

Guidelines for Strategic Investments & Acquisitions In India



January 2008

Table of Content

1. Introduction

2. Transaction Structures

3. Strategic Considerations

4. Valuation Basics

5. Due Diligence

6. Competing and Creating Value

Key Messages

- ✓ India continues to offer great investment opportunities not only in the knowledge sectors, but now also in more traditional sectors such as manufacturing, banking, pharmaceuticals, telecom and others, which are likely to attract significant amounts of investment
- ✓ The regulators in India are going extra mile to facilitate inflow of foreign investments into the country
- ✓ Deal Structuring parameters in India are driven by factors such as exit, valuations, currency risks, tax consideration and government regulation
- ✓ There are salient differences in the due diligence process between India and US - an understanding of the key aspects is crucial
- ✓ Monitoring investments is key to creating and sustaining value.

India continues to create good investment opportunities

Progressive Reforms Process

- Opportunities to enter new sectors as the reforms process opens them up for foreign direct investment (FDI). For example, Single Brand Retail, Life and General Insurance

Strong Economic Environment

- Growing GDP and FDI, falling rates of interest and maturing capital markets creates private equity investment opportunity in infrastructure, telecom, cement, toll roads, bridges, manufacturing, technology, and pharmaceuticals

Large Domestic Market

- Growing consumer population expands markets across sectors
- Opportunities to use India as a test market for clinical trials and developing products for the global market
- Growing through acquisitions of strong Indian companies across sectors

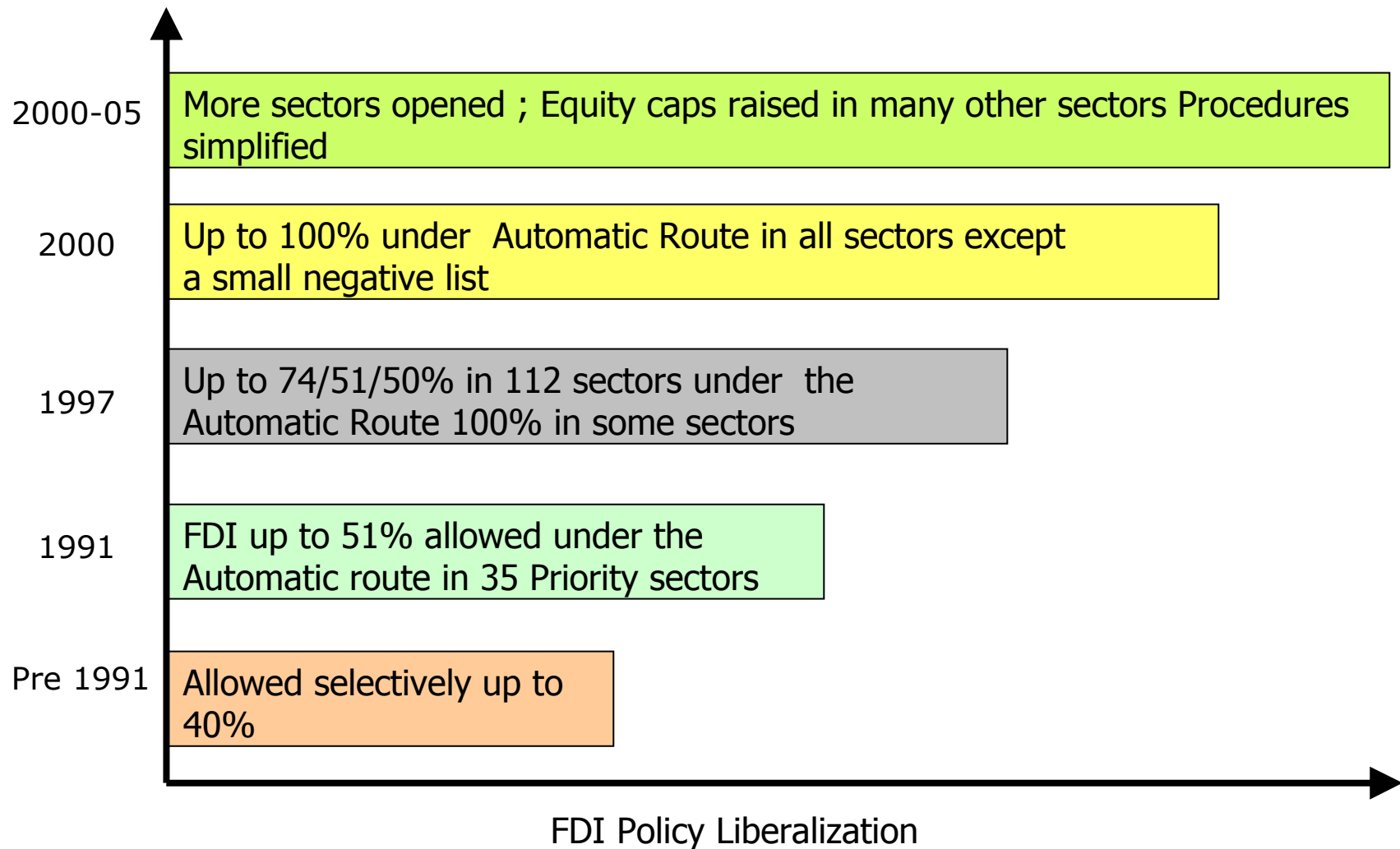
Availability of resources

- Availability of raw material and highly skilled workforce
- Opportunities to set up manufacturing bases in India, both for fulfilling local demand, as well as for developing a global sourcing hub
- Opportunities to set up R&D, software development and engineering centers that cater to their global operations
- Opportunities to set up centers for business process outsourcing
- Leveraging India as a source of high quality managerial talent

India has become an attractive investment destination

- ✓ According to ATKearney's FDI Confidence Index 2004, India is the second most attractive destination for manufacturing.
- ✓ According to UNCTAD's World Investment Report, 2005, India is 2nd most attractive investment destination among the Transnational Corporations (TNCs)
- ✓ Indian industry globally competitive in a wide range of manufacturing skill-intensive products:
 - Apparels, electrical and electronics components; speciality chemicals; pharmaceuticals; etc.
- ✓ Automotive components: Major MNC's & their OEMs sourcing high-quality components from India
 - Volvo, GM, GE, Chrysler, Ford, Toyota, Unilever, Clariant, Cummins, Delphi
- ✓ Indian companies now having manufacturing presence in many countries
 - Over 55% of approved outward investment by India companies in manufacturing activities

It is becoming easier to invest in India



Drivers of US India Strategic Acquisitions & Mergers

Fund Motivation

High Return on Investment
 Asset Diversification
 Risk factor is decreasing
 Availability of Good Opportunities
 Solid Fundamentals

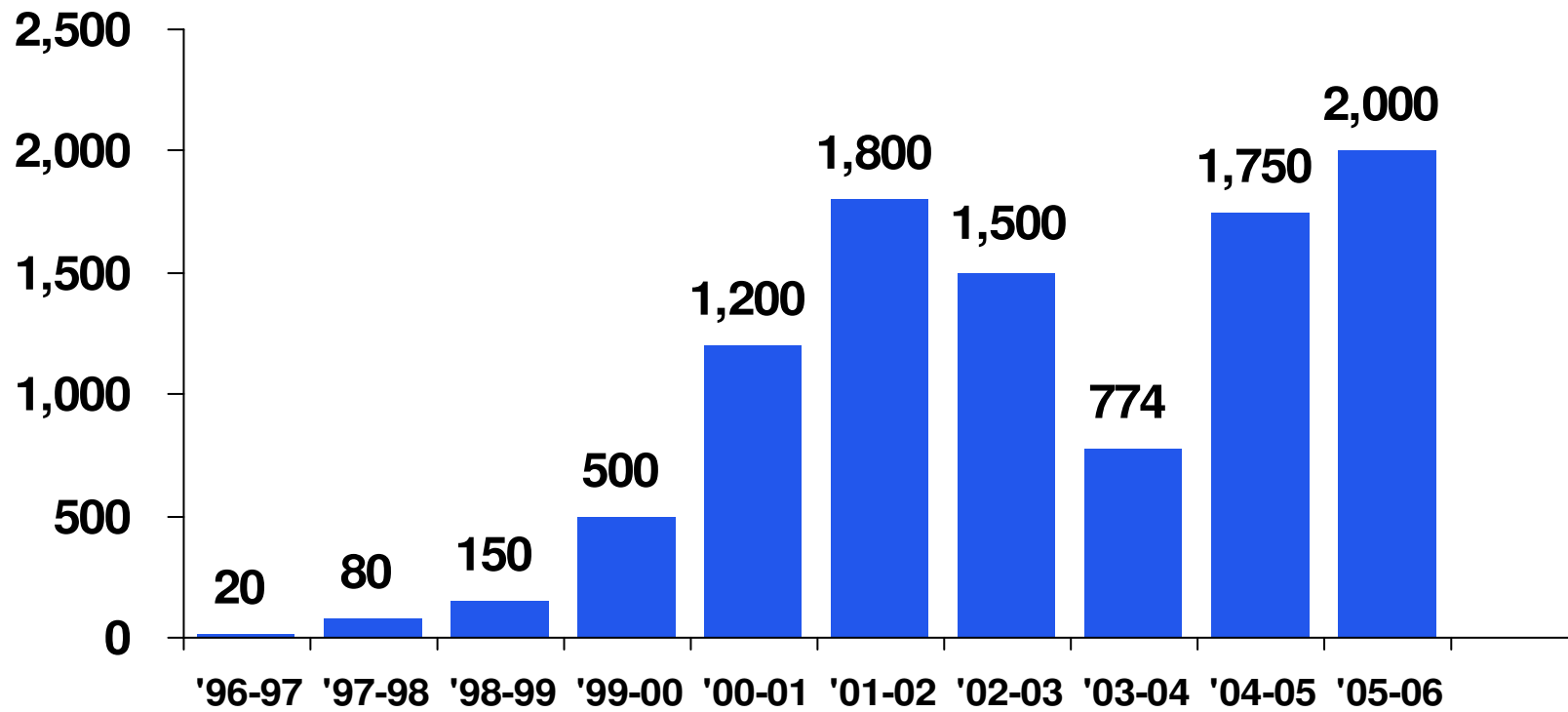
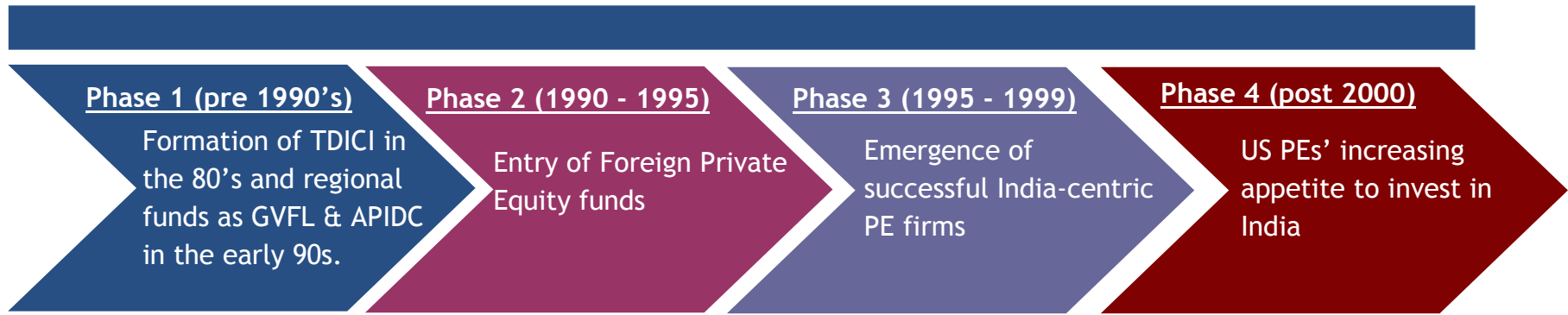
Company Motivation

Revenue enhancement
 Cost Reduction
 Buy vs. Build
 Redeployment of Assets
 Industry psychology
 Diversification
 Cost of Capital

Indian Party Motivation

Access to Global Markets
 Revenue Enhancement
 Better Management advice and support
 Access to capital
 “Stepping it up”

The last five years has seen a significant increase in number of private equity funds and strategic acquirers



Private Equity Investment in India

*Source: DealTracker

There is a vast universe of PE funds in India

Type of Funds	Avg Deal Size	Key Funds
1 Venture Capital Fund	upto \$20 m	Sequoia-Westbridge, ICICI Ventures, JumpstartUP, UTI Ventures, IFC, Intel Capital, SIDBI
2 Mid market private equity funds	\$10 - \$30 m	CVC, ChrysCapital, Actis, Baring, GW Capital, Oak, Kotak, ILFS, IDFC
3 Late Stage Private equity fund	\$30 - \$100 M	Warburg, Temasek, General Atlantic Partners, 3i
4 Buyout Funds	> 100 m	New Bridge, Carlyle, Apax, Blackstone, ICICI Venture
5 Fund of Funds	> 100 m	Evolve India
Others..		
6 Real Estate Funds		IREO, Ascendas India Property fund, OZ Capital, Trikona
7 Hybrid Hedge Funds		Oaktree Mgmt, New Vernon Pequot Capital

* Source: Business Today

But too much capital raises issues

- Too much money chasing few deals
- Late stage deals getting expensive
 - Increasing role of strategic investors -Intel, IBM, Motorola, CISCO, EMC
- Return Expectations are Coming Down
- Number of Early Stage Investors is limited
 - SIDBI, NewPath,
 - IITS, Indian Institute of Sciences (incubation)
 - **Limited amount of true “risk-capital” will impact entrepreneurial activity**
- Increased Difficulty Realizing Exits via IPO - Recent Stock Market turbulence

Private Equity Investments are spread over a wide variety of industries.

Sector	No. of deals	% of deal volume	Total Deal Value (\$ Million)	% of deal value
Automotive	7	5.6%	194	9.6%
Aviation	5	4.0%	51	2.5%
Banking And Financial Services	10	8.1%	185	9.1%
Cement	4	3.2%	88	4.4%
Energy And Power	4	3.2%	128	6.3%
Food & Beverages	5	4.0%	144	7.1%
Hotel	6	4.8%	61	3.0%
It&Ites	22	17.7%	244	12.0%
Manufacturing	5	4.0%	67	3.3%
Media & Entertainment	8	6.5%	142	7.0%
Pharma, Healthcare & Biotechnology	19	15.3%	374	18.4%
Shipping	3	2.4%	70	3.4%
Telecom	4	3.2%	15	0.7%
Textiles & Apparel	10	8.1%	107	5.3%
Others	12	9.7%	163	8.0%
Total	124	100.0%	2033	100.0%

Acquisitions and Mergers are also spread over a wide variety of industries

Sector	No. of deals	% of deal volume	Total Deal Value (\$ Million)	% of deal value
Automotive	7	5.6%	194	9.6%
Aviation	5	4.0%	51	2.5%
Banking And Financial Services	10	8.1%	185	9.1%
Cement	4	3.2%	88	4.4%
Energy And Power	4	3.2%	128	6.3%
Food & Beverages	5	4.0%	144	7.1%
Hotel	6	4.8%	61	3.0%
It&Ites	22	17.7%	244	12.0%
Manufacturing	5	4.0%	67	3.3%
Media & Entertainment	8	6.5%	142	7.0%
Pharma, Healthcare & Biotechnology	19	15.3%	374	18.4%
Shipping	3	2.4%	70	3.4%
Telecom	4	3.2%	15	0.7%
Textiles & Apparel	10	8.1%	107	5.3%
Others	12	9.7%	163	8.0%
Total	124	100.0%	2033	100.0%

1. Introduction

2. Transaction Structures

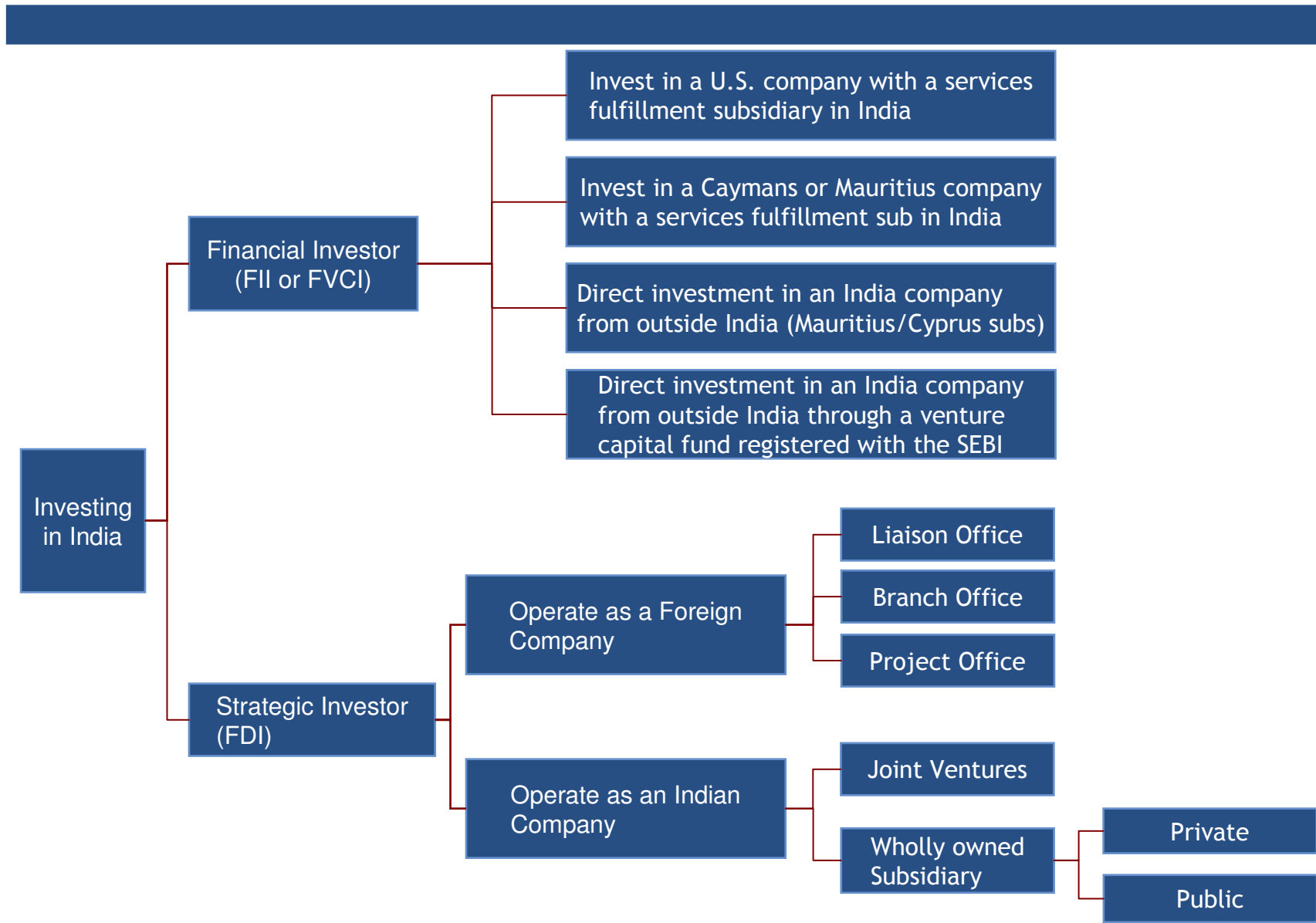
3. Strategic Considerations

4. Valuation Basics

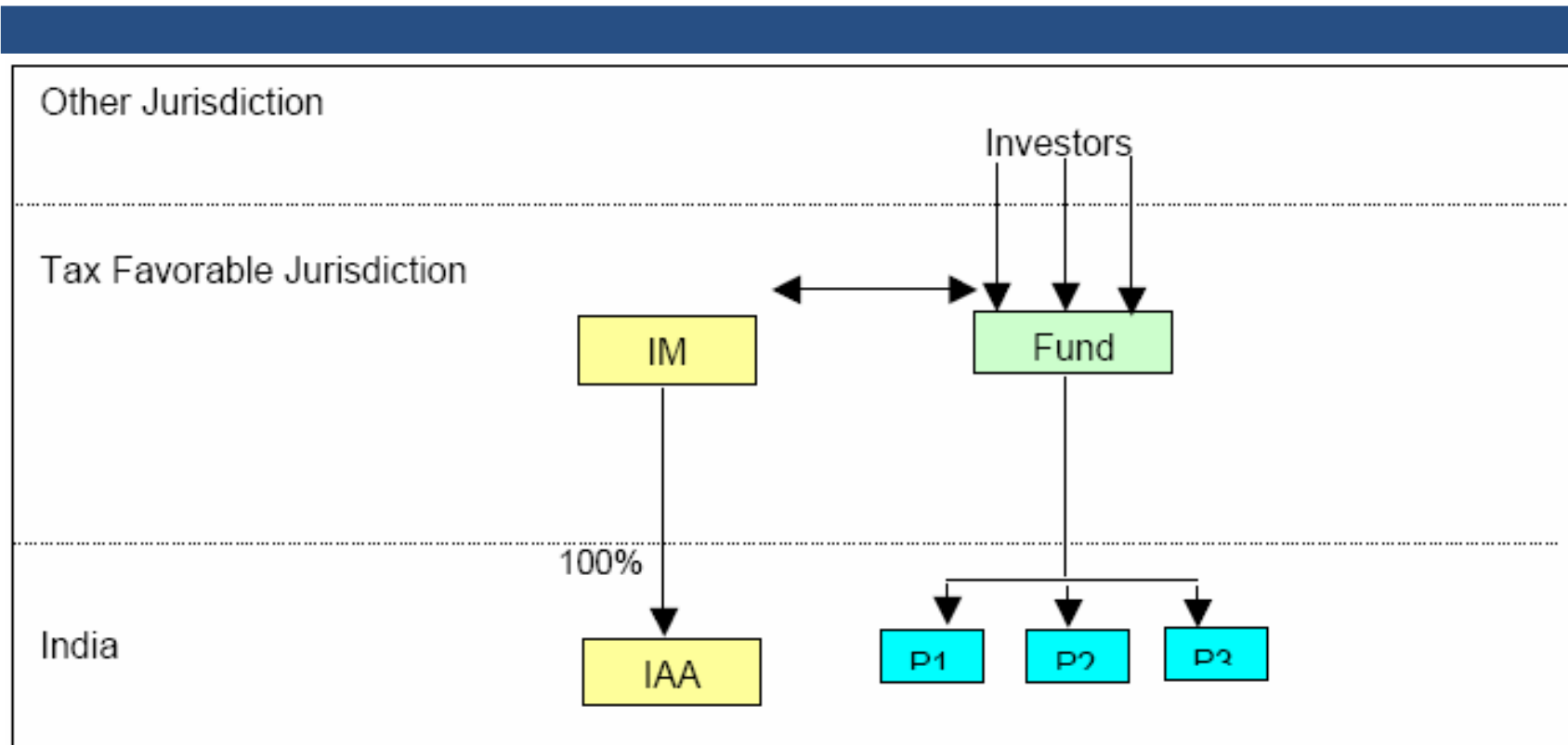
5. Due Diligence

6. Competing and Creating Value

There are several ways to invest in India

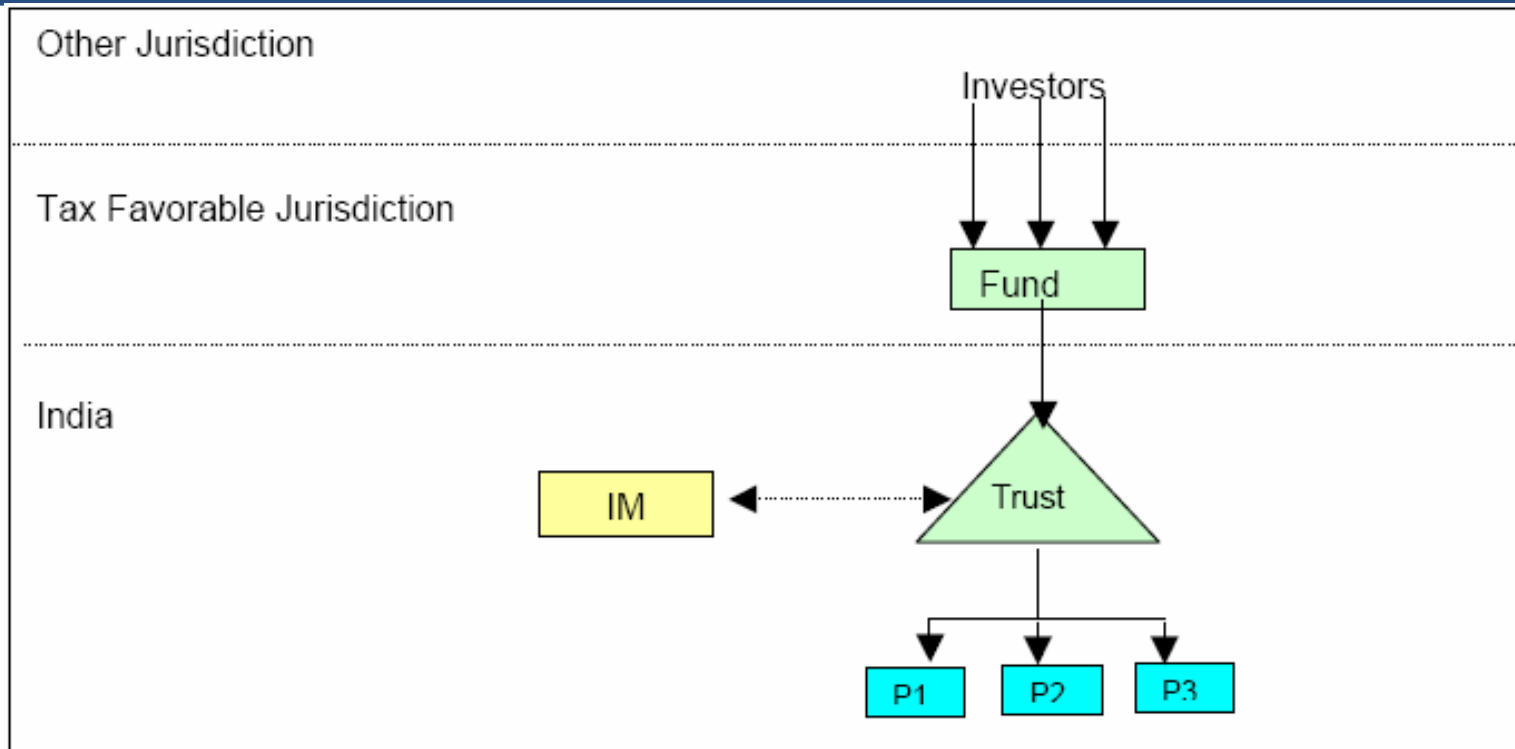


Offshore Structure is commonly used for financial investment



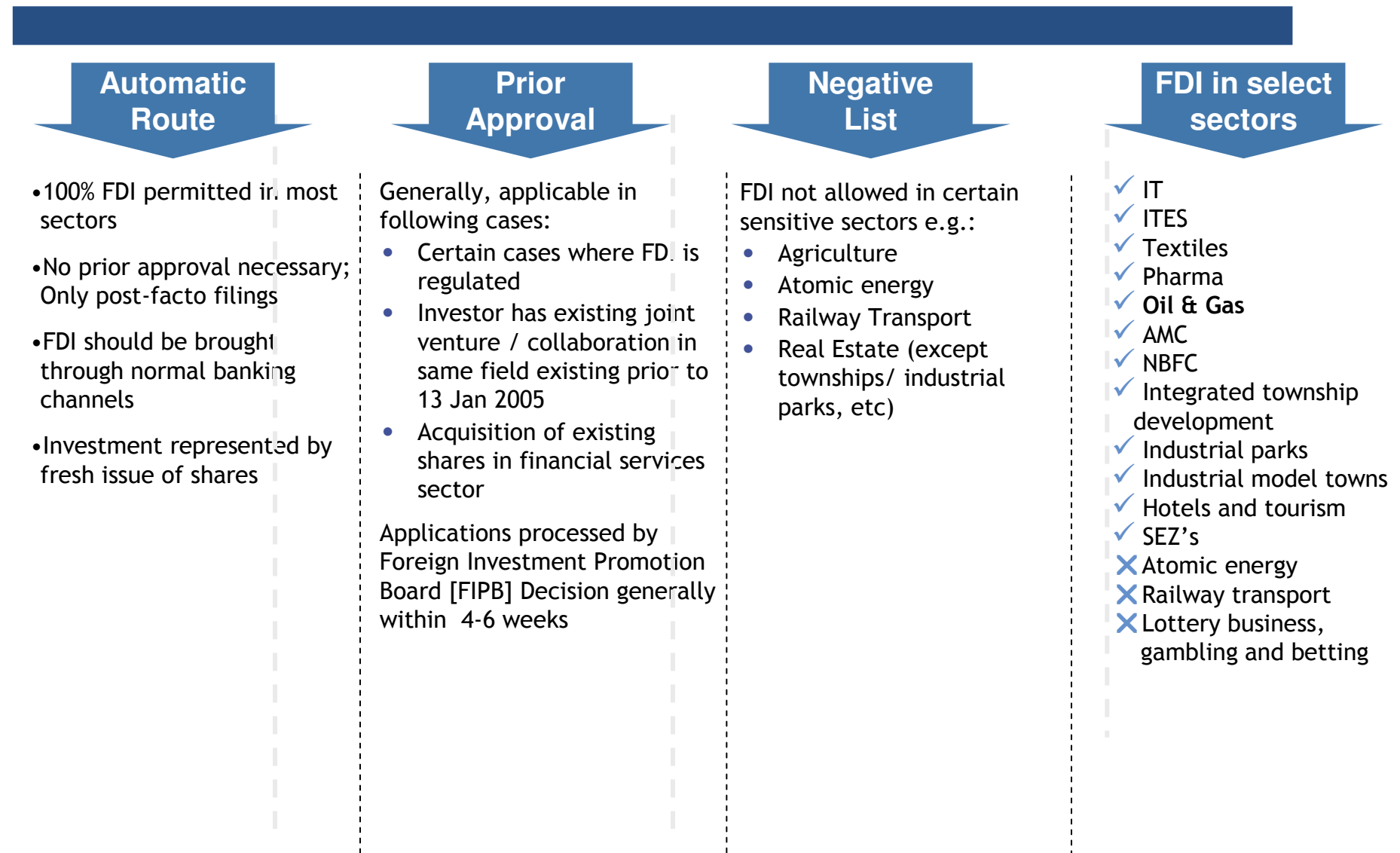
Under this structure an investment vehicle (“Fund”), which could be an ordinary company, an LLC or an LP organized in a tax favorable jurisdiction outside India will pool investments from investors. The Fund will then make investments directly into Indian portfolio companies. There would generally be an offshore investment manager (“IM”) for managing the assets of the fund and an investment advisor (“IAA”) in India for identifying deals and to carry out preliminary due-diligence on prospective investment opportunities.

Unified Structure is used for financial investments if domestic investors are also expected to participate



This structure is generally used where domestic (i.e., Indian) investors are expected to participate in the fund. Under this structure, a trust or a company is organized in India. The domestic investors would directly contribute to the trust whereas overseas investors pool their investments in an offshore vehicle and this offshore vehicle invests in the domestic trust.

Strategic Investors seeking India presence commonly use the automatic route



In order for a foreign investment to be eligible for the automatic route, certain conditions must be met

- The investment should be by way of subscription of a fresh issue of shares and not by way of purchase of existing shares from existing shareholders of the company.
- The investment should be within the sectoral equity caps prescribed, where applicable.
- The investment should not be in sectors where industrial license is required to be obtained or where foreign investment has been expressly prohibited.
- FDI Regulations prescribe a minimum price for foreign investment which is arrived at on the basis of a prescribed formula, unless made by Foreign Venture Capital Investors registered with SEBI
- With the exception of the IT sector, in all other sectors, the foreign investor cannot avail of the automatic route if such investor already has a previous venture or tie-up in the same field in India. However, this requirement applies essentially to strategic business investors and not to financial investors who may hold other portfolio investments in Indian companies.

Strategic Investment structuring - Form of Indian Entity

Liaison Office

- LO is not permitted to generate any income on its own account and the parent must reimburse the LO for costs it incurs for its operations.

Branch Office

- Activities of the branch are restricted to the permitted activities, which include the exportation/importation of goods; the rendering of professional or consultancy services; and the rendering of services in information technology and software development in India.

Subsidiary

- The wholly-owned subsidiary in India presents certain advantages over a branch office, such as greater flexibility with respect to the activities that can be carried out in India by the WOS.

Joint Ventures

- Investments on a repatriation basis by foreign residents, NRIs, and PIOs would require the FIPB's prior approval. India currently does not permit the formation of Limited Partnerships ("LPs").

Due to Tax consideration, Mauritius has emerged as the most favorable jurisdiction for investing into India

- Mauritius has emerged as the most favorable jurisdiction for investing into India because of the favorable Tax Treaty that India has entered into with Mauritius and has in fact become one of the largest investors into India.
- Under the Tax Treaty, any capital gains earned by a Mauritius entity on shares held in an Indian company are exempt from tax in India.

Tax rates in India

Category	Status	Capital Gains			
		Long Term#		Short Term	
		Listed	Unlisted	Listed	Unlisted
Corporate	Resident	0*/10%**	20%	10%	30%
	Non-Resident	0*/10%**	20%	10%	40%

Long-term means where securities have been held for more than 12 months.

* Provided the transaction takes place on the stock exchange and the Securities Transaction Tax ("STT") has been paid.

**For transactions outside the stock exchange.

The above rates are exclusive of the currently applicable surcharge of 2.5% on the tax and an education cess of 2% on the tax as well as the surcharge. In case of a domestic company the surcharge applicable is 10%.

Considerations in determining deal structure

- **Ease of exit** including any currency exchange restrictions, the impact of Sarbanes-Oxley in the U.S. and overseas company listing requirements in India;
- **Relative valuations** in the U.S. and India capital markets for the type of investment, particularly a services business;
- **Ease of acquisition** by the likely set of acquirers as an exit strategy;
- Investor “comfort” with the limitations on **preference shares** under the India Companies Act of 1956, as amended (the “*Companies Act*”); and
- Location of “**market pull**” for the investee company.

Common Deal Structures

■ Mergers & Acquisitions

- Inbound (US company acquiring an Indian company)
 - Cash, Cash & Stock, Earnouts
- Outbound (Indian company acquiring companies overseas)
 - Mostly cash / Adjustments / earn-outs
- Within the Country
 - Cash, Cash + Stock, Stock, earnouts

■ Private Equity / Venture Capital

- Stock
- Convertible Preferred
- Convertible Debenture
- Warrants

Deal Structure Parameters

- ✓ Type of security
- ✓ Liquidation preference, conversion, automatic conversion redemption
- ✓ Voting rights, board/observer rights
- ✓ Change-of-control, transfer-of-control clauses
- ✓ Ownership, capitalization table
- ✓ Position in Capital Structure
- ✓ Ability to Stage Commitments
- ✓ Restriction on asset sales
- ✓ Anti-dilution protection
- ✓ Right of first offer/refusal

Structuring Instruments

Some of the usual reasons in an Indian context why a foreign investor would prefer an instrument other than equity shares are outlined below.

- The investor may wish to get a preference on dividend or liquidation or both.
- Prevailing Indian exchange control laws do not permit foreign equity investment beyond a certain level in certain sectors.
- The investor may wish to get disproportionate voting rights on its investment in return for the strategic value such investor may bring to the table.
- Indian corporate and securities laws may place certain restrictions with respect to equity shares which may not suit the commercial understanding between the parties.
- The investor may seek liquidity in overseas markets and the maximum flexibility in terms of exit options.

Structuring Instruments Denominated in Indian Rupees

Convertible Preference Shares

A convertible preference share is a preference share that is converted to equity shares based on a specified conversion ratio upon maturity. Till the time of conversion, the shareholder would continue to receive dividends at a specified rate.

Convertible Debentures

Debentures are basically debt instruments. In the case of a convertible debenture, the debenture holder would receive interest from the company till the maturity date, after which the debentures would be converted into equity shares ranking on par with the other equity shares of the company.

Warrants

A warrant is basically a right to subscribe to equity shares at a later stage. Warrants that have been issued and are outstanding are not counted for the purposes of reckoning sectoral investment caps. It is for this reason that warrants are often used as stopgap instruments by foreign investors to ensure that they do not exceed the sectoral caps, but at the same time retaining the right to acquire the shares underlying the warrants within a specified timeframe, in case the sectoral caps are enhanced.

Structuring Instruments Denominated in Foreign Currency

The reason a foreign investor would wish to receive an instrument denominated in foreign currency is to get liquidity in an international market.

ADRs/GDRs -

They are treated as foreign securities issued by an Indian company and these instruments are founded on underlying equity shares. The underlying shares are denominated in Indian Rupees while the ADRs and GDRs are usually denominated in dollars. Foreign investors in Indian companies who seek to have their investment evidenced by a dollar denominated instrument can therefore, seek to have ADRs/GDRs issued to them by the company by way of a private placement.

FCCBs

These are basically considered as external commercial borrowings of the Indian company. They provide for an interest return to the investor for a specified maturity period at the end of which they can be converted into equity shares of the issuing company.

Sample Deal Structures - Financial Investments

Hexaware Technologies Ltd. - Issued 10.57 million common shares at INR 142 for gross proceeds of INR 1,500 million and 1.10 million convertible preference shares at INR 1364 for gross proceeds of 1,500 million. The preference shares carry a coupon rate of 2.95% for the first 18 months and in case if the conversion option is not exercised the shares shall carry a coupon rate of 5% thereafter.

Apar Industries Limited - a private placement of 3,445,978 **Cumulative Compulsorily Convertible Preference Shares** at a price of INR 185 (\$4.23) per share for gross proceeds of INR 637.51 million (\$14.57 million) on September 6, 2005. ARIA Investment Partners II, LP, a private equity fund managed by CLSA Private Equity Limited subscribed to the shares. The shares bear interest at a rate of 5.40%. Each of the said preference shares shall be compulsorily converted into one equity share within one year from the date of allotment.

Hindustan Sanitaryware & Industries Ltd. - Issued 3.3 million fully convertible debentures to Henderson Private Capital on June 8, 2005. The debentures were valued at INR 160.25 each for gross proceeds of INR 528.83 million and carry a coupon rate of 4% per annum. The debentures were offered on a preferential allotment basis would be convertible into one equity share of INR 5 each for each debenture held at a premium of INR 155.25 per equity share anytime within 18 months from the date of issue.

Glenmark Pharmaceuticals Ltd. - Secured \$10 million in convertible debt funding from CDC Capital Partners. The conversion price was fixed in the band of Rs. 270 to Rs. 350 (\$5.53 to \$7.16) a share, depending on the net profit of the company in the YE March 31, 2003.

Sample Deal Structures - Acquisitions

Enucleus, Inc. (OTC: ENUI.OB) acquired Applitech Solution Limited on May 16, 2005 for a reported value of \$2.8 million. Under the agreement, Enucleus purchased customer contracts, accounts receivables, and software for total consideration of **1 million shares of Enucleus common stock, 350,000 five-year warrants at a strike price of \$0.40, plus a deferred cash payment that will be equal to one half of the net earnings of those assets in 2005 to a maximum of \$2.5 million.**

eFunds International India Private Limited, a subsidiary of eFunds Corporation (NYSE: EFD) signed an agreement on March 31, 2005, to acquire India Switch Company Private Limited from HMA Group for approximately for \$23.1 million. The payment includes an **initial cash payment of approximately \$17.5 million, subject to working capital adjustments and holdback arrangements; along with approximately \$2.5 million may be paid after one year subject to certain milestones and an assumption of outstanding debt of approximately \$3.1 million.**

Kanbay International, Inc. (NASDAQ:KBAY) acquired Accurum, Inc. for approximately, \$12 million. The purchase price consists of a \$5 million **closing payment, subject to certain adjustments, plus contingent payments of up to \$7 million, payable upon the achievement of certain performance targets.**

Exit Options

IPO in India -

It must be noted however that all pre-IPO share capital of a company would be locked-in for a period of one year after the completion of the IPO. An exception has been carved out in this regard for VCFs registered with the SEBI. Therefore, offshore funds, which are registered with the SEBI as FVCIs would be entitled to this exception and can divest their holdings immediately after an IPO.

ADR/GDR Listing -

The investor could also, if it held its investment in the form of ADRs/GDRs as explained earlier, exit at the time of an ADR/GDR issue by the company in an overseas market. Alternatively, even if the investor held its investment in the company in the form of equity shares, it could exit by way of a sponsored ADR/GDR program once the company gets listed. This would provide the investor the opportunity to exit in an overseas market at the time of an ADR/GDR issue by the company.

Exit through Strategic Sale

Strategic Sale -

If the transferee is an Indian resident, then as per the FDI Regulations notified by the RBI, if the investee company is listed at the time of exit, then the investor cannot exit at a price that is higher than the prevailing market price of the shares. In case the Indian company is unlisted at the time of such exit through a strategic sale, then the exit price will have to be as determined by a chartered accountant or an investment banker registered with SEBI. However, the RBI has carved out a specific exemption from this exit pricing restriction for FVCIs registered with SEBI. Further, if the strategic buyer happens to be another non-resident party, then again, the exit pricing restrictions of the RBI will not be applicable.

1. Introduction

2. Transaction Structures

3. Strategic Considerations

4. Valuation Basics

5. Due Diligence

6. Competing and Creating Value

For Financial Investors, there are significant advantages to register as a Foreign Venture Capital Investor (FVCI)

- It is *not* mandatory for an offshore fund to register with SEBI as a foreign venture capital investor (“FVCI”). However there are significant advantages to doing so.
- Government of India has exempted FVCIs from taking prior Governmental approval even if the FVCI seeks to invest in the same field as the one in which it already has an investment.
- As per a notification issued by the RBI in December 2000, FVCIs shall benefit from free entry and exit pricing
 - Thus investments or exits by FVCI involving transfer of shares between residents and non-residents will not be subjected to the restrictive pricing guidelines of the RBI otherwise applicable to foreign investors under the foreign direct investment route.
 - For purchase of shares of an unlisted company, the minimum price to be paid by the non-resident investor is linked to the net asset value (“NAV”) of the shares. Similarly, for exits involving transfer from a non-resident to a resident, the exit price is capped at the price of the shares on the stock exchange (if the shares are listed) or to the NAV if the shares are unlisted. A special exemption has been carved out for FVCIs

For Financial Investors, there are significant advantages to register as a Foreign Venture Capital Investor (FVCI)

- SEBI has also exempted transfer of shares from FVCIs to the promoters from the public offer provisions under the Takeover Code, if the portfolio company gets listed post investment. FVCIs registered with SEBI have been accorded Qualified Institutional Buyer ("QIB") status and would accordingly be eligible for subscribe to securities at the Initial Public Offering ("IPO") of a VCU through the book-building route.
- Under the SEBI Guidelines, the entire pre-issue share capital of a company going in for an IPO is locked for a period of one-year from the date of allotment in the public issue. However, an exemption has been granted to domestic venture capital funds registered with SEBI and FVCIs. This would essentially allow the FVCI to exit from their investments post-listing..
- A private equity investor generally reserves certain veto rights in the company and in most cases is actively involved in the IPO decision by the company. If the private equity is not registered as a FVCI, there is a possibility that the private equity investor be treated as a part of the promoter group thereby subjecting it to certain onerous requirements otherwise applicable to promoters. The SEBI has clarified that a SEBI registered venture capital fund or a FVCI would generally not be treated as promoters for the purpose of the above guidelines.

Eligibility Criteria for FVCI

In order to determine the eligibility of an applicant, SEBI would consider

- a. The applicant's track record;
- b. Professional competence;
- c. Financial soundness;
- d. Experience
- e. Whether the applicant is regulated by an appropriate foreign regulatory authority or is an income tax payer, or
- f. submits a certificate from its banker of its or its promoter's track record where the applicant is neither a regulated entity nor an income tax payer.

The applicant can be a pension fund, mutual fund, investment trust, investment company, investment partnership, asset management company, endowment fund, university fund, charitable institution or any other investment vehicle incorporated and established outside India.

Investment Condition and Restriction for FVCI

All investments to be made by a FVCI would be subject to the following conditions:

- FVCI is permitted to invest its entire corpus in a domestic SEBI VCF.
- At least two-thirds of the FVCI's investible funds shall be invested in unlisted equity shares or equity linked instruments of a venture capital undertaking. Further, FVCIs can invest upto 33.33% by way of:
 - Subscription to IPO of a Venture Capital Undertaking (“VCU”) whose shares are proposed to be listed;
 - Debt or debt instrument of a venture capital undertaking in which the FVCI has already made an investment by way of equity;
 - Preferential allotment of equity shares of a listed company, subject to a lock-in period of one year; and
 - The equity shares or equity linked instruments of a financially weak company

Acquiring Shares or Assets of Indian Company

The acquisition of the business of an Indian Company can be accomplished in one of the following ways:

- Sale of Shares
- Sale of Assets
 - Sale of an entire business for a lump-sum consideration.
 - Sale of individual assets of a business.

Regulatory Approvals

Following recent liberalization, transactions, entailing the transfer of existing shares in an Indian company between the residents and non-residents generally fall under the automatic route (i.e. no prior regulatory approval, but prescribed documents must be filed with the relevant Authorised Dealer/Banker). The transfer price needs to fall in line with the valuation methodology prescribed under foreign exchange regulations

The transfer of shares from a non-resident to another non-resident would also generally not require any prior regulatory approval, except in cases where the transferee non-resident has a previous joint venture (financial/technical) or tie up in India as stipulated.

Acquiring Shares or Assets of Indian Company

Sale of Assets: 'Slump Sale'

The sale of a business undertaking is on a slump-sale basis when the entire business is transferred as a going concern for a lump-sum consideration. 'Cherry picking' assets would not be possible under this kind of transaction. The implications for this type of transaction are described below.

Income Tax Implications

Where the business of the transferred company is more than 36 months old, the business would be treated as a long-term capital asset and the gains from its transfer would be taxed at a rate of 20 percent (plus applicable surcharge and education cess). Otherwise, the gains would be subject to tax at 33.66 percent in the case of a domestic company and at 41.82 percent in the case of a foreign company.

On a slump sale, the purchaser records the assets acquired into its books by allocating the purchase consideration on the basis of fair values of assets acquired and claims depreciation thereon, wherever applicable. Part of the consideration could also be attributed to eligible intangible assets based on their fair values (as discussed in 'Sale of Assets: Itemized Sale' below) and depreciation should be available on the stepped-up value of these assets, if supported by a valuation report from an independent adviser.

Transfer Taxes

The transfer of assets by way of a slump sale would attract stamp duty. The rates of stamp duty would generally range between five per cent and 10 per cent.

Acquiring Shares or Assets of Indian Company

Amalgamation

In India, one of the most popular and tax-efficient means of corporate consolidation is amalgamation. Amalgamation enjoys favorable treatment under income tax and other laws, subject to fulfillment of stipulated conditions under the respective laws.

Exchange Control Regulations

In India, capital account transactions are still not fully liberalized. Hence, certain foreign investments required the approval of the Government of India. A court-approved merger is specifically exempted from obtaining any such approvals if, post-merger, the stake of the foreign company does not exceed the prescribed sectoral cap.

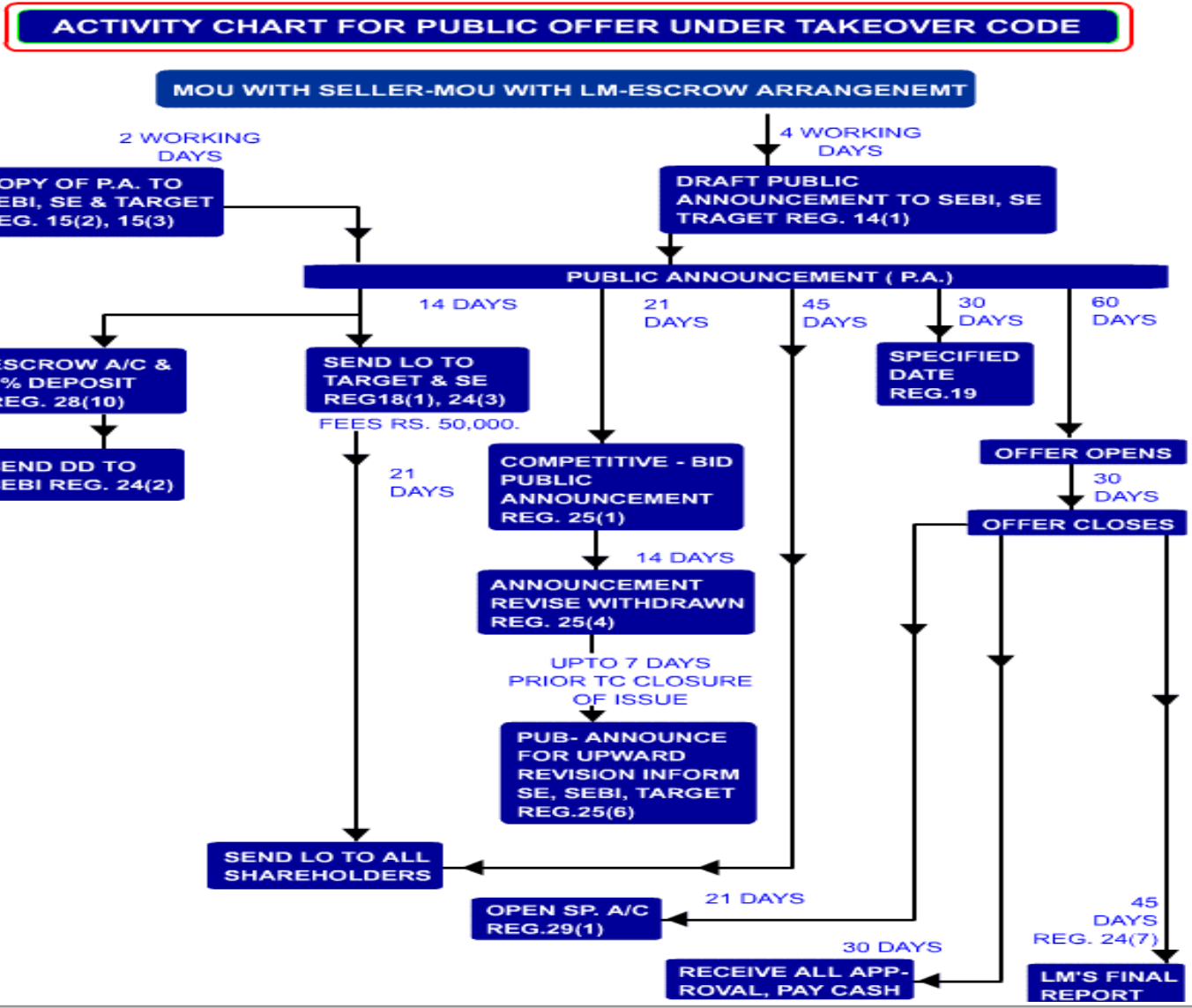
Takeover Code Regulations

The acquisition of shares in a listed company beyond a specific percentage triggers implications under the regulations of India's Stock market regulator, the Securities and Exchange Board of India (SEBI). However, a court-approved merger is specifically excluded from the application of these regulations.

Thus, a court-approved merger is the most tax-efficient means of corporate consolidation or acquisition, subject to following considerations:

- More procedural formalities and a longer time frame of four to six months.
- Both the parties must be corporate entities in India.

Steps in Public Offer



Exit Consideration

Exit consideration

Capital gains

No objection certificate required for new ventures - No objection certificate from Indian Partner has been a key negotiation point for Foreign Company having existing JV relationship in India. NOC has been made in-applicable for new ventures by foreign company.

Shareholders agreement and implications thereof - right a first refusal, tag along rights and drag along rights

liquidation process - long drawn and court approval process

Cash Repatriation

Capital and income arising from foreign investment in India can be freely repatriated (except for cases where the investment is made on non-repatriation basis), subject to provision of a no-objection certificate from the Indian revenue authorities or a certificate from a chartered accountant confirming that taxes payable, if any, are deposited into the Indian government treasury.

Anti Dilution Mechanisms

In most cases, particularly in private equity investments, the investor seeks to ensure a downside protection against dilution by way of a ratchet mechanism. The basic principle on which the ratchet mechanism operates is that whenever the company issues additional shares to a third party at a price that is lower than the investor's entry price, then such investor would get issued such number of additional shares at no cost to ensure anti-dilution of the investor at no additional cost. While this is a fairly accepted term in virtually all private equity investments, Indian law poses certain practical difficulties in giving effect to this kind of a ratchet mechanism.

Indian company law requires that no shares can be issued by a company at a discount to par value¹². Therefore, it is not possible to issue shares at no cost to any shareholder as envisaged in the ratchet mechanism. One has to find indirect, and often complicated means of funding the ratchet.

1. Introduction

2. Transaction Structures

3. Strategic Considerations

4. Valuation Basics

5. Due Diligence

6. Competing and Creating Value

Valuation

- Pricing of the shares would have to be per the guidelines issued by the Reserve Bank of India, the central banking and monetary authority in India.
- For listed Ventures the pricing should be as per the SEBI guidelines for preferential allotment which specifies that the price should be higher of the following:
 - Average of past 26 weeks weekly high and low
 - Average of the past 2 weeks high and low
- For Unlisted Companies the pricing / valuation has to be as per the erstwhile CCI guidelines which should be duly certified by a SEBI registered merchant banker
- The CCI method operates on the following methods:
 - NAV Method
 - Earnings Capitalization method
- The fair value is derived on the basis of the average of the NAV method and Earnings Capitalization methods. As per RBI the consideration paid should be higher of the average price.

Sample Valuation for Indian Transactions

Date	Target/Issuer	Transaction Type	Transaction Value (\$mm)	% Stake	Revenue X	EBITDA X	Buyers/Investors
04/21/2006	Geometric Software Soln.Co. Ltd.	PP	10.09	6.38%	3.4	11.94	ICICI Venture Funds Management Company Limited
04/03/2006	MphasiS BFL Ltd.	M&A	382.69	51.72%	3.5	16.6	Electronic Data Systems Corp.
03/15/2006	KPIT Cummins Infosystems Ltd.	PP	2.5	2.90%	1.4	n.a	International Finance Corporation
03/09/2006	Tata Teleservices (Maharashtra) Ltd.	M&A	269.76	8.00%	14.9	304.33	Sterling Group of Cos / Temasek Holdings
01/28/2006	Gujarat Ambuja Cements Ltd.	M&A	476.95	14.80%	4.5	14.83	Holcim Ltd. (VIRTX:HOLN)
12/26/2005	Suryalakshmi Cotton Mills Ltd.	PP	7.76	10.70%	1.3	4.89	UTI Venture Funds
11/30/2005	Centurion Bank of Punjab Ltd	PP	84.0	13.40%	11.0	n.a	ChrysCapital, Citigroup Venture Capital International, India Value Fund Advisors Private Limited
10/28/2005	Bharti Airtel Ltd.	M&A	831.53	4.40%	8.7	n.a	Vodafone Group plc (LSE:VOD)
10/26/2005	Micro Inks Ltd.	M&A	74.45	20.00%	1.7	n.a	Michael Huber Munchen GmbH
10/25/2005	Micro Inks Ltd.	M&A	188.53	50.50%	1.7	n.a	Michael Huber Munchen GmbH
09/06/2005	Jubilant Organosys Ltd.	PP	24.9	3.57%	2.6	14.78	General Atlantic LLC
08/16/2005	VisualSoft Technologies Ltd.	M&A	8.18	14.00%	1.3	n.a	SAIF II Mauritius Co. Ltd.
08/02/2005	i-flex Solutions Ltd.	M&A	592.85	41.00%	5.1	21.95	Oracle Corp. (NasdaqNM:ORCL)
08/02/2005	i-flex Solutions Ltd.	M&A	315.83	20.00%	5.6	23.97	Oracle Corp. (NasdaqNM:ORCL)
06/22/2005	HDFC	M&A	233.39	4.90%	12.0	n.a	-
03/14/2005	Bharti Airtel Ltd.	M&A	559.44	6.00%	5.6	15.06	Capital International, Inc., Fidelity Investments
02/21/2005	KPIT Cummins Infosystems Ltd.	M&A	7.98	8.50%	1.8	n.a	Lehman Brothers Holdings Inc.
02/15/2005	Hindustan Oil Exploration Co. Ltd.	M&A	24.99	20.00%	11.1	12.82	Burren Energy India Ltd.
02/14/2005	CRISIL Ltd.	M&A	55.38	65.57%	3.1	5.47	Standard & Poor's

Sample Valuation for Indian Transactions

Date	Target/Issuer	Transaction Type	Transaction Value (\$mm)	% Stake	Revenue X	EBITDA X	Buyers/Investors
01/20/2005	Associated Cement Companies Ltd.	M&A	314.86	36.21%	0.9	5.21	Ambuja Cement India Ltd.
11/29/2004	Kotak Mahindra Finance Ltd.	PP	16.9	2.75%	2.6	n.a	Warburg Pincus LLC
11/10/2004	Jubilant Organosys Ltd.	PP	51.28	9.70%	1.7	11.27	Citigroup Venture Capital, Ltd., Henderson Asia Pacific Equity Partners I, L.P., Henderson Private Capital
11/08/2004	Blue Dart Express Ltd.	M&A	125.88	68.21%	2.1	7.34	DHL Express (Singapore) Pte. Ltd.
10/14/2004	It'd Cementation India Ltd.	M&A	17.8	100.00%	0.1	n.a.	Italian-Thai Development Public Co. Ltd. (SET:ITD)
08/13/2004	Bharti Airtel Ltd. (BSE:BHARTI)	M&A	207.7	3.33%	5.1	14.87	California Public Employees' Retirement System
06/08/2004	Flextronics Software Systems Ltd.	M&A	226.43	55.00%	4.9	17.69	Flextronics International Ltd. (NasdaqNM:FLEX)
05/25/2004	Max India Ltd.	PP	45.66	29.00%	1.3	n.a	Warburg Pincus LLC
04/03/2004	IVRCL Infrastructures & Projects Ltd.	PP	17.8	37.00%	0.3	3.15	ChrysCapital, ChrysCapital II, L.P., Citigroup Venture Capital, Ltd.
04/03/2004	Welspun India Ltd.	PP	17.24	14.50%	1.4	6.85	ICICI India Advantage Fund, ICICI Venture Funds Management Company Limited
04/02/2004	Avaya GlobalConnect Ltd.	M&A	18.0	25.10%	0.8	4.77	Avaya Inc. (NYSE:AV)
04/01/2004	e-Serve International Ltd	M&A	125.4	55.62%	3.0	11.68	Citigroup Inc. (NYSE:C)
12/02/2003	UTI Bank	M&A	67.6	14.71%	3.0	n.a	Hsbc Asia Holdings (UK)
07/25/2003	Punjab Tractors Ltd.	M&A	30.72	23.50%	1.2	n.a	CDC Group plc
06/20/2002	ING Vysya Bank Ltd.	M&A	71.67	24.00%	3.8	n.a	ING Groep NV (ENXTAM:INGA)
05/14/2001	Carrier Aircon Ltd.	M&A	24.33	49.00%	0.6	n.a	Carrier Corporation

Sample Valuation for Indian BPO Transactions

Indian Transaction Multiples		
<i>In USD millions except multiples</i>		
	Val. (MC)	Multiples (1 Year Forward)
GECIS/PE Funds	833	Approx 2.00
IBM / Daksh	155	2.8 (Current)
Wipro / Spectramind	120	3.0
AVB / Transworks	13	1.0
ICICI OneSource / FirstRing	15	1.0
ICICI OneSource / Customer Asset	20	1.3
Warburg / WNS	42	1.2
Perot Systems / Vision Healthsource	9	3.0 (Current)
	Avg.	1.8

Valuation Notes - Indian ITES Companies

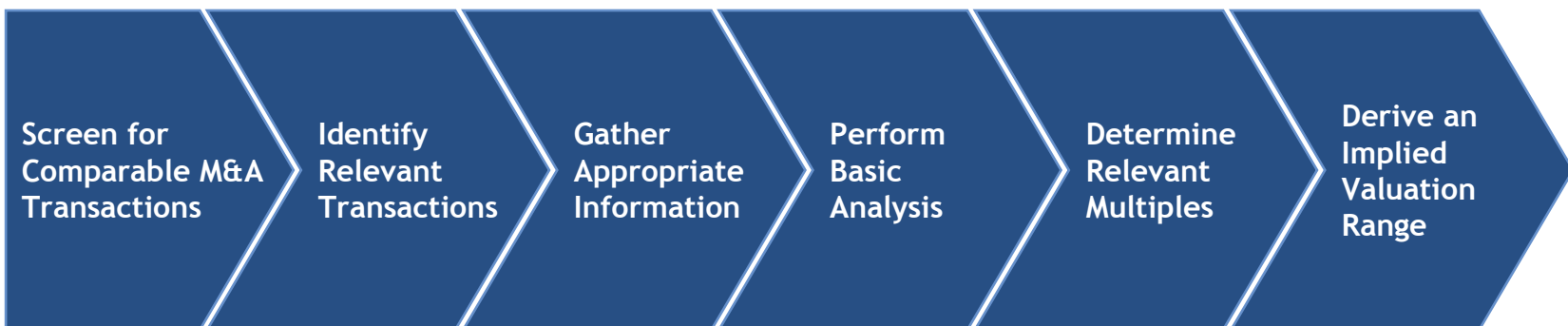
- Very high valuations for first few pure play ITES companies making an Initial Public Offer
- Maturity in valuations and stability in business to reduce valuation
- Mean valuation estimates of all ITES companies over the next few years would be as follows
 - Revenue multiple of 1.40 to 1.50 times of projected 12 months revenues
 - EBIDTA multiple of 7 - 8 times projected EBIDTA
 - PE multiple of 10 - 12
- Market to also differentiate amongst the various players - Tier I, Tier II and Tier III based on variety of factors
 - Valuations of Tier I companies normally exceeds the mean or median valuations in any industry by atleast 30%

Valuation Basics and Beyond

Comparable Company Analysis Methodology Steps



Comparable Acquisition Analysis Methodology Steps



1. Introduction

2. Transaction Structures

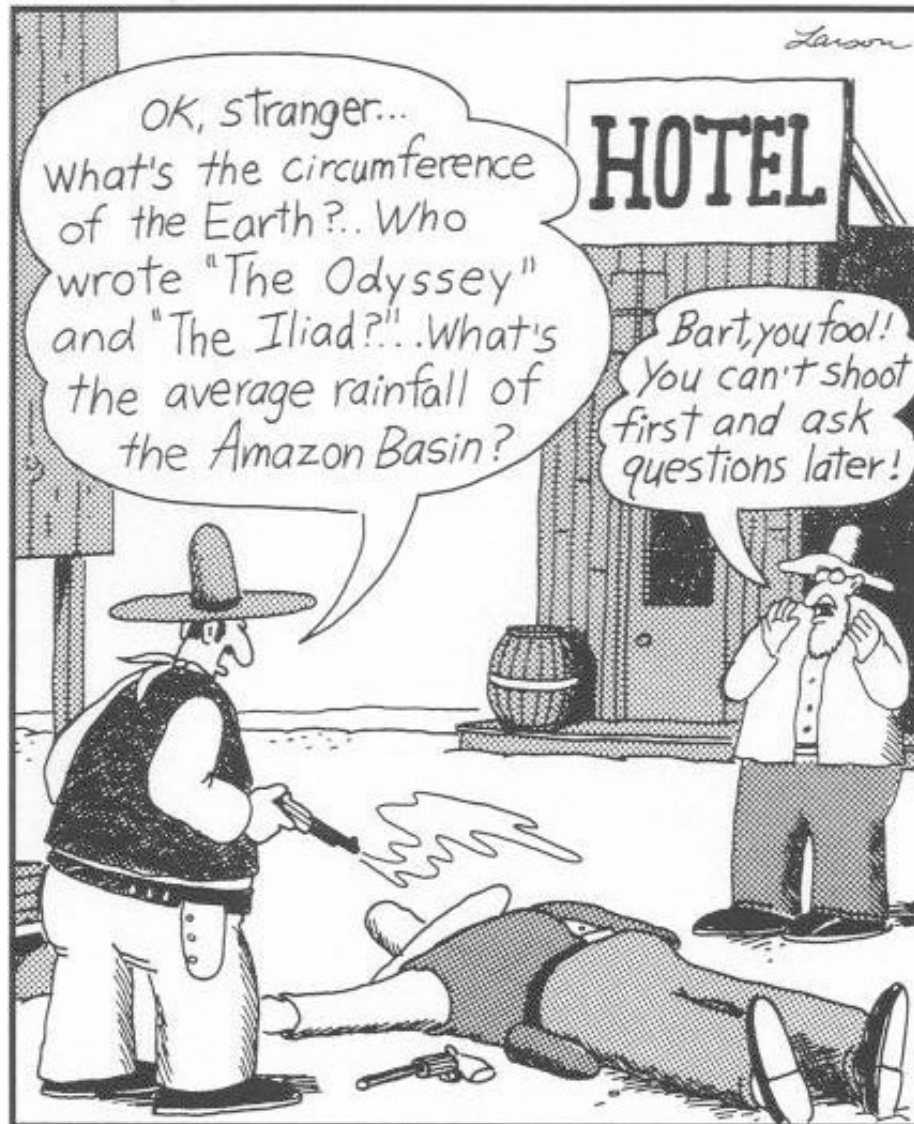
3. Strategic Considerations

4. Valuation Basics

5. Due Diligence

6. Competing and Creating Value

The Bottom Line



Ten Tips to Successful Due Diligence (Source: E&Y Report: Doing

Successful transactions in India)

1. Know the mindset of the target company

Comprehensive information required for the due diligence process is not readily available with the Indian companies due to lack of detailed management information system. For example, detailed schedule of margins by product and by customer may not be easy to come by with these companies. The forecasting methodologies of such small and medium sized Indian companies are not very robust, often leading to simplistic projections. The forecasts tend to be aggressive, without a track record to boot.

2. Understand key differences in doing a due diligence in the western countries and in India

Going in for a due diligence process with the right expectations is a critical success factor for US investors. The quality of financial statements, financial infrastructure and business and business process will be lower and less explicit than western investors are accustomed to. This results in the need to explore more risk areas and take more time for the due diligence.

Doing Due Diligence US vs India (Source: E&Y Report: Doing Successful

transactions in India)

	Western Countries	India	
		Large Companies with prior M&A experience	Others
1. Transparency in financial information	High	Medium	Low to Medium
2. Normal duration of due diligence	1-8 weeks	1-8 weeks	3-12 weeks
3. Assistance required by target company to prepare for due diligence	Minimal	Minimal	Generally require assistance
4. Basis of financial information	US GAAP and IFRS	Generally Indian GAAP, some companies prepare as per US GAAP or IFRS	Indian GAAP
5. Audited financial information	By reputable standards	By reputable standards	May not be very reliable
6. Extent of related party transaction	Varies; typically fully disclosed	Usually extensive; fully disclosed	Usually extensive; may not be fully disclosed
7. Disclosure of contingent liabilities	Usually transparent	Generally adequate disclosures	Inadequate disclosures
8. Reliance on computerized systems	Typical	Typical	Evolving; dependence on manual process
9. Reliability on representations and warranties	Normally reliable	Untested	Untested
10. Enforceability of indemnification	Strongly; backed by courts	Untested: may need to consider "holdbacks" or "escrows"	Untested: may need to consider "holdbacks" or "escrows"

Ten Tips to Successful Due Diligence (Source: E&Y Report: Doing

Successful transactions in India)

3. Listen for the word “NO”:

Asian culture is less direct in some respects. Western investors rarely hear their Indian counterparts say “no” even though they do not mean “yes”.

4. Look out for Hidden Skeletons:

Inadequate disclosures impede the ability to access critical information that might alter the investor's perception with regard to the value of the company, environment issues and aggressive tax positions among others.

5. Evaluate Corporate Governance:

Companies are slowly realizing the importance of corporate governance and some of the leading organizations are benchmarking to global standards. Some others are moving towards improvement.

6. Keep an Eye on Related Party Transactions:

As a hangover of the licensing raj, Indian businesses are generally structured as conglomerates or group businesses which create extensive related party transactions.

Ten Tips to Successful Due Diligence (Source: E&Y Report: Doing

Successful transactions in India)

7. Avoid Legal Minefields

Weak corporate governance is compounded with tardy legal systems where dispute resolution often remains a distant goal..

8. Communicate with Care

In any transaction, communication must be handled with utmost care. Sensitivity to Indian culture with regard to dealing with the owners who are also the entrepreneurs of the company will help to make the venture more rewarding.

9. Manage the Control Freaks

It is often observed that founding members of a start-up will refuse to give up control and settle for a minority ownership stake (a common condition for many start-ups in exchange for Private Equity funding).

10, Think Global, Act Local

Firms with a presence in India have a distinct edge due to their wide networks of contacts and experience of the Indian business environment.

Challenges

Preferred Shares: The notion of Preferred shares is not acceptable according to Indian law. However, many law firms have agreed upon the OCCPS (Optionally Convertible Cumulative Preference Shares) as a structure that provides an investor with many of the same benefits of Preferred shares while adhering to Indian law.

Exit limitations: The Indian stock market is quite active, many would even say too active. That is, it is fairly “easy” to go public, but it’s quite hard to get analyst coverage and remain a valid public company with significant trading volume. One advantage is the ability to create an ADR (Alternative Depository Record), which is an instrument that can be easily traded on a US stock exchange.

Currency hedging: An additional level of complexity when making direct investments into India that is not encountered in US based deals is the fluctuation of the Indian Rupee. Most VC investors are not used to, nor have extensive knowledge of and experience in currency hedging and protection.

Accounting: As in any non-GAAP based economy, it is hard to make an investment without a deep understanding of the local accounting standards. However, one advantage of the Indian market is that many management team members have worked in the US or for US companies, and hence have a good understanding of GAAP accounting rules.

Drill Down Due Diligence (Source: E&Y Report: Doing Successful transactions

in India)

Possible Tasks	Objectives
Phase I	
1. Review audit workpapers	Identify risk areas which need special attention
2. Raise asset/liability questions	Validate book value of assets/liabilities and assess the impact on future earnings
3. Analyse income statement fluctuation	Understand the seasonality of the business, assess quality of earnings etc
4. Identify potential pro forma adjustments	Ensure that historical profitability of the acquired business is truly reflected
5. Assess stand alone matters	Evaluate standalone costs incase of carve-outs.
6. Identify contingent liabilities	Determine impact on valuation and identify areas for detailed due diligence
Phase II	
1. Evaluate profitability by product/ segment/ geography	Develop in-depth understanding of the business, assess the quality of earnings
2. Analyse correlation between price and volume	Same as above
3. Identify key cost drivers and expense variability	Same as above
4. Review capital expenditure history	Determine impact on valuation
5. Analyse working capital sensitivity and seasonality	Determine impact on valuation and buyers financing needs
6. Analyse projections versus history	Assess the practicability of the projections for profitability, working capital and capex. Determine impact on valuation.
7. Evaluate the human resources and benefits issues	Determine impact on valuation
8. Quantify pro-forma EBITDA	Same as above
9. Discuss findings with target and Finalize Due Diligence report	Present the factual analysis to the target to ensure that facts are correct, and no facts are missed out.
	Summarize key findings and observations, raise alerts, if any, to facilitate investment decision
10. Develop CPs, CSs, Reps, warranties and indemnities for purchase agreement from a financial perspective	Minimizing the investment risk

1. Introduction

2. Transaction Structures

3. Strategic Considerations

4. Valuation Basics

5. Due Diligence

6. Competing and Creating Value

Competing and Creating Value

According to McKinsey, “the main source of value in private equity deals is company outperformance.”

Outperformance is the direct result of operational excellence, which comes many factors including:

- Active Management by Investors
- Solid Strategic Planning
- Continuous Improvement Programs
- Managerial Changes
- Turnaround Management
- Monitoring of Metrics to Assess Performance

Assess Potential Upside

- Develop action plan during due diligence
- Determine what strategic and operational changes are required

Make Operational Changes

- Develop new products
- Expand distribution or sales force
- Management changes
- Productivity gains
- Cost reductions
- M&A/Dispositions

Preserve Value Along the Way

- Make sure core business is solid
- Stable market position
- Generate Cash Flow

Competing and Creating Value

Private Equity Firms Must:

- Take a pro-active approach to deal sourcing
 - Develop investment themes
 - Identify promising industries, markets
 - Consider market trends, as opposed to fads
- Buy smart
- Maintain price discipline
 - Risk/Reward Matters, Value at Exit vs. Entry Price
- Maintain investment discipline
 - Stick with industries they know, focus on a particular type of transaction, avoid the temptation to follow crowds and match post-closing work required with their skill set

Monitoring Investments

- ✓ Assess Performance
- ✓ Keep Management Focused
- ✓ Identify Areas for Improvement
- ✓ Review Monthly Reports, Board Packages
- ✓ Participate in Board Meetings
- ✓ Attend Industry Conferences
- ✓ Discuss Results with Management
- ✓ Talk to Department Heads, Other Managers
- ✓ Scan News Headlines
- ✓ Analyze Industry Studies, Equity Research
- ✓ Check for Fraudulence, Inconsistencies

What are the keys to success?

- ✓ Good Fortune, Timing
- ✓ Deal Flow, Industry Contacts, Perspective
- ✓ Business Judgment
 - ✓ Evaluation and Analysis
 - ✓ Due Diligence, Structuring
 - ✓ Participation, Monitoring, Maintenance
- ✓ Investment Maturity
- ✓ Patience, Humility

About Virtus Global Partners

Virtus Global Partners is a global investment and advisory firm with offices in the US and India. Our primary focus is on US and India based cross border businesses.

We provide a full range of investment banking services including cross border M&A, strategic partnerships, fundraising and general advisory services. Our corporate clients include mid to large size venture-backed enterprises as well as quoted companies.

Our focus sectors include technology and technology enabled businesses, pharmaceuticals, auto ancillary, food processing and industrials.

Virtus Global Partners provides:

- Deep knowledge of US and Indian core industry markets;
- Senior level access to leading industry executives, investors and entrepreneurs, both in US and India;
- In-depth technical and financial skills for value-enhancing deal structuring;
- Refined and responsive transaction process;
- Corporate culture built on teamwork, integrity and professionalism; and
- Relentless focus on maximizing value for our clients.

For more information contact Robin Hughes at rhughes@virtusglobal.com