals, or “receivership acquisition” buy-out. It
is not very common although it offers a clear purchase, excluding liabilities, and
induction of new management from the outset. This involves a greater risk than
the other two forms because an organization sold out by a receiver will carry
forward existing problems.

Venture buy-outs are both a successful investment strategy for venture capitalists
as well as a welcome exit route. However, in any buy-out it is necessary that the
operational efficiency of the concerned unit should improve. For this objective the
following conditions are required to be fulfilled:

- Presence of good management team is essential. This presupposes good
  human relations, experienced guidance and management commitments
  and motivations.
• Capital adequacy should be ensured with lowest capital gearing costs.

4.7 VENTURE CAPITAL BUY-INS:

Buy-ins are a variation of buy-outs and are frequently used in the USA for inducting new management from outside and improving the operations of an enterprise. The incoming new management usually is unfamiliar with the operations of the enterprise and there is thus a greater element of risk. Buy-ins differ from takeovers because the acquirer in a buy-in is an individual or group of individuals with industry expertise and, although unfamiliar with the target company's business, has a feel for the business.