A Guide for

Raising Equity Investment By MSMEs

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सचिव
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MSME
भारत सरकार
सूक्ष्म, लघु और मध्यम उद्यम मंत्रालय
GOVERNMENT OF INDIA
MINISTRY OF MICRO, SMALL AND MEDIUM ENTERPRISES

FOREWORD

MSMEs will have to dream and act big for India to take its rightful place in the global economy. Accordingly, the MSMEs will need to go for substantial equity infusion for enhancing their debt absorbing as well as risk taking capacity.

As part of the Atmanirbhar Bharat Abhiyan, the Government has announced various measures for MSMEs including Debt, Sub-debt and equity financing Schemes. However, in order to avail the benefits from the equity/equity like schemes, there needs to be greater understanding amongst MSMEs about the pros and cons of equity financing. Moreover, Government schemes can only work as catalyst in creating an active ecosystem with participation from discerning private investors. Partnering with experienced equity investors who can handhold MSMEs in their growth journey, can lead to better corporate governance, technology upgradation and market expansion.

Against this backdrop, the initiatives of SIDBI Venture Capital Ltd. (SVCL), a wholly owned subsidiary of SIDBI, to bring out **'A Guide for Raising Equity Investment by MSMEs'** is apt and very timely. The guide elucidates various issues of equity financing in an easy to understand and relatable way. I would encourage MSMEs to take advantage of this guide and prepare themselves for raising equity investment and partner with investors for a bright future, better growth and for creating value for all stakeholders.

I am also happy to note that the guide would be published in other regional languages. Once again, I congratulate the SVCL and SIDBI team for taking this noble initiative and wish them all success.

A. K. Sharma
Secretary

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Finance is lifeblood of any business, MSMEs being no exception. While there has been substantial improvement in the availability of debt capital for MSMEs from formal institutional sources in India, the access to equity and equity like capital has continued to elude them.

Both demand and supply side factors have contributed to constrict flow of equity to MSMEs. The demand side constraints have largely been driven by misconceived notions in the minds of MSMEs such as fear of losing ownership control, compulsion for more disclosure, ceding seats on boards to the investors, etc. On the supply side, there have been challenges of having access to appropriate information and awareness driven by inadequate interaction between MSMEs and equity providers.

'A Guide for Raising Equity Investment by MSMEs' is an attempt to bridge the distance between MSMEs and equity providers. The guide provides a step by step process for MSMEs to prepare themselves for equity investment by discerning investors. MSMEs can benefit from the information that has been brought into this concise document, including potential sources of funding and successful experience sharing of entrepreneurs.

I hope MSMEs will be able to make the best out of this guide in their aspiring growth journey.

Manoj Mittal
Deputy Managing Director
SIDBI

The Government of India, in recent past, has taken several initiatives to strengthen MSMEs to realise the avowed goal of "Atmanirbhar Bharat". One of the key areas of thrust has been facilitating access to equity capital to MSMEs through Fund of Funds operations. While access to debt capital has been well streamlined and understood by MSMEs, the awareness regarding equity capital has generally been limited among MSMEs. It is felt that there is need for an organised effort to enhance the awareness regarding equity capital among MSMEs.

'A Guide for Raising Equity Investment by MSMEs' is a step in the right direction to guide MSMEs to prepare themselves and raise equity investment to face a globalised market. The guide sets out succinctly the major issues as well the steps involved in the equity fund raise process. I am sure the booklet will be of immense help to the MSMEs and encourage them to access the equity fund raising market.

I congratulate SVCL and SIDBI for publishing this booklet and hope that it will encourage next generation MSME entrepreneurs to grow manifold.

Dr. Archana Hingorani
Managing Partner
Siana Capital Management LLP

What is MSME?

Micro, Small and Medium Enterprise

MSME

Composite Criteria:
Investment in Plant & Machinery/Equipment and Annual Turnover

MICRO

Investment in Plant and Machinery or Equipment:
Not more than Rs. 1 crore

Annual Turnover:
Not more than Rs. 5 crore

SMALL

Investment in Plant and Machinery or Equipment:
Not more than Rs. 10 crore

Annual Turnover:
Not more than Rs. 50 crore

MEDIUM

Investment in Plant and Machinery or Equipment:
Not more than Rs. 50 crore

Annual Turnover:
Not more than Rs. 250 crore

Revised classification of MSME applicable w.e.f 1st July 2020 as per the notification published in the Gazette of India

Source: https://msme.gov.in/know-about-msme

MSME & Investment Lifecycle

EARLY STAGE

Self, Friends & Relatives Funding

Initial investment by founder

Angel Funding / Seed Funding

Individual or entities with surplus cash

GROWTH / EXPANSION STAGE

Banks/Financial Institutions

Term Loans and Working Capital Loans

Venture Capital / Private Equity

Equity infusion leads to higher networth and can be used to leverage debt

Equity investor can be a partner to rely on and should be of sound reputation

Partner can improve systems and processes to benefit the business in the long run and help to build value

MATURE STAGE

Initial Public Offer

Expansion of business by raising funds from public.

Exit opportunity for existing investors.

Equity Funding & Acquisitions.

Listing on NSE Emerge & BSE platform.

Sources of Funds

There are several funding options emerging in India and entrepreneurs can explore to raise funding from alternative sources to meet their requirements. Some of the sources available for exploration are as follows:

	AMOUNT AVAILABLE	COST OF FUNDING	AVAILABLE RESOURCES	ISSUES
SELF FUNDING	Very Limited	Very Low	Very Limited	Amount may not be available in sufficient quantity
FAMILY & FRIENDS	Limited	Low	Limited	Process may be fast but smaller amounts from many individuals may prove difficult to manage
INTERNAL ACCRUAL FROM BUSINESS	Limited	Low	Limited	Amount may not be sufficient and may not be available when needed most
LOANS OR DEBTS	Medium	Medium or Fixed	Medium	Loans process faster than friends and family but lenders may demand security such as property etc. Strict terms of repayment exists.
EQUITY INVESTOR	High	Variable	Medium	Relatively longer time. Investor would be a shareholder. High expectations of growth and financial returns. Joint decisions with the equity partner with respect to major (not day-to-day) issues

Debt Financingmeans when a firm raises money for working capital or capital expenditures through means of financial instruments such as debentures or bonds (with or without embedded conversion and other options) or through other means such as equipment finance loans, general purpose corporate loans etc. Debt financing typically has a fixed/floating interest liability with a defined repayment tenure.

LOANS FROM BANKS/NBFCS

The traditional way of generating debt funds is by procuring loan from financial institutions such as Banks & NBFCs for general purpose or to meet working capital requirements. Such debt financing would include general purpose borrowing, equipment finance, working capital financing such as factoring (recourse & non-recourse) etc.

VENTURE DEBT

Debt financing solutions provided to early stage enterprises without collateral and equity dilution. Generally, venture debt has a higher cost of interest as compared to other debt sources.

BONDS & DEBENTURES

The company can issue bonds/debentures to qualified institutional buyers/ retail investors. However, the same involves significant compliance costs as compared to other sources of debt.

FINTECH PLATFORMS

New Age Fintech Platforms also provide an alternative to MSME companies to raise debt. The cost of debt in such a case may be higher than traditional sources.

Equity Financing

Equity financing means the raising of capital through sale of shares i.e. providing the investor an ownership interest in the company.

Generally, equity financing involves allocation of ordinary equity shares to the investors. However, quasi equity instruments such as convertible preference shares, warrants and convertible debentures may also be used as a quasi equity instrument to raise equity financing.

The investment could be by way of only one such instrument or it could be a mixture of such instruments.

The valuation could be fixed at the time of investment or it could be in convertible instruments, where valuation could be pegged to a milestone.

While debt would generally have a fixed cost, equity does not. At the same time, because of the higher risk, the expectations of return from equity investment are higher.

EQUITY & QUASI EQUITY INSTRUMENTS

EQUITY SHARES

Equity shares are also known as Ordinary shares or as Owned Capital

PREFERENCE SHARES

Cumulative/Non-Cumulative

Redeemable/Non-Redeemable

Participating/Non-Participating

Convertible/Non-Convertible

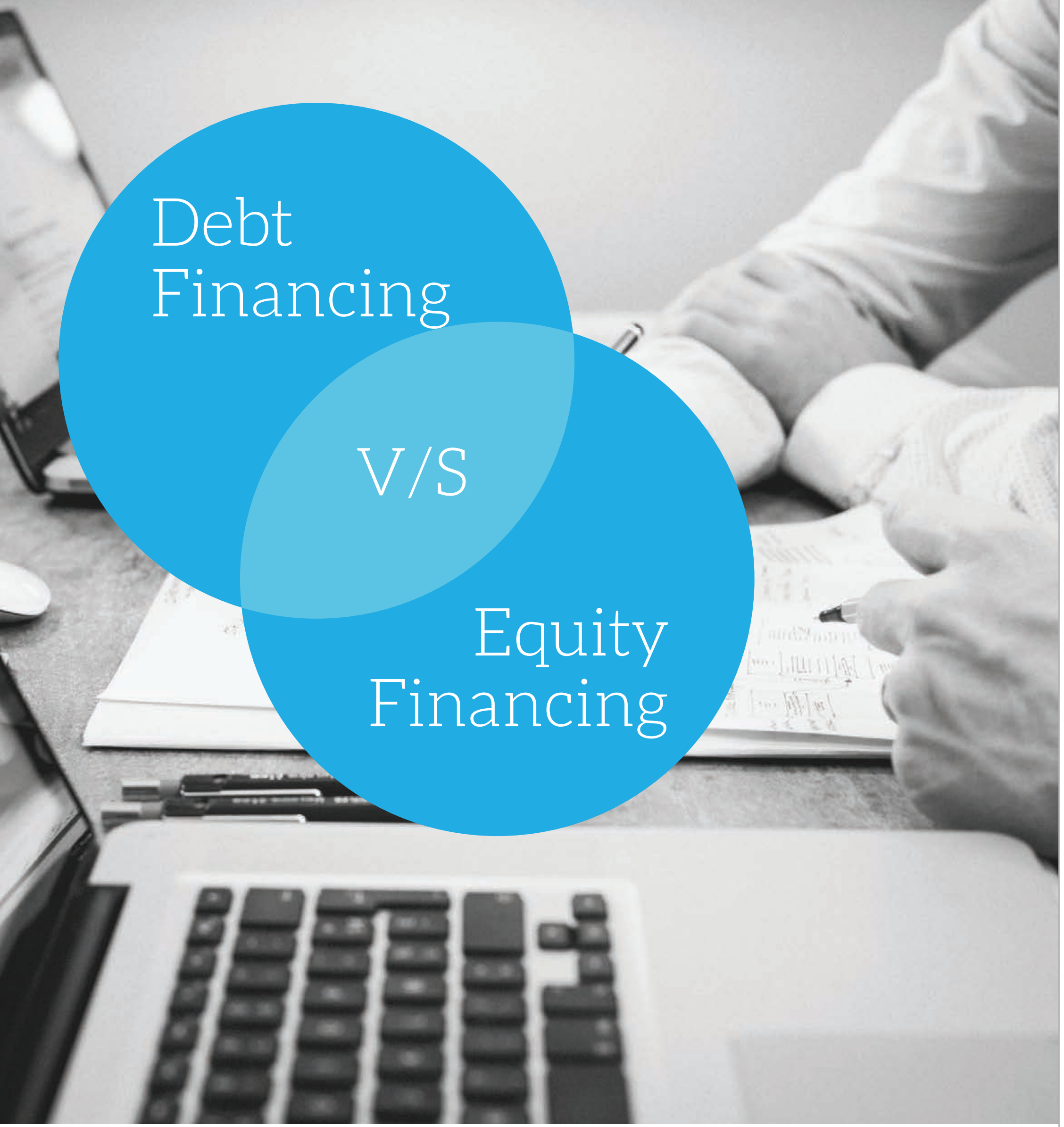
Preference shares with Call/Put Option

DEBENTURES

Secured/Unsecured

Redeemable/Non-Redeemable

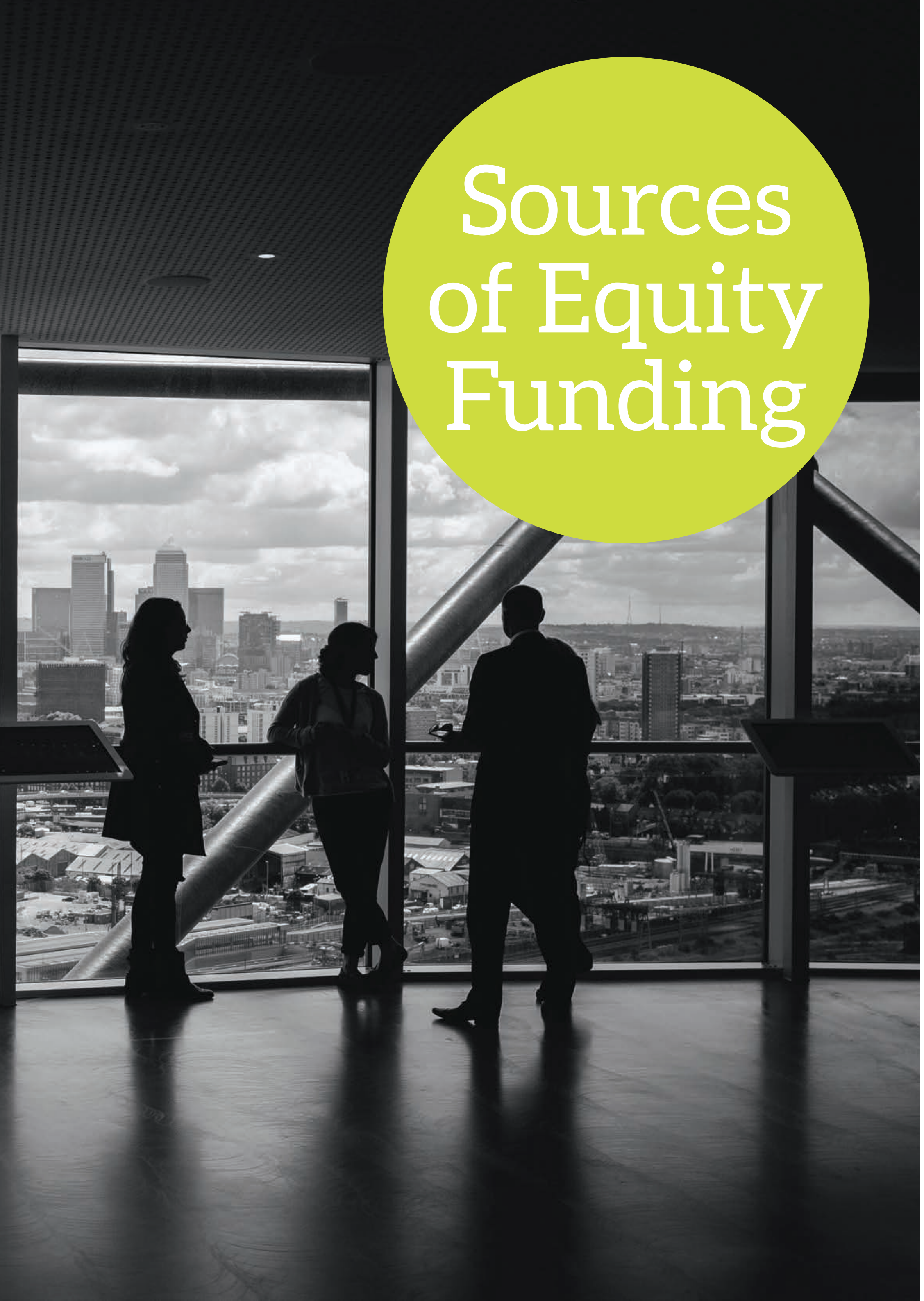
Convertible/Non-Convertible



The decision to raise equity or debt financing would involve a trade off based on the company's current and targeted debt-equity ratio. Further, it would also be a decision based on the ability of the company to access such source of funding while maximizing the return to its investors. Various other factors such as willingness to dilute the ownership, additional cost of compliance with equity funding, commitment to existing lenders and investors, the credit rating of the company, the end use of the funds etc. are considered in deciding the source of financing.

	DEBT	EQUITY
OWNERSHIP	No dilution of ownership interest in the business	Dilution of ownership interest in the business
MANAGEMENT INFLUENCE	None, unless some special conditions have been agreed on.	Equity shareholders have voting rights along with rights to board representation.
REPAYMENT	Debt has a maturity date	Stock has no maturity date
OBLIGATIONS	Payment of Interest & Repayment of Principal according to fixed schedule	No obligation to pay dividends
CLAIMS ON INCOME & ASSETS	Senior to Equity	Subordinate to Debt
COLLATERAL	Collateral dependent	No Collateral
COST	Generally cost of debt is cheaper as they have priority in repayment over Equity shareholders.	Generally cost of equity is in proportion to the risk return profile of the company as Equity investor have residual interest in the company.
TAX BENEFITS	Tax shield on interest payments	No tax benefits

Sources of Equity Funding



Equity Financing refers to supplying capital to an enterprise in return for an ownership share in it.

Equity Investors can be broadly classified into three categories, based on the lifecycle stage of MSME they invest into:

ANGEL INVESTORS

Invests in Early Stage MSMEs and ticket size is relatively small

VENTURE CAPITAL FIRMS

Invests in Breakeven stages, normally known as quasi-equity finance

PRIVATE EQUITY FIRMS

Invests in Growth and Mature Stages and invest a larger ticket size

Although organized VC/PE funds have been investing in India for over 25 years, the MSME sector continues to be underserved by formal external equity.

Equity as a source of financing is under utilized and the prevalence of investment by venture capital and angel investors is low when compared to other countries. MSMEs in India generally rely on friends & family as sources of equity.

Venture Capital and Alternative Investment Funds registered with the Securities and Exchange Board of India can be found at the links given below:

https://www.sebi.gov.in/sebi-web/other/OtherAction.do?doRecognisedFpi=yes&intmId=21

https://www.sebi.gov.in/sebi-web/other/OtherAction.do?doRecognisedFpi=yes&intmId=16

Indian Private Equity & Venture Capital Association (IVCA) provides information about their members, including venture capital and private equity firms as well as knowledge partners. This can be accessed at the link below:

https://ivca.in/our-members/

Ministry of Finance
Government of India

Ministry of MSME
Ministry of Micro, Small and Medium Enterprises
Government of India

DPIIT
Department for Promotion of Industry and Internal Trade
Ministry of Commerce & Industry
Government of India

Government of India Initiatives for VC Industry

FUND OF FUNDS FOR STARTUPS (FFS)

Under the Startup India program, the Government created the FFS with a corpus of ₹ 10,000 crore to provide funding support for Startups, over a period of XIV and XV Finance commission cycles. The Fund was set up with the approval of Union Cabinet in June 2016.

The operational guidelines were issued as per Cabinet approval. The FFS is managed by Small Industries Development Bank of India (SIDBI) and contributes to the corpus of Alternative Investment Funds (AIFs) for investing in equity and equity linked instruments of various Startups.

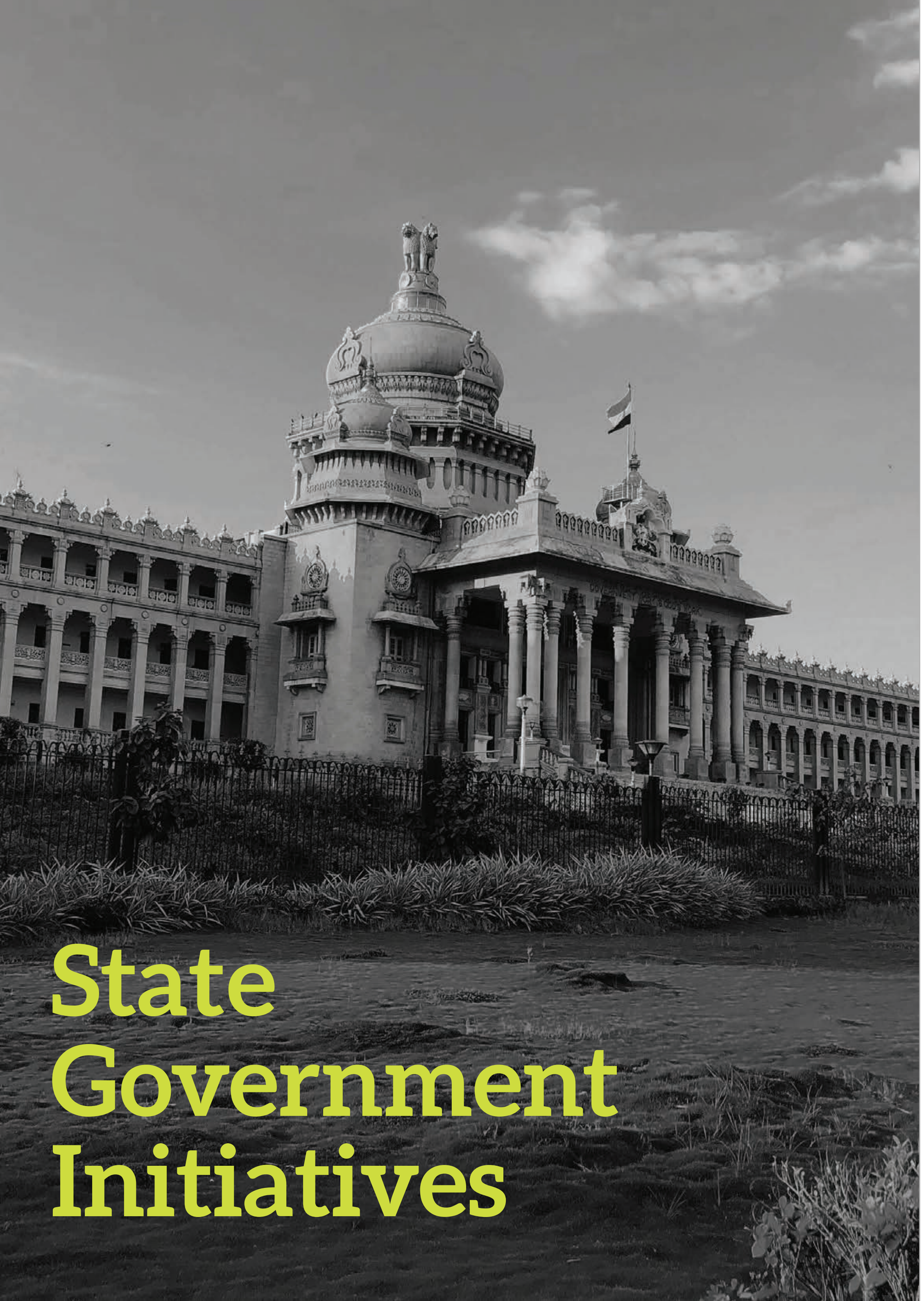
SELF-RELIANT INDIA FUND (SRI FUND)

With Government intervention, the SRI Fund scheme would be able to channelise diverse variety of funds into underserved MSMEs and address the growth needs of viable and high growth MSMEs.

SRI Fund, in the form of Fund of Funds (FoF), will be oriented towards providing funding support to the Daughter Funds for onward provision to MSMEs as growth capital, in the form of equity or quasi-equity, for :

- Enhancing equity/equity like financing to MSMEs and listing of MSMEs on Stock Exchanges
- Supporting faster growth of MSME Businesses and thereby ignite the economy and create employment opportunities;
- Supporting enterprises which have the potential to graduate beyond the MSME bracket and become National / International Champions;
- Supporting MSMEs which help make India self-reliant by producing relevant technologies, goods and services.

SRI Fund is a Fund of Funds with initial support from Government of Rs. 10,000 crore, which will be further leveraged to Rs. 50,000 crore.



State Government Initiatives

GUJARAT

GVFL Ltd., supported by the State Government of Gujarat is one of the oldest venture funds in the country.

KARNATAKA

Government of Karnataka has operationalised fund of funds for investing in venture funds that invest in Startups in various sectors. Following Venture capital funds have been launched in the State with key focus on selected sectors:

- Karnataka Semiconductor Venture Capital Fund (KARSEMVEN Fund) with ₹ 93 crore
- KITVEN 3 (Bio-tech) with ₹ 50 crore
- KITVEN 4 (Animation Visual Effects Gaming and Comics) with ₹ 20 crore

RAJASTHAN

Bhamashah Techno Fund of ₹ 500 Crores for Startups has been introduced to give an open sky to the potential Start-ups of the state of Rajasthan.

UTTAR PRADESH

Government of Uttar Pradesh has established a UP Startup Fund with a corpus size of ₹ 1,000 crore.

BIHAR

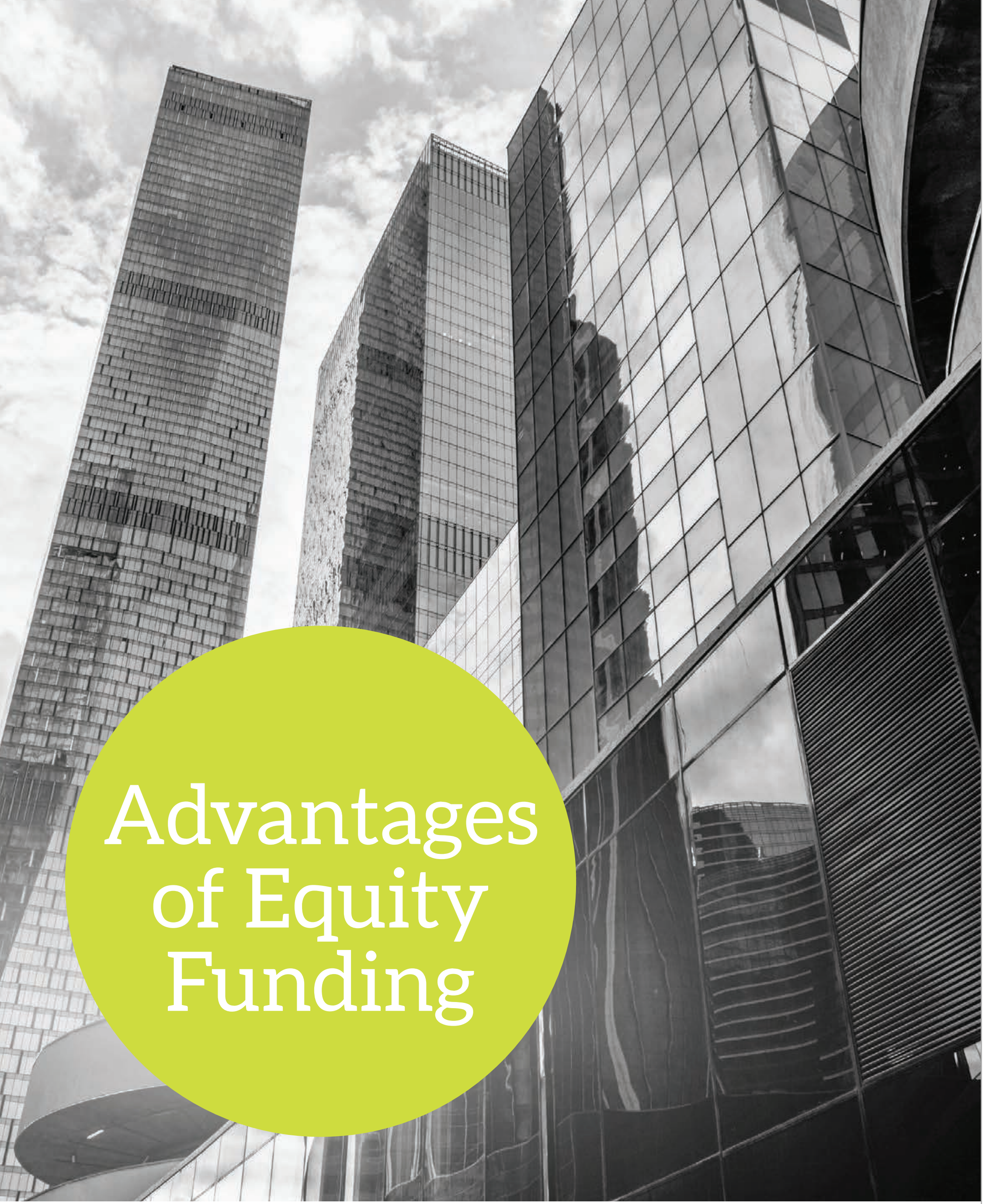
Government of Bihar has created Bihar Startup Fund Trust with a corpus of ₹ 500 crore for funding Startups.

KERALA

Kerala Startup Mission (KSUM), the nodal agency for Startup initiative in Kerala is partnering with SEBI accredited Venture Capital Funds for the creation of corpus fund for supporting the emerging startups in the State.

Leading MSME VC & PE Investors

Aavishkaar	https://www.aavishkaarcapital.in/
BanyanTree Growth Capital	http://banyantreefinance.com/index.php
DSG Consumer Partners	https://dsgcp.com/
Everstone Capital	https://www.everstonecapital.com/
Fireside Ventures	https://firesideventures.com/
GVFL Ltd.	http://www.gvfl.com/
IFCI Venture Capital Funds Ltd.	http://www.ifciventure.com/
InvAscent Capital Partners	https://www.invascent.com/
Karnataka Asset Management Co. Pvt. Ltd.	http://www.kitven.com/
Kedaara Capital	http://www.kedaara.com/index.html
Kotak Private Equity	https://alternateassets.kotak.com/kotak-private-equity-fund.php
LGT Lightstone Aspada	https://www.aspada.com/
Lighthouse Advisors India Pvt. Ltd.	http://www.lhfunds.com/index.html
Matrix Partners India	https://www.matrixpartners.in/
Motilal Oswal	https://www.motilaloswalgroup.com/Our-Businesses/Private-Equity
NABVENTURES Ltd.	https://nabventures.in/
Norwest	https://www.nvp.com/india/
Orbimed	http://www.orbimed.com/en
Rabo Equity	https://www.raboequity.com/index.php
Rajasthan Asset Management Co. Pvt. Ltd.	http://www.rvcf.org/
SBICAP Ventures Ltd. (Neev Fund)	https://sbicapventures.com/neev_fund/
Sequoia Capital India	https://www.sequoiacap.com/india/
SIDBI Venture Capital Ltd.	www.sidbiventure.co.in
Sixth Sense Ventures	http://www.sixth-sense.in/
Somerset Indus Capital Partners	http://www.somersetinduscap.com/



Advantages of Equity Funding

Possible new opportunities with no fixed repayment obligation on the company

LESS BURDEN

With equity financing, there is no loan to repay. The business does not have to make a monthly loan payment which can be particularly important if the business does not initially generate a profit. This in turn, gives the freedom to channel more money into a growing business.

LEARN AND GAIN FROM PARTNERS

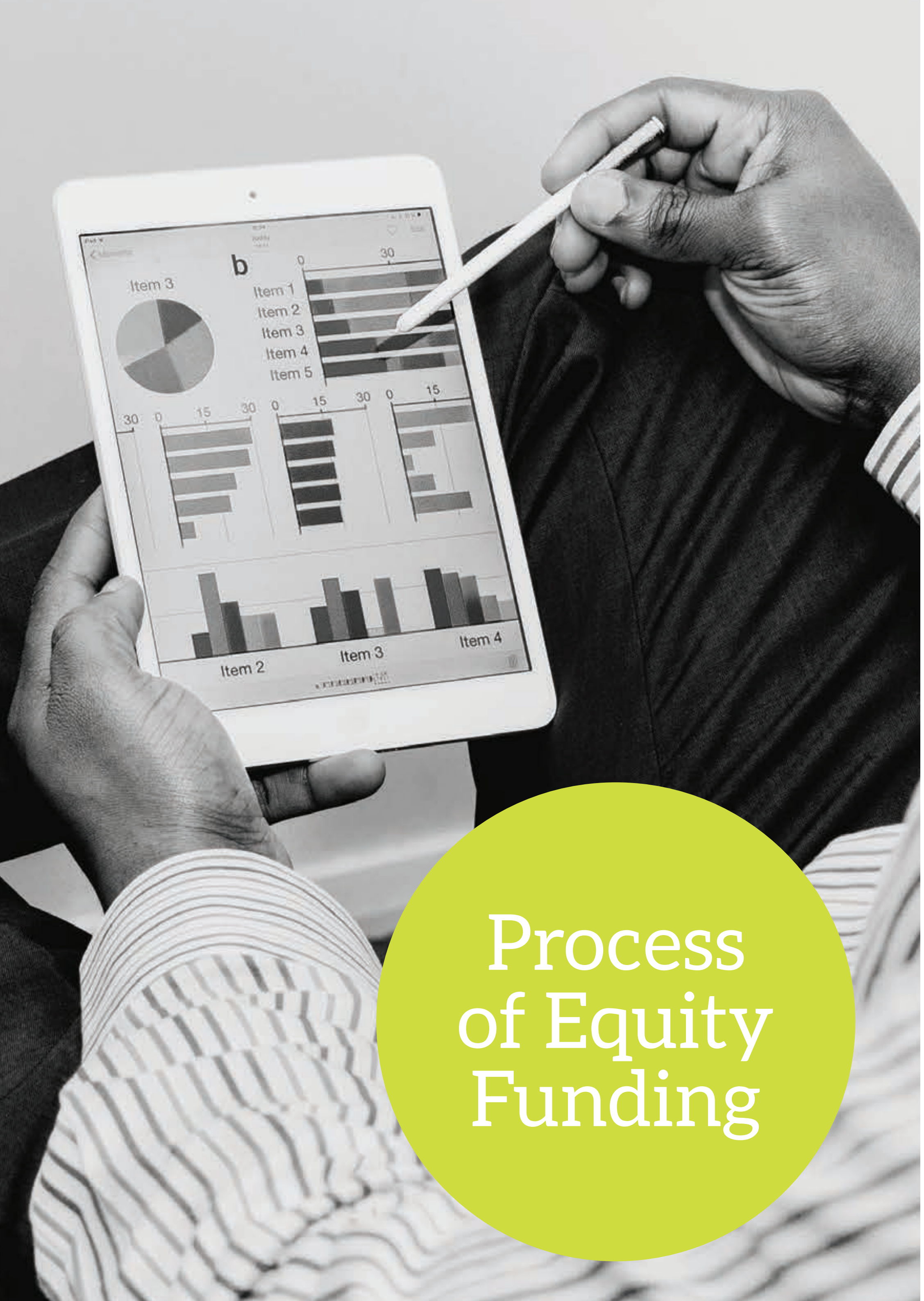
With equity financing, you might form informal partnerships with more knowledgeable or experienced individuals. Some might be well-connected, allowing your business to potentially benefit from their knowledge and their business network.

FOLLOW UP FUNDING

Investors are often prepared to provide follow-up funding as the business grows.

NO COLLATERAL

As compared to raising debt, equity funding does not have to be dependent on any security or collateral in order to raise funds but is based on business plans and revenue models.



Process of Equity Funding

Preparation of Pitch/ Preliminary Due Diligence

Appointing advisors / consultants if required, to advise and guide the company on the process of equity raising

Prepare business plan

Identify and approach the investors.

Identify and position key selling points

Vendor Due Diligence

(This process takes usually 2-6 months)

Evaluation & Negotiation

Preliminary meetings with investors

Procuring term sheets

Preliminary Due Diligence

Prepare proposed valuations

Negotiate valuation & other terms

(This process takes up to 2-3 months.)

Execution & Closing

Evaluate proposed financial structures

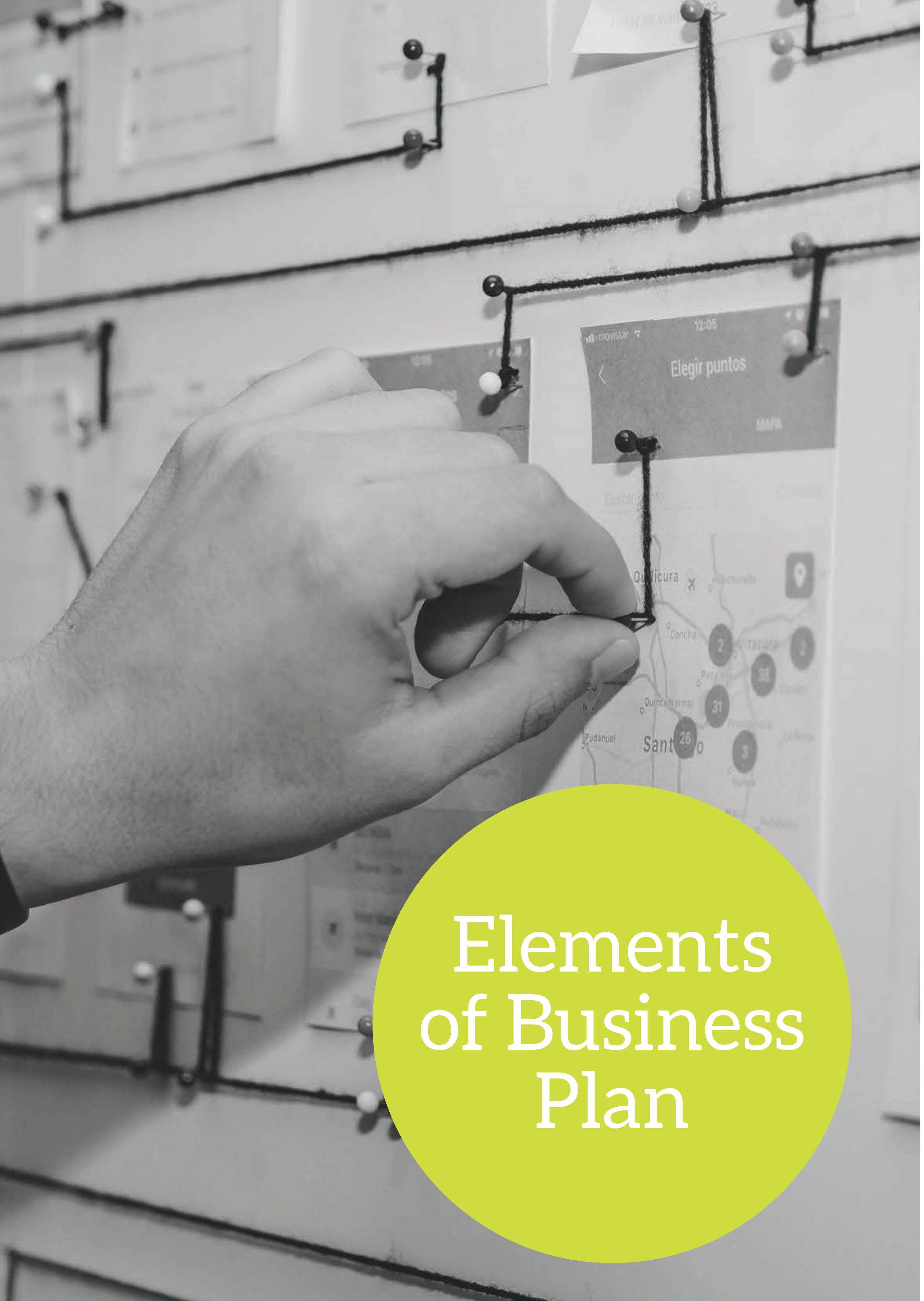
Signing definitive purchase & sale agreements for Equity subscription and Shareholders agreement.

(This process takes 1 month depending upon time taken for negotiations.)

Post Compliances

Post compliance with conditions given, funds are drawn down from the investors.

(This usually takes 1 month depending on time taken for compliances)



Elements of Business Plan

BUSINESS BACKGROUND

The business plan should provide the evolution of the company. The business concept needs to be described, including its product and market it is going to serve. It should elaborate on its key revenue generating segments and future plans.

FINANCIAL FEATURES

The business plan should provide historic financial data for analysis purpose. This mainly involves elaborating on important financial points of the business including sales, profits, cash flows and return on investment.

FINANCIAL REQUIREMENTS

The company should elaborate on its capital structure and its capital requirements for the future. The company should give information on how the proceeds will be utilised for expansion purposes.

BUSINESS POSITION

Give information pertaining to the company, its legal form of operation, when it was formed/incorporated, the principal stakeholders and key personnel of the company.

MAJOR MILESTONES

The company has to provide information about its achievement of various milestones and the developments within the company that are essential to the success of the business.

Pitch for Equity Funding

Business Pitch is a presentation by one or more people to an investor or group of investors for raising equity.

Pitch should generally have the following structure in order to pitch for financing:

- Introduction
- Core Team
- The Business Model
- Valuation and the amount of Investment required
- Key Milestones
- Strategy to achieve key milestone
- Competitive position
- The business exit strategy

While preparing the pitch, the company should also assess the objectives of the investor and the company's key selling points including its financial ratios.

Analyse your Company

An investor while making an investment decision, does careful analysis of financial parameters to find out true worth of the company. This can be done by examining the company's P&L account, balance sheet and cash flow statements. Therefore, an investor shall use the financial ratios as a guide to know more about the company. Similarly, the company can use these ratios to market itself to the investors. Some key ratios are as follows:.

PRICE RATIOS

- Price/Earnings Ratio
- PEG Ratio
- Price/Sales Ratio
- Price/Book Ratio

Useful to value the company depending on the industry.

PROFITABILITY RATIOS

- Return on Assets
- Return on Equity
- Net Profit Margin

Used to assess the profitability of the entity vis a vis its revenue or assets or equity employed.

LIQUIDITY RATIOS

- Current Ratio
- Quick Ratio
- Interest Coverage Ratio
- Debt Service Coverage Ratio

Helpful to assess the short term cash flow/working capital position to meet short term liquidity needs.

LEVERAGE RATIOS

- Debt to Equity or Debt to Capital Ratio
- Debt to Assets Ratio
- Debt to EBITDA Ratio

Used to assess the capital structure/fixed payment obligations of the company

EFFICIENCY RATIOS

- Asset Turnover Ratio
- Inventory Turnover Ratio
- Receivable Turnover Ratio

Determines how well the assets employed are utilised in the business.

Analyse your Company

Financial ratios are dynamic and

- Vary from time to time
- Vary depending on the industry
- May be affected by business factors such as seasonality
- Shall be affected due to change in accounting policy/methods

Therefore a company must adjust for such factors in its analysis if it substantially affects the output.

Financial Ratios are also useful for

- **Trend Analysis:** Analyse for patterns in historical and the projected period.
- **Benchmarking:** Compare with companies in the similar industry and with similar size

What Investors Look For

Key Considerations of Equity Investors

GROWTH PROSPECTS

Competitive landscape
Strong product development
High barriers to entry
Multiple markets and products

MANAGEMENT TEAM

Experience
Commitment
Alignment with investors
Execution capability

INDUSTRY OUTLOOK

Changing customer preferences
Presence of disruptive technologies
Industry growth prospects
Regulatory issues

ROBUSTNESS OF BUSINESS MODEL

Large customer base
Strong supply chain
Stable and recurring cash flows
Low capital expenditure requirements

Objectives of the Investor

Key Considerations of Equity Investors - What Investors Look For

"The primary objective of the investors is to generate superior returns and therefore they look to identify and invest in profitable and scalable business ventures including innovative business model or new products & technologies."

Investors are interested in investment opportunities, which are generally expected to provide a target return. The main idea is to ensure that the companies are able to perform so well that returns follow naturally from their growth and operations.

Investment decisions are generally based on fundamentals of the company. Generally, investors are likely to aim to take significant minority stakes based on total investment in an investee companyand would look to play an impactful and active role with representation on the board of directors of such investee companies in order to help create value for such company. A few investors may like to also take majority ownership stake.

Investors would discuss with the company and agree on a well-defined exit path for the investor after the period of investment is over. Exit alternatives generally include:

- sale of investor's stake to another investor;
- sale of company / investor's stake to a strategic buyer;
- buyback of investor's stake by entrepreneur/promoter/company;
- stock exchange listing.

Valuation

A business valuation is a general process of determining the economic value of a whole business or company unit.

The valuation put on the business is a critical issue for both the entrepreneur and the investor.
The key factors that will go into a determination of valuation include:

- The experience and past success of the founders
- Future projections of the company
- The market size of the company's business
- Company's progress towards a viable product
- The recurring revenue opportunity of the business model
- Valuations of comparable companies
- Economic environment

The higher the valuation, the less dilution the entrepreneur will have to encounter. The lower the valuation, the investor will have more upside potential and less risk, creating a higher motivation for the investor to assist in the company.

Valuation of an enterprise could be done by any one method or a combination of methods. A business could be valued by sales revenue multiple, EBITDA multiple, net profit multiple, discounted cash flow, book value etc.

For example, if an enterprise has achieved a net profit of Rs. y crore, the investor may value it by a multiple of x times of its net profit, resulting in an equity value of Rs. xy crore. The following page provides two of the most popular valuation methods which are preferred by equity investors while valuing a company.

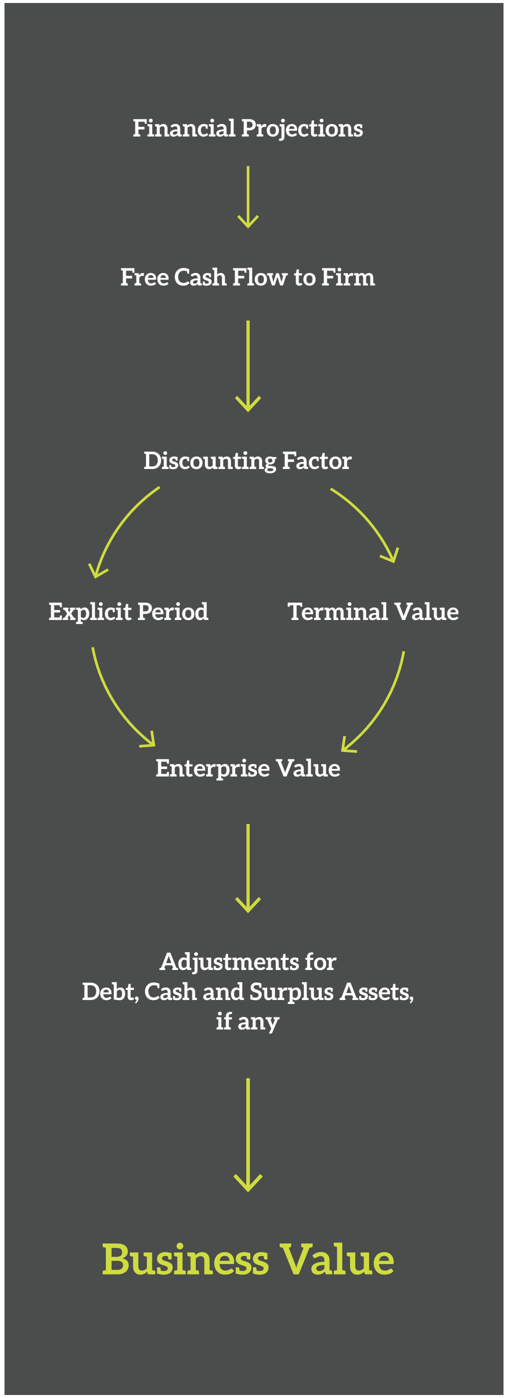
Valuation Methods

Discounted Cash Flow Method:

While using the Discounted Cash Flows or Earnings (of Underlying Business) valuation technique to estimate the Fair Value of an Investment, the Enterprise Value of the Investee company is derived by using reasonable assumptions and estimations of expected future cash flows (or expected future earnings) and the terminal value.

The said cash flows are discounted to the present by applying the appropriate risk-adjusted rate that captures the risk inherent in the projections.

The Enterprise Value is then adjusted for surplus or non-operating assets or excess liabilities and other contingencies and relevant factors to derive an Adjusted Enterprise Value for the Investee Company.

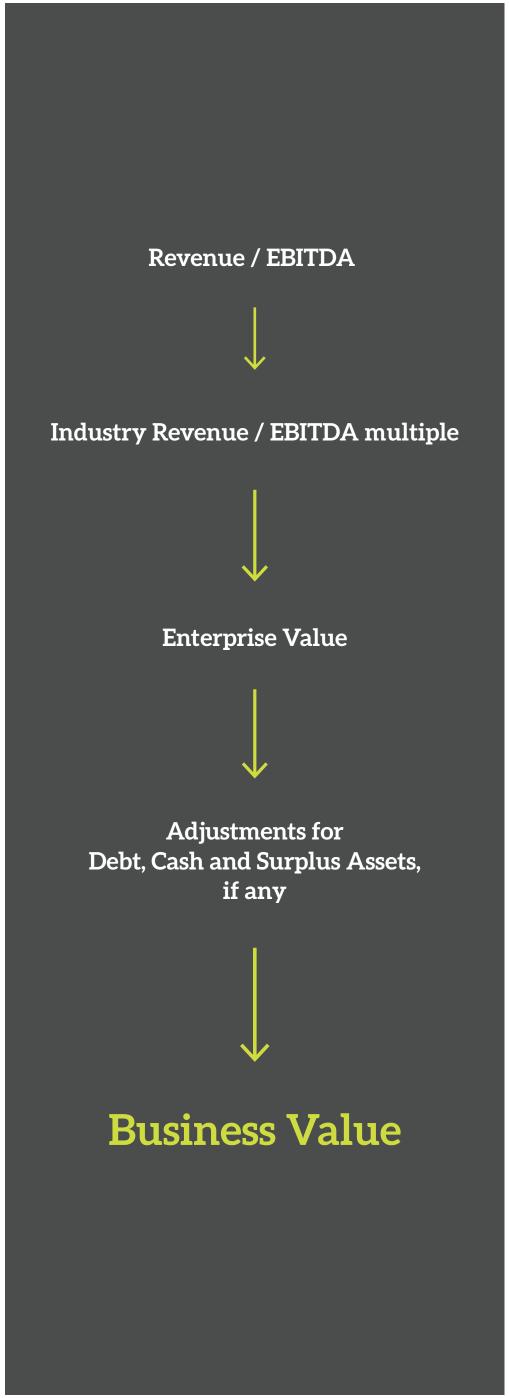


Comparable Companies Method:

The value is determined on the basis of multiples derived from valuations of comparable companies, as manifest through stock market valuations of listed companies.

This valuation is based on the principle that market valuations, taking place between informed buyers and informed sellers, incorporate all factors relevant to valuation. Relevant multiples need to be chosen carefully and adjusted for differences between the circumstances.

To the value of the business so arrived, adjustments need to be made for the value of contingent assets/liabilities, surplus asset and dues payable to Preference Shareholders, if any, in order to arrive at the value for equity shareholders.



After the investor has gone through the business plan, there would be multiple rounds of meetings with the promoters and the management team. The investor would take up internal processes for deciding on making the investment. If investor decides on going ahead with the investment, it would provide a term sheet setting out the major terms of investment including amount, valuation, instruments and rights of the investor.

The company would need to evaluate the investor and the term sheet based on

- Reputation
- Investment objectives and eligibility criteria
- Fund life and exit time horizon
- Experience in MSME investing and past record in handling MSME companies
- Amount of investment, valuation and rights asked for by investor
- Experience of investing in company's particular industry
- Active or passive role

The entrepreneur may then want to understand the term sheet and negotiate some of the clauses, if required, with the investor. After the terms are agreed upon, the company may formally accept the terms and proceed ahead with other steps such as third party due diligence.

Due Diligence

Due Diligence is an audit or investigation conducted by a third-party financial expert and reviews all financial records of the company. It is a final precautionary measure undertaken before entering into an agreement. Due diligence can be either done by the company (sell side) or investor (buy side).

Due Diligence by the Company (referred to as Sell side or Mock DD or Vendor DD)

- Typically, prior to equity financing, the company itself may initiate a due diligence (called vendor due diligence) which should involve a full due diligence of the company.
- A strong focus is on the financial business drivers that determine the future results.
- Vendor (sell-side) due diligence will increase the quality of the offers received and maximize the value of a business.

Due Diligence by the Investor (referred to as Buy side DD)

- Similarly, the investor may initiate buy side due diligence which generally involves an investigation and analysis to assess the investment suitability and the key issues facing the company.
- The strong focus is on the financial business drivers that determine the historic and projected results. Buy-side due diligence runs through all business areas of a company.

The objectives of buy-side due diligence are:

- To get a detailed understanding of the company
- To get an understanding of possible risks in all areas of the company
- Assess the competency of managers and senior business leaders
- To identify business drivers that will be critical to the future success of the company
- To get input for future legal documents

If the due diligence exercise is satisfactory, the investor may then go ahead with the investment. Prior to disbursement of funds, promoters will be required to execute all the documents stipulated under the terms of investment, including Shareholders' Agreement / Subscription Agreement etc. and comply with the conditions precedent to the investment.

Due Diligence: Adding Value

The due diligence process can uncover inconsistencies in the processes of the business, including compliances with regulatory filings, secretarial filings, payment of taxes, contracts and agreement, delays and defaults, contingencies etc.

Ongoing or historical delinquencies with lenders / financial institutions / banks and historical issues of a legal nature, especially of a criminal nature are likely to lead to discomfort.

Once these are brought to light, a process of setting them right has to be put in place, for the long-term effectiveness of the business. The due diligence process should generally include introducing written procedures / checklists / standard operating procedures etc. Typically, some MSMEs may not have it in place at all. It may also include human resource related contracts and agreements with senior staff such as confidentiality and non-compete agreements etc.

This makes the business more attractive and valuable. Therefore, when the fund-raising is being undertaken, the buyer / investor will not enter into further negotiations as the issues would have been resolved or would be in the process of being resolved. This also reduces the risk for the investor. A clean track record shows investors that the promoters are credible as entrepreneurs and have intentions of sticking around and running the business in compliance with the laws.

The cost and time incurred for this exercise is relatively less compared to the benefits.

To fasten the due diligence process, the company can create a data room, which can be either physical or a virtual online one. Access to this data can be provided to the investor and the third-party financial agency which is undertaking the process.

Due Diligence: How to be Prepared?

Due diligence may typically be a painful process for MSMEs. Company management may be very confident of completing the entire process in a short time. However, that is usually not the case as it can be time consuming and may cover a wide range of issues and areas such as given below.

Due diligence process is not a fault-finding process. It also includes rectification of non-compliances and improvement in systems. This is ultimately to the benefit of the company.

It pays to be prepared, by setting the house in order, before commencement of the process. Depending on the level of preparedness of the company, the time taken to complete the due diligence would vary. Company management could keep the following in mind while preparing for due diligence:

- Having adequate internal systems for data capture, storage and retrieval.
- Be up to date with compliances regarding corporate governance, secretarial and regulatory issues.
- Have adequate number of quality personnel to interact with the due diligence teams to understand their data requirements and provide the information in specific formats.

TYPES AND AREAS OF DUE DILIGENCE

- Commercial
- Legal
- Financial
- Strategic
- Tax
- Environmental
- Human Resources

Important Issues In Preparing for The Equity Fund Raising

Being fully prepared for the entire exercise can reduce the time taken. Company management should analyse the following risks and prepare accordingly:

- Equity raising exercise being undertaken for the first time – no experience
- Lack of clarity in strategy, objectives, business plan
- Business lacks growth potential / may not be able to generate returns as per investor's requirement
- Fund raising process started at the last moment when the business is in urgent need of funds
- Delays in providing information to the investor as promoters may be simultaneously running the business as well as coordinating with potential investors
- Advisors appointed by the company for the fund-raising exercise are inexperienced

The entire process may also have certain expenses by way of advisors' fee, travel, cost of compliances etc. which may have to be borne by the company.

Investors would generally require :

- The enterprise to be a company form of organisation. If it is a proprietorship or partnership, it may need to be converted into a company or its business to be transferred to a company. A company structure is generally required to facilitate the fund raising by way of subscription to equity or quasi equity.
- A functional board of directors.
- An organisation structure for the management team, with roles and responsibilities clearly defined.
- A strong finance team, to provide reliable data, in formats required by the investors, during the fund-raising process. The finance team would help in effective financial reporting and analyses, cash flow management, cost optimisation, proper maintenance of books of accounts.

Investor Relationship

Investors look to invest in enterprises that:

- Are open to change
- Are willing to accept strategic and operational support in order to achieve rapid growth.

Investors would generally have the option for a nominee director and/or an observer on the board of directors of the company. Investor would insist on regular board meetings with the presence of investor nominee.

Important decisions would need investor approval such as business strategy, hiring at senior level, employee compensation policies, raising debt or equity and large contracts etc.

Investors would want to spend significant time in developing a relationship with each company, which may go a long way in creating value and help face future challenges.

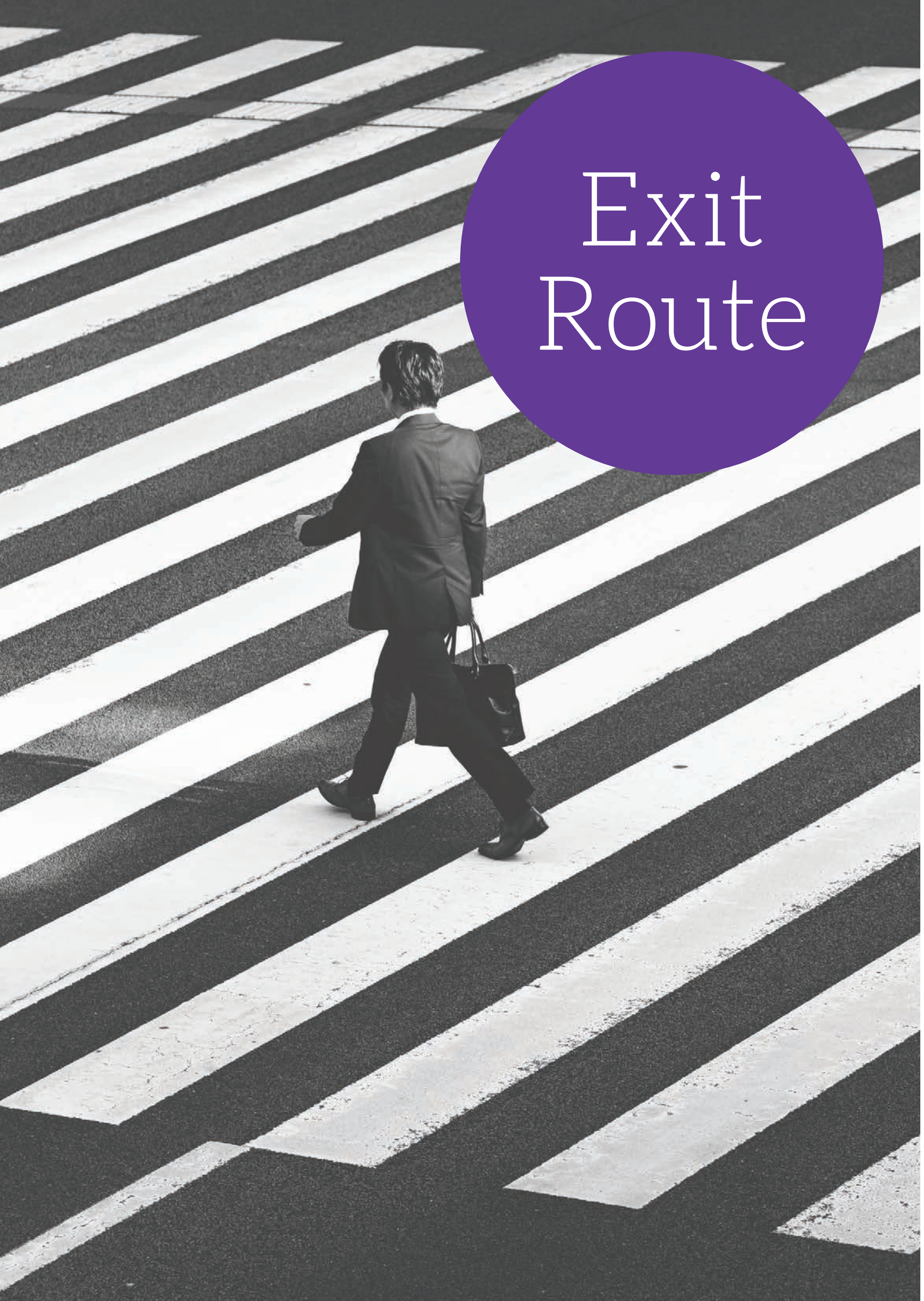
Investors may provide significant help in building appropriate systems and processes, putting up a strong top management team, managing team aspirations, smooth and fast execution of projects.

Share profit: Investors will expect a share of the profits. However, it could be a worthwhile trade-off if benefiting from the value they bring as financial backers and/or their business acumen and experience.

Perceived loss of control: As most entrepreneurs would have been running their enterprise independently, they might feel uncomfortable with the rights required by investors. However, as financial investors would generally take a minority stake in the company, they would not be running the operations (except in majority ownership by investors). The investor needs to be taken into confidence for major business decisions. The investor's prime interest would be in exiting the investment at a later date and making a profit from their investment.

Potential conflict: Sharing ownership and having to take the investor along in major decisions could lead to stresses if there are differences in vision, management style and ways of running the business. It can be an issue to consider carefully and thrashing out while negotiating the terms with the investor. At the same time, the promoters can expect the investor to be a partner and good sounding board while taking major decisions.

Time consuming: Raising equity finance is demanding, time consuming and may be costly. It may take management focus away from the core business activities during the fund-raising exercise (short-term). This exercise would however be to the long-term benefit of the business once equity is raised.



Exit Route

Equity investors usually have an investment horizon of 5-7 years and plan to exit after that, making a substantial profit on their investment. There are many exit strategies that institutional equity investors can use to offload their investment. The following are the exit routes for the equity investors:

INITIAL PUBLIC OFFER (IPO)

One of the ways to exit is to come out with an Initial Public Offering of the company and raise fresh funding, as a part of the IPO to the public. Investor may sell their shares in the IPO or sell their shares after the company gets listed and the shares start trading on the exchange.

STRATEGIC ACQUISITION

Strategic acquisition or trade sale, where the company invested in is sold to another suitable company. This is one of the exit routes for private equity funds. The buyer will usually have a strategic advantage in acquiring this business as they may complement each other. For this reason, the buyer will often pay a premium to acquire such a business.

SECONDARY SALE

The investors will sell their stake in the business to another private equity firm.

REPURCHASE BY THE PROMOTERS

This is an exit strategy where the management or the promoters of the company buy back the equity stake from the investors.

COMPANY BUYBACK

Buyback is one of the ways by which a company provides an exit route to the shareholders by purchasing their shares.

LIQUIDATION

This is the least favourable option but sometimes will have to be used if the promoters of the company and the investors have not been able to successfully run the business.

Success Stories

The National Stock Exchange of India Ltd. and the BSE Ltd. (formerly Bombay Stock Exchange) are leading stock exchanges in India and offer platforms for listing of SMEs.

NSE EMERGE

The National Stock Exchange of India Limited was established in 1992 as the first dematerialized electronic exchange in the country. Its SME platform is known as NSE Emerge

https://www1.nseindia.com/emerge/

BSE SME

The BSE Ltd. was established in 1875 and it is Asia's oldest stock exchange. Its SME platform is known as the BSE SME Platform

https://www.bsesme.com/index.aspx

These platforms can provide exit route to the investor.
Some success stories of listing on these platforms are provided in the following pages.

Thejo Engineering Limited

Thejo Engineering Limited was incorporated in 1974 as a partnership firm at Gudur, Tamil Nadu between Shri K.J. Joseph and Shri Thomas John. It became a Public Limited Company in 2008. It is currently based in Chennai with manufacturing facility at Ponneri.

The company was into repair and maintenance services to companies using conveyor belt systems and manufacturing complementary products such as conveyor belt accessories, mill liners, hoses etc.

Events in the company for generating capital in FY 2013 :

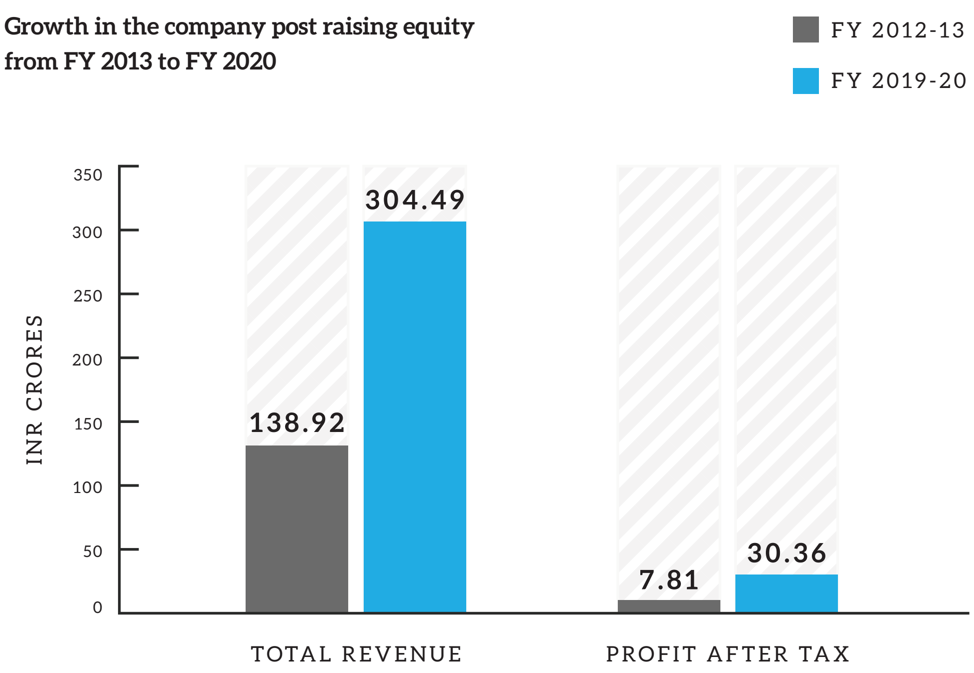
- The company raised Venture capital of INR 2 Cr from India Opportunities Fund
- The first company to list on NSE Emerge Platform and raised INR 19 Cr through IPO

In FY 2012, the company had two small subsidiaries in Saudi Arabia and Australia. Today, in FY 2020 the company has global presence with four subsidiaries in Saudi Arabia, Australia, Brazil and Chile.

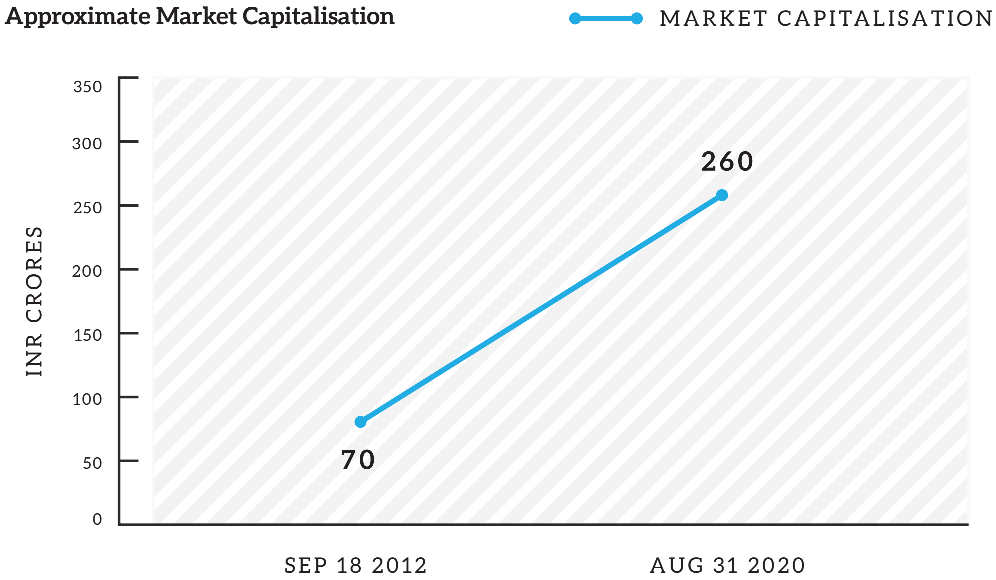
"We raised capital through IPO in 2012 and became the first company to list on NSE-EMERGE. Apart from raising the funds, listing helped us to upgrade our Governance and adopt best practices, which has its own value. Listing has also improved the profile of our Company."

- K.J. Joseph and Thomas John, Promoters, V.A. George Managing Director, Thejo Engineering Limited

Growth in the company post raising equity from FY 2013 to FY 2020



Approximate Market Capitalisation



Shrenik Limited

Shrenik Limited (SL) was incorporated in 2012. SL is primarily engaged in the business of trading of different types of papers in Gujarat and Rajasthan through distribution channel. They offer coated papers, notebook papers, photocopy papers, folding box boards, etc.

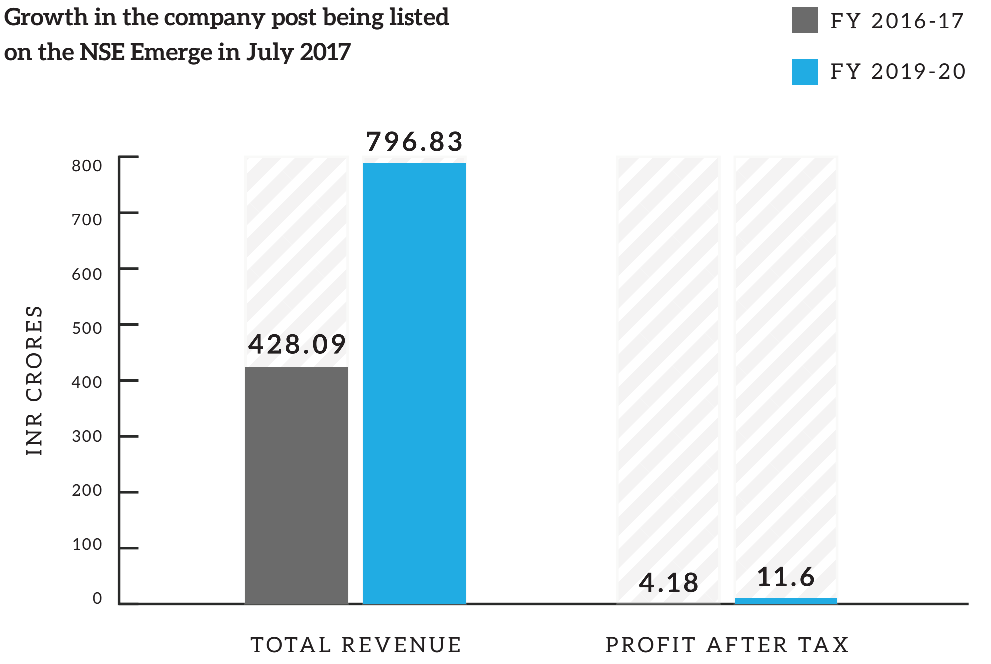
The company serves customers with variety of papers like copier, maplitho, coated paper, FBB Board and a speciality paper commodity royal executive bond.

Besides being a wholesaler they have also introduced their own brand. Its customer base is in Gujarat and Rajasthan.

SL is also a wholesaler for Tamil Nadu Newsprint and Papers Ltd in Gujarat and for Asia Pulp in Gujarat and Rajasthan. Its sticker sheets are used in soap and pharma industries, and stationery business.

It got listed on the NSE Emerge in July 2017. Since its listing in FY18, its market cap valuation has increased appoximately 5x in FY20, thereby unlocking value and opening up potentially new funding opportunities and better access to funds.

Growth in the company post being listed on the NSE Emerge in July 2017



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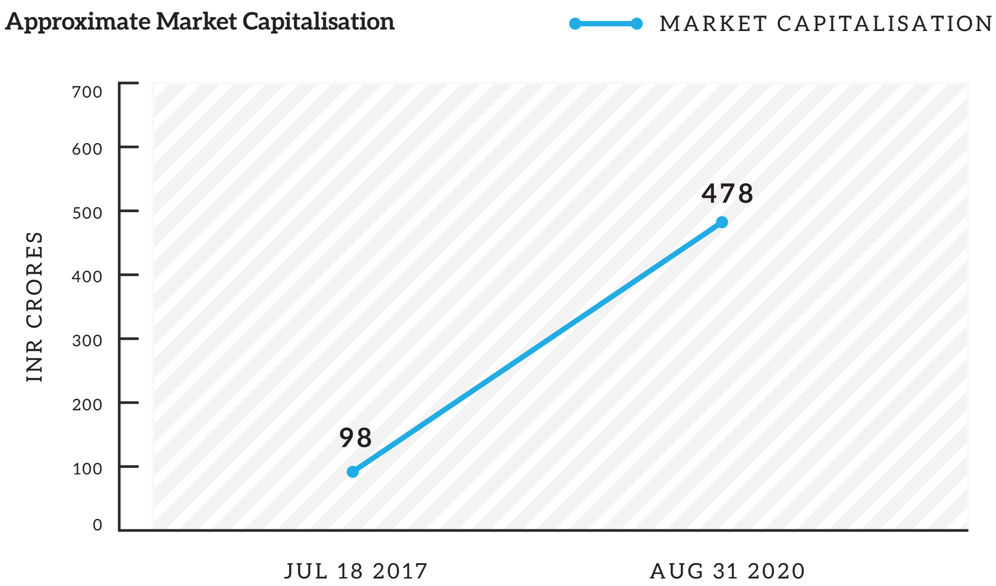


Valiant Organics Limited

Valiant Organics Limited (VOL) was incorporated in 1984.

VOL is a chemical manufacturing company mainly engaged in the business of manufacturing and marketing various types of chlorophenols in India. Chlorophenols are mainly used in agro-chemical industry, pharmaceutical industry, dyes industry as well as in manufacturing of cosmetics and veterinary drugs.

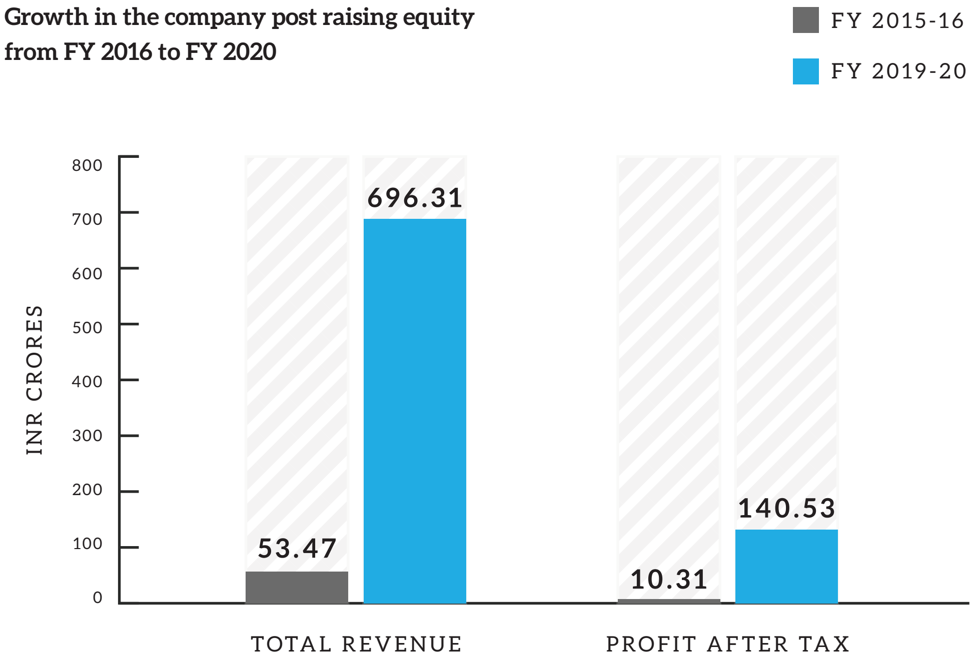
VOL started with exports in the year 2008. VOL also offers customised specification of Chlorophenols as per the customer needs.

VOL operates a manufacturing facility at Sarigam Industrial Estate having an installed capacity of 4,800 metric tonnes per annum.

VOL got listed on the SME Board of the BSE in the year 2016.

In the year 2017, VOL acquired Abhilasha Tex-Chem Pvt. Ltd.

Growth in the company post raising equity from FY 2016 to FY 2020



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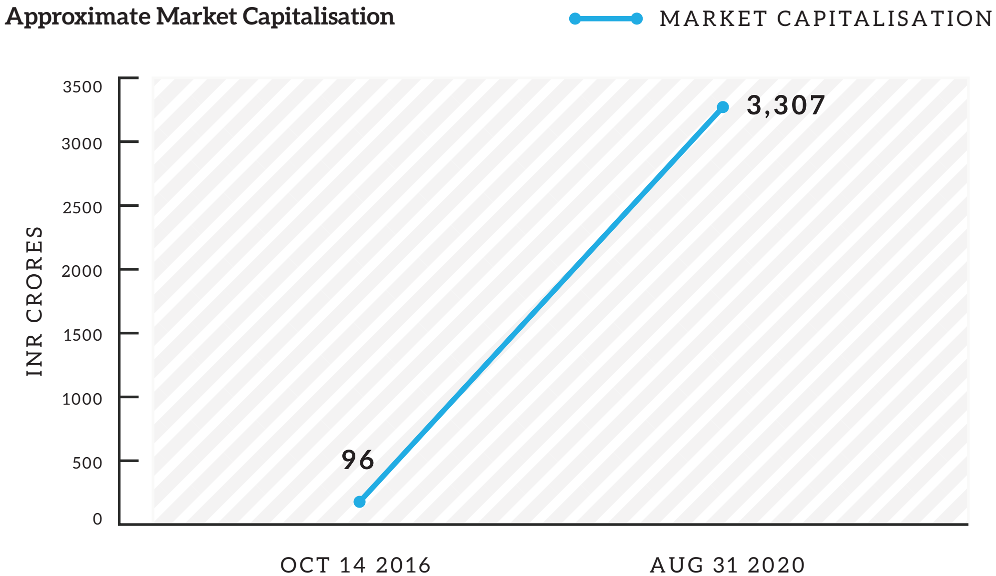

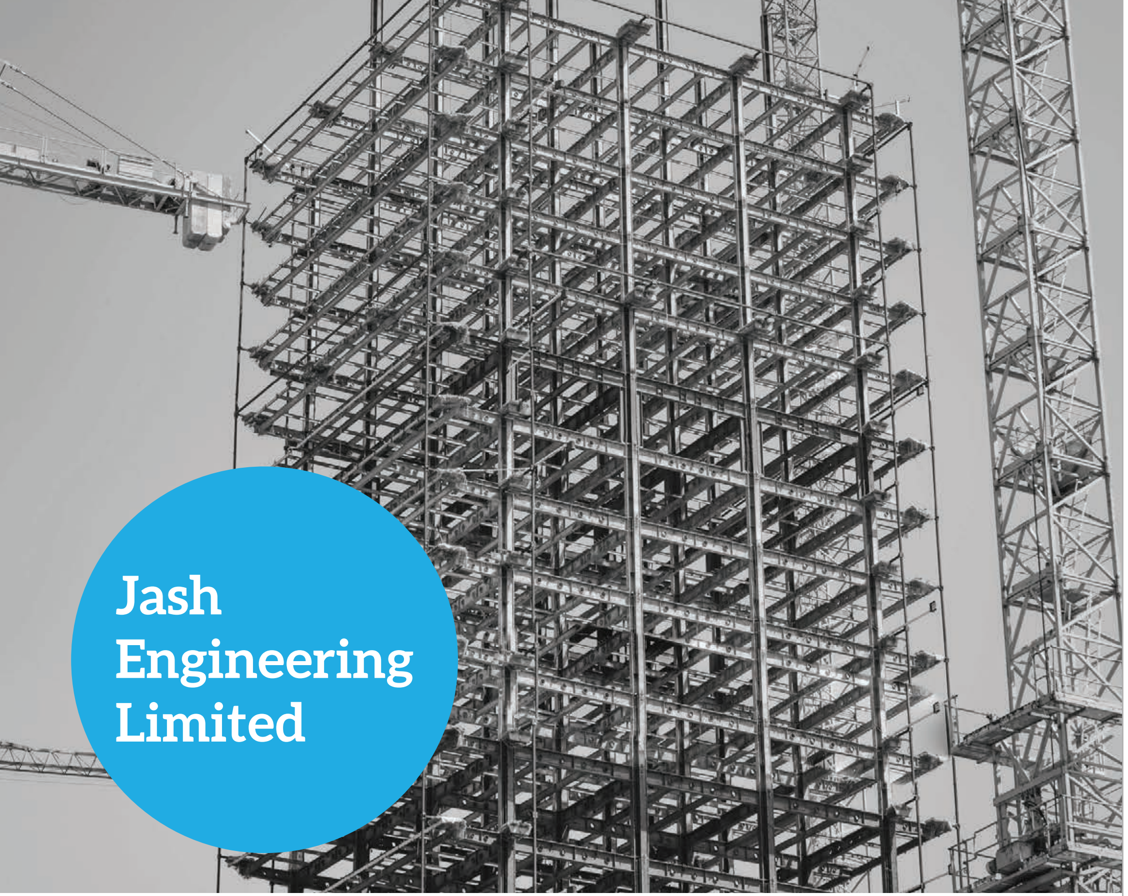

Jash Engineering Limited

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Jash Engineering Limited (JEL) is a leading member of the Jash Group which was founded by Mr. Jashbhai Patel in the year 1948.

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Jash Engineering Ltd is based in Madhya Pradesh.

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JEL is engaged in manufacturing of wide range of products used in water intake systems, water and waste water pumping stations and treatment plants, storm water pumping stations, water transmission lines, power, steel, cement, paper & pulp, petrochemicals, chemical, fertilizers and other process plants.

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In 2012, Pragati India Fund, a fund managed by Pragati India Asset Management via P.I. International L P, invested INR 22.75 Cr in JEL.

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JEL has 5 wholly owned subsidiaries such as Shivpad Engineers Pvt Ltd in Chennai, India, Jash USA Inc in Texas, USA, Mahr Maschinenbau GmbH in Vienna, Austria, Engineering & Manufacturing Jash Ltd, in Hong Kong and Rodney Hunt in Texas, USA.

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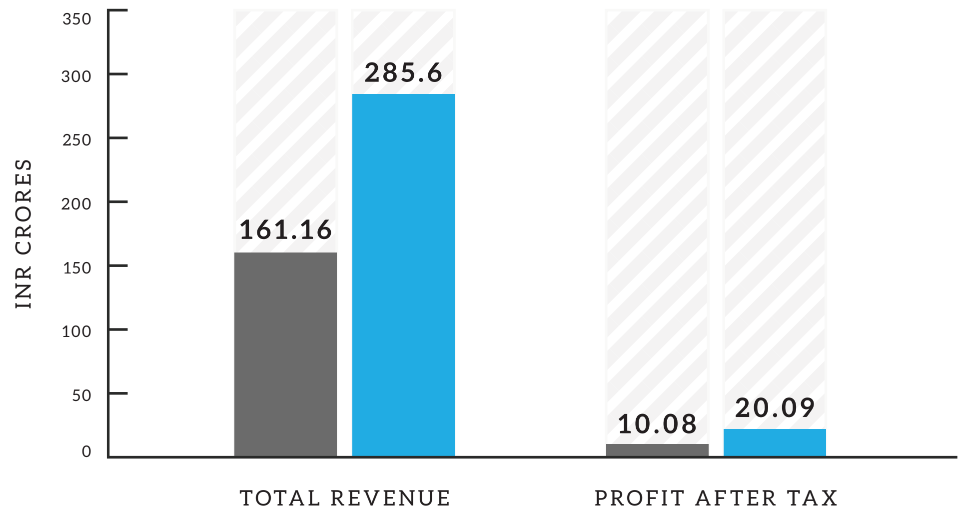
JEL got listed on NSE Emerge in the year 2017.

Growth in the company post being listed on the NSE Emerge in July 2017



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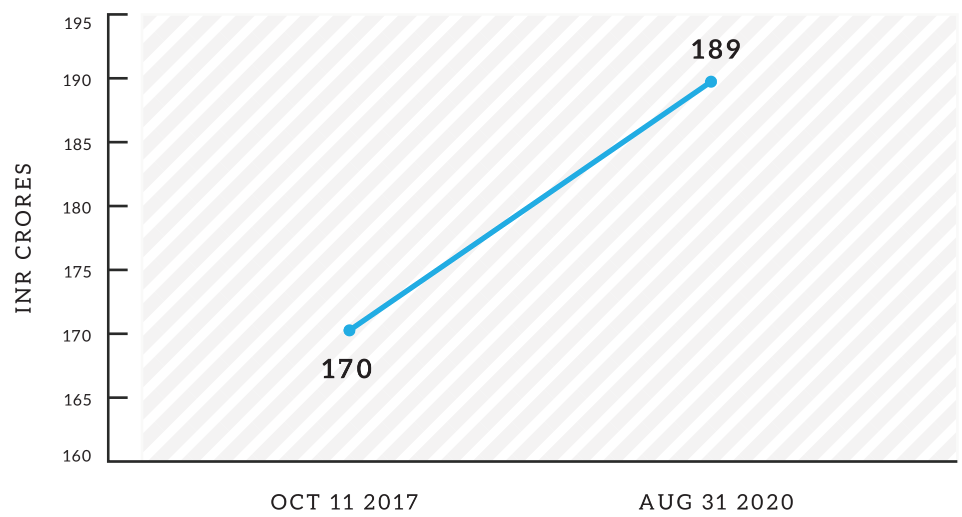


Creative Peripherals Distribution Limited

Creative Peripherals Distribution Limited (CPDL) was incorporated in 1992.

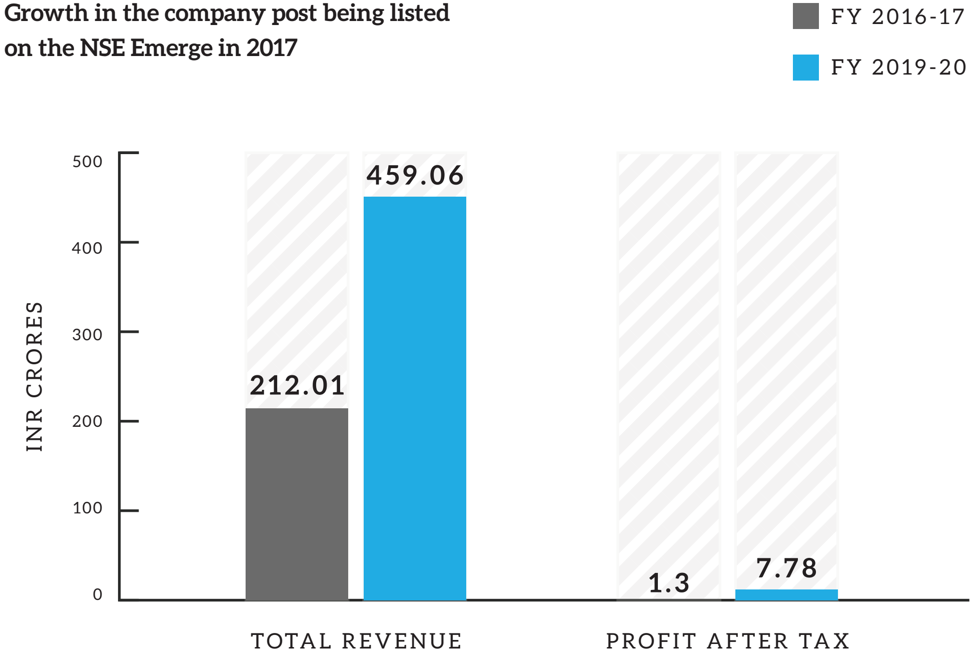
CPDL distributes consumer electronics to retailers and resellers in India. It distributes IT, imaging, lifestyle, and telecom products.

CPDL is a broad based distribution model which is based on multiple products and multiple brand strategy.

It has partnered with a number of renowned brands for distribution in the country such as Rapoo Technologies Ltd, Lino Manfrotto + Co S.p.a, Transcend Information Inc, ViewSonic International Corporation, Olympus Corporation, Belkin Inc, Zioncom (Hong Kong) Technology Ltd, Apple India Private Ltd, Sennheiser Electronics India Private Ltd, Gopro Cooperatief U.A, TPV Technology India Private Ltd, Printronix, SIEPL India Electronics Private Ltd, Vintron Informatics Ltd and Samsung India Electronics Private Ltd.

CPDL got listed on NSE Emerge platform in the year 2017. Since its listing in FY17, its market cap valuation has increased approx. 3x in FY20, thereby unlocking value and opening up potentially new funding opportunities and better access to funds.

Growth in the company post being listed on the NSE Emerge in 2017



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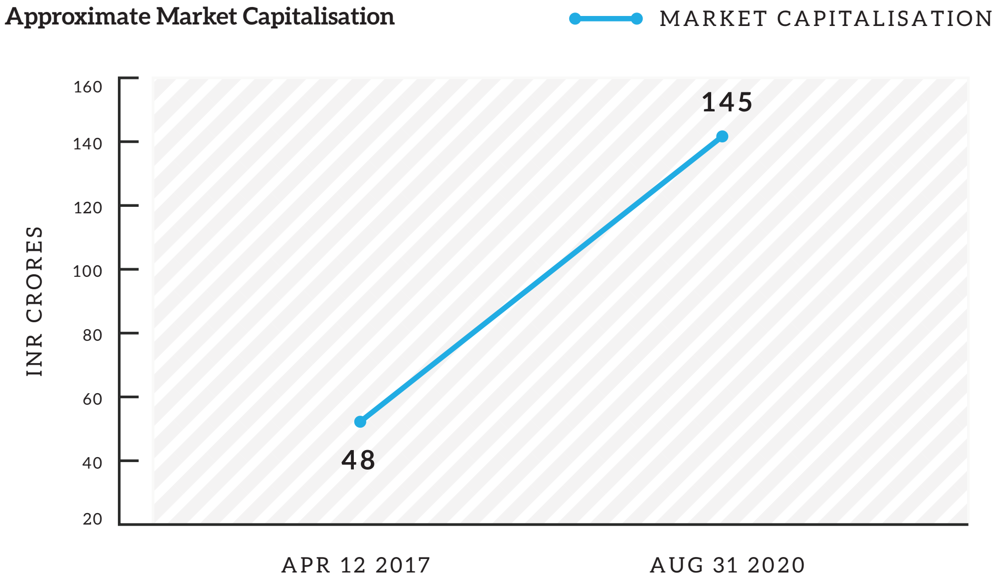

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