

## PRIVATE EQUITY, CABON CREDIT AND GREEN ENERGY

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### PRIVATE EQUITY FUNDING

Raising capital in today's context is a different ball game compared to what was a decade ago. Today on one side there are people with interesting business ideas but not enough funds to finance their ideas. On the other hand, there are people with abundant funds and willing to support viable business propositions.

**Private equity**, in finance, is an asset class consisting of equity investment in running companies that are not traded in stock exchange. A private equity investment will generally be made by a private equity firm, a venture capital firm or an angel investor. Each of these categories of investor has its own set of goals, preferences and investment strategies; each however providing capital to a target company to nurture expansion, new product development, or restructuring of the company's operations, management, or ownership.

Among the most common investment strategies in private equity are: leveraged buyouts, venture capital, growth capital, distressed investments and mezzanine capital. In a typical leveraged buyout transaction, a private equity firm buys majority control of an existing or mature firm. This is distinct from a venture capital or growth capital investment, in which the investors (typically venture capital firms or angel investors) invest in young or emerging companies, and rarely obtain majority control.

Private equity is also often grouped into a broader category called private capital, generally used to describe capital supporting any long-term, illiquid investment strategy.

Leveraged buyout, LBO or Buyout refers to a strategy of making equity investments as part of a transaction in which a company, business unit or business assets is acquired from the current shareholders typically with the use of financial leverage. The companies involved in these transactions are typically mature and generate operating cash flows.

Growth Capital refers to equity investments, most often minority investments, in relatively mature companies that are looking for capital to expand or restructure operations, enter new markets or finance a major acquisition without a change of control of the business. Companies that seek growth capital will often do so in order to finance a transformational event in their life cycle. These companies are likely to be more mature than venture capital funded companies, able to generate revenue and operating profits but unable to generate sufficient cash to fund major expansions, acquisitions or other investments. Because of this lack of scale these companies generally can find few alternative conduits to secure capital for growth, so access to growth equity can be critical to pursue necessary facility expansion, sales and marketing initiatives, equipment purchases, and new product development.

The primary owner of the company may not be willing to take the financial risk alone. By selling part of the company to private equity, the owner can take out some value and share

the risk of growth with partners. Capital can also be used to affect a restructuring of a company's balance sheet, particularly to reduce the amount of leverage (or debt) the company has on its balance sheet.

A Private investment in public equity, or PIPEs, refers to a form of growth capital investment made into a publicly traded company. PIPE investments are typically made in the form of a convertible debentures or preferred capital for a certain period of time.

Mezzanine capital refers to subordinated debt or preferred equity securities that often represent the most junior portion of a company's capital structure that is senior to the company's common equity.

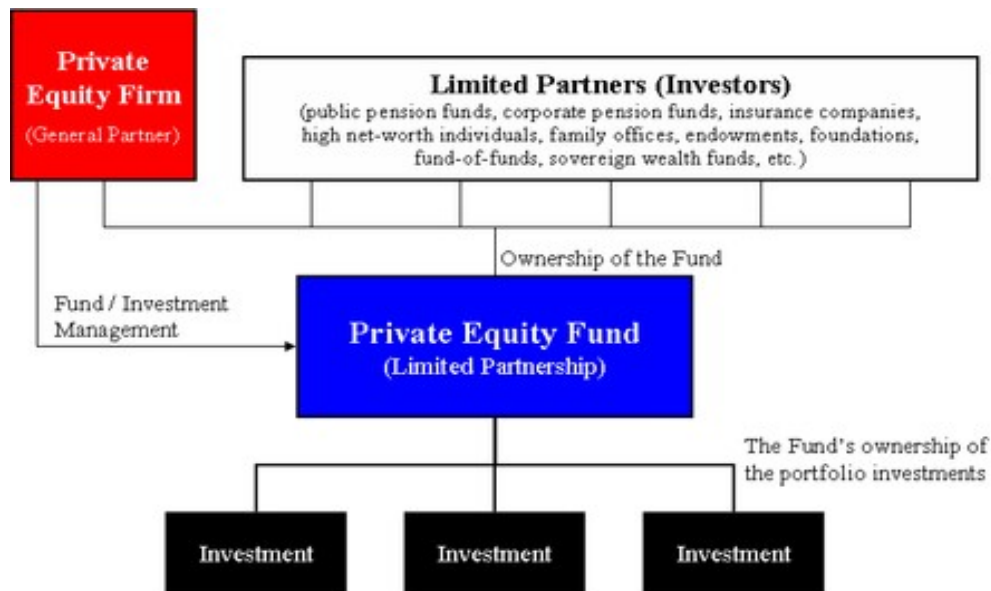
Mezzanine capital, which is often used by smaller companies that are unable to access the high yield market, allows such companies to borrow additional capital beyond the levels that traditional lenders are willing to provide through bank loans. In compensation for the increased risk, mezzanine debt holders require a higher return for their investment than secured or other more senior lenders. Mezzanine securities are often structured with a current income coupon.

Venture capital is a broad subcategory of private equity that refers to equity investments made, typically in less mature companies, for the launch, early development, or expansion of a business. Venture investment is most often found in the application of new technology, new marketing concepts and new products that have yet to be proven.

Venture capital is often sub-divided by the stage of development of the company ranging from early stage capital used for the launch of start-up companies to late stage and growth capital that is often used to fund expansion of existing business that are generating revenue but may not yet be profitable or generating cash flow to fund future growth.

Entrepreneurs often develop products and ideas that require substantial capital during the formative stages of their companies' life cycles. Many entrepreneurs do not have sufficient funds to finance projects themselves, and they must therefore seek outside financing. The venture capitalist's need to deliver high returns to compensate for the risk of these investments makes venture funding an expensive capital source for companies.

Being able to secure financing is critical to any business, whether it's a startup seeking venture capital or a mid-sized firm that needs more cash to grow. Venture capital is most suitable for businesses with large up-front capital requirements which cannot be financed by cheaper alternatives such as debt. Although venture capital is often most closely associated with fast-growing technology and biotechnology fields, venture funding has been used for other more traditional businesses.



Returns on private equity investments are created through one or a combination of three factors that include: debt repayment or cash accumulation through cash flows from operations, operational improvements that increase earnings over the life of the investment and multiple expansion, selling the business for a higher multiple of earnings than was originally paid.

A key component of private equity for institutional investors is that investments are typically realized after some period of time, which will vary depending on the investment strategy. Private equity investments are typically realized through one of the following avenues:

- an *Initial Public Offering (IPO)* – shares of the company are offered to the public, providing a partial immediate realization to the financial sponsor as well as a public market into which it can later sell additional shares;
- a *merger or acquisition* – the company is sold for either cash or shares in another company;
- a *Recapitalization* – cash is distributed to the shareholders (in this case the financial sponsor) and its private equity funds either from cash flow generated by the company or through raising debt or other securities to fund the distribution.

Role of CAs today has evolved to a stage where as Chartered Accounts we help the two of them to meet. A CA can be of resource to both the parties. CA could be of help to the business venture in the following manner:

- Take the business proposal to the right PE

Private Equity investors spread across the globe. They show interest in a venture if its sustainable, long term and possesses robust business model. The investor look for a complete run through of the proposal with financial data properly arranged. Finding the right kind of PE investor is the key to success in roping in the "Investment". This requires specific knowledge of the investor profile, investor interest and investor's location. Business proposal

involves preparation of techno economic feasibility report, detailed project report and also an executive summary. Majority of the report will be on revenue, finances, loans etc. CA is in a vantage position to lend professional service on this score. CA possesses the ideal knowledge base on Company law, Taxation, SEBI guidelines, FEMA rules etc to prepare legally and technically correct report. When I mention as CA I mean both practicing CA and employed CA. Practicing Ca are in a better position to throw more light on the subject since they deal with varied types of such projects. Ca in service has the depth of knowledge of the industry in which he serves and lends extremely pointed inputs for the proposal. Hence both are equally valuable to contribute to such proposals. It's the size and nature of the proposal which determines the involvement of either of them.

#### Identification of the Investor:

CAs, with their wide and varied contacts, geographic presence and network connections, can play a key role in the identification of the PE Investor. There are enough and more web sites on the subject which are very useful for scouting the investor. But, such scouting does not lead to success unless the Investor is made to show interest in the proposal. There the maturity and persuasive skills of the CA come in handy. Once the investor(s) is indentified the business plan need to be presented in detail to them.

#### Help the Investor to understand the nature of business:

CA need to set up a team of technical and non technical persons to make prsntation to the prospective investor about the proposal. This requires in depth and through knowledge of the project, its intricacies, strength, weakness, opportunities and threats of the venture, governmental controls, investment norms of RBI, FEMA rules, environmental regulations, growth potential of the venture, uniqueness of the venture etc.

CA need to do home work very carefully and be prepared with answers for all the critical issues in the proposal. With inherent strength developed from the CA curriculum, who can be a better person than a CA on this? The only perceived weakness of CA is effective communication. Let us gear up.

#### Why the business deserves premium

Many a time PE funding is sought by business house, with a medium term track and success record, for modernization, expansion, diversification, backward or forward integration etc. Needless to say, the business will have a reasonably healthy balance sheet, intrinsic goodwill; unvalued or undervalued patents, extensive investment done on research and development and so on. The hidden strength need to be exposed in the form of valuation of the business. This need expert financial acumen and intelligence. CA possesses it in abundance. Many financial valuation models are available. But what suits the business best will be decided on a case to case basis. Sound knowledge on the Accounting Standards, IFRS and Disclosure requirements are essential for this. We can venture in to this domain with confidence, since we have requisite core knowledge in all the above issues.

Valuation decides the premium the enterprise can demand on the investment. However, an investor will look for a safe exit route, few years down the line. For this convincing business

plan and exit strategy, dividend policy, premium valuation on buy back etc., need to be put in place up front. CA, with vast domain expertise in finance, accounting, taxation, Company Law and FEMA, will be front runner to set the tone. Every dollar of incremental valuation, fetches incremental equity at a premium! Which business will refuse to accept this?

Structuring the deal:

Finally structuring the PE deal involves compliance with legal and financial regulations. The investor will prefer to get a slot in the Board; the investee will prefer to hold controlling interest. CA is in a envious position to strike a deal so that there is win-win situation for all.

In short CA could assist the private equity investment activity for a business in the following way:

- Undertaking an Initial appraisal of Management's financing proposition
- Assess and advise on Business proposal
- Valuation of the business
- Prepare a financial model of cash-flows and return on investment
- Planning the capital/ funding structure
- Review and appraise the terms of deal
- Negotiate deal terms whenever necessary
- Project management of transaction
- Advising on the future plans/ exit route including IPO

According to an updated 2011 ranking created by industry magazine Private Equity International (published by PEI Media called the PEI 300), the largest private equity firm in the world today is TPG, based on the amount of private equity direct-investment capital raised over a five-year period. As ranked by the PEI 300, the 10 largest private equity firms in the world are:

1. TPG Capital
2. Goldman Sachs Principal Investment Area
3. The Carlyle Group
4. Kohlberg Kravis Roberts
5. The Blackstone Group
6. Apollo Global Management
7. Bain Capital
8. CVC Capital Partners
9. First Reserve Corporation

## NOW LET US GET IN TO GREE ENERGY (MORE COMMONLY TERMED AS SUSTAINABLE ENERGY)

Sustainable energy is the sustainable provision of energy that meets the needs of the present without compromising the ability of future generations to meet their needs. Technologies that promote sustainable energy include renewable energy sources, such as hydroelectricity, solar energy, wind energy, wave power, geothermal energy, and tidal power, and also technologies designed to improve energy efficiency.

Green Energy is energy that can be extracted, generated, and/or consumed without any significant negative impact to the environment. The planet has a natural capability to recover which means pollution that does not go beyond that capability can still be termed green.

Green power is a sort of renewable energy that provides the highest environmental benefit. The U.S. Environmental Protection Agency defines green power as electricity produced from solar, wind, geothermal, biogas, biomass, and low-impact small hydroelectric sources. Enterprises buy green power to avoid environmental impacts and its greenhouse gas reduction benefits.

Within the emerging economies, Brazil comes second to China in terms of clean energy investments. Supported by strong energy policies, Brazil has one of the world's highest biomass and small-hydro power capacities and is poised for significant growth in wind energy investment. India is also fast catching up in green energy with the enactment of law in 2010 for sustainable energy and treatment of Municipal solid waste.

While India ranked the 10th in private clean energy investments among G-20 members in 2009, over the next 10 years it is expected to rise to the third position, with annual clean energy investment under current policies forecast to grow by 369 percent between 2010 and 2020.

Indian Government is now insisting on use of green energy in telecom, domestic and industrial applications, wherever power is generated with diesel equipments. Business community is looking for alternate sources of energy such as Solar, Wind and Hybrid power. The effort involves technology tie-up, memorandum of understanding, joint venture agreements, investment structuring, technology transfer and so on. CA has a phenomenal role in all these areas.

### **CARBON CREDIT**

Burning of fossil fuels is a major source of industrial [greenhouse gas](#) emissions especially for power, cement, steel, textile, fertilizer and many other industries which rely on fossil fuels (coal, electricity derived from coal, natural gas and oil). The major greenhouse gases

emitted by these industries are [carbon dioxide](#), [methane](#), nitrous oxide, hydro fluorocarbons (HFCs), etc., all of which increase the atmosphere's ability to trap infrared energy and thus affect the [climate](#).

Carbon credits and carbon markets are a component of global attempt to mitigate the growth in concentrations of greenhouse gases (GHGs). One carbon credit is equal to one metric tonne of carbon dioxide, or in some markets, carbon dioxide equivalent gases. Carbon trading is an application of a trading approach. Greenhouse gas emissions are capped and then [markets](#) are used to allocate the emissions among the group of regulated sources.

Under the [Kyoto Protocol](#), the 'caps' or [quotas](#) for [Greenhouse gases](#) for the developed [Annex 1](#) countries are known as **Assigned Amounts** and are listed in Annex B. The quantity of the initial assigned amount is denominated in individual units, called Assigned amount units (AAUs), each of which represents an allowance to emit one metric tonne of carbon dioxide equivalent, and these are entered into the country's national registry.

In turn, these countries set quotas on the emissions of installations run by local business and other organizations, generically termed 'operators'. Countries manage this through their national registries, which are required to be validated and monitored for compliance by the UNFCCC. Each operator has an allowance of credits, where each unit gives the owner the right to emit one metric tonne of [carbon dioxide](#) or other equivalent [greenhouse gas](#). Operators that have not used up their quotas can sell their unused allowances as carbon credits, while businesses that are about to exceed their quotas can buy the extra allowances as credits, privately or on the open market. As demand for energy grows over time, the total emissions must still stay within the cap, but it allows industry some flexibility and predictability in its planning to accommodate this.

By permitting allowances to be bought and sold, an operator can seek out the most cost-effective way of reducing its emissions, either by investing in 'cleaner' machinery and practices or by purchasing emissions from another operator who already has excess 'capacity'.

Since 2005, the Kyoto mechanism has been adopted for CO<sub>2</sub> trading by all the countries within the European Union and from 2008, EU participants link with the other developed countries that ratified Annex I of the protocol, and trade the six most significant anthropogenic greenhouse gases. In the United States, which has not ratified Kyoto, and Australia, whose ratification came into force in March 2008, similar schemes are being considered.

Carbon credits create a market for reducing greenhouse emissions by giving a monetary value to the cost of polluting the air. Emissions become an internal cost of doing business and are disclosed in many countries in the [balance sheet](#).

For example, consider a business that owns a factory putting out 100,000 tonnes of greenhouse gas emissions in a year. Its government is an Annex I country that enacts a law

to limit the emissions that the business can produce. So the factory is given a quota of say 80,000 tonnes per year. The factory either reduces its emissions to 80,000 tonnes or is required to purchase carbon credits to offset the excess. After costing up alternatives the business may decide that it is uneconomical or infeasible to invest in new machinery for that year. Instead it may choose to buy carbon credits on the open market from organizations that have been approved as being able to sell legitimate carbon credits.

There are many companies that sell carbon credits to commercial and individual customers who are interested in lowering their [carbon footprint](#) on a voluntary basis. They purchase the credits from an investment fund or a carbon development company that has aggregated the credits from individual projects. Buyers and sellers can also use an exchange platform to trade, such as the Carbon Trade Exchange, which is like a stock exchange for carbon credits. The quality of the credits is based on the validation process.

Presently the carbon credit is traded between Euro 4 to 6 in the market. Earlier it has been traded to as high as Euro 15 to 17. There has been a slump in the trading value in the recent months. Investment companies who are in to the trading have down sized their portfolio size on carbon credit trade now.

CA plays a key role in assisting the companies to monitor the carbon credit momentum and also arrange in sourcing or selling of carbon credits.

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