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Different exit modes for PE/VC – A comparative analysis

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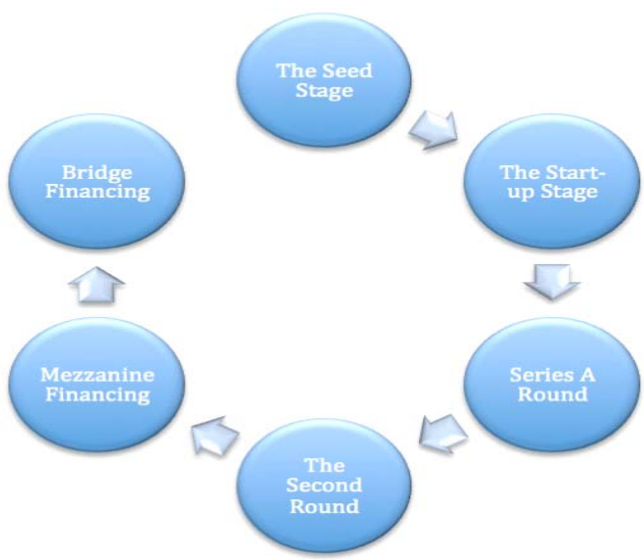
Abstract
One of the emerging and innovative source of finance is the venture capital funding and private equity funding especially for high risk projects of start-ups and existing players. The funding goes through different stages. The return generated varies as per the stages of funding and more so on the exit routes followed. Present paper focuses on the comparative analysis of returns generated through different exit modes used by venture capitalists.

Keywords: High risk projects, venture capital (VC) funding, private equity (PE) funding, stages of funding, exit mode

Introduction
VC/PE players focus on high potential growth small companies, thus expecting exponential growth in returns. Normally, they conduct indepth research on the business plan and try to assess the feasibilty of the project.

Stages of Financing



i) The first stage of venture capital financing is seed stage. In the seed-stage the company is still in the establishment stage of commercial operations and requires funding for further research and product development.
ii) The next is the start-up stage wherein companies just got organized or have been in business for a short time but have not yet sold their product in the marketplace. The funding in this stage is provided for new product development and initial marketing.
iii) Series A and Second Round of funding is provided to initiate commercial manufacturing and sales.

iv) Mezzanine Financing and Bridge Financing is the usually the final stage of funding to enable the VC/PE to exit through various routes.

Different modes of VC/PE Exits are

i. IPO Exit route- One of the popular modes of exit is by floating the shares to public and getting listed on the stock exchange. This is normally preferred when good economic condition prevails.
ii. Mergers & Acquisitions- VC/PE can exit the investment in the unlisted company by selling off the shares to the listed company.
iii. Public Market- Another mode of exit is the selling of the shares to another company operating in the same industry. It provides VC/PE immediate exit from the investment.

Review of Literature

Cefis *et al.* (2012) [7] in the paper "The Effect of Specialization on the Exit Strategy of Private Equity Firms" studied the Private Equity (PE) exit strategies, focusing on two specific PE firm behavior: specialization by industry and by stage. They found that PE firms with higher industry focus are more likely to exit their investments through acquisition, as a deep knowledge of a specific market enables PE firms to mitigate information asymmetries with the buyer. On the other hand, PE firms with higher portfolio diversification are more prone to exit through an IPO.

Cao (2011) [4] in his paper "IPO Timing, Buyout Sponsors' Exit Strategies and Firm Performance of RLBOs" found that LBO duration is negatively related to hot IPO market conditions. He also suggested that the IPO timing does not affect the sponsor's exit strategies and monitoring post IPO.

Alexander and Muelke (2010) [21] said that apart from IPOs, trade and secondary sales (acquisition exits) are of major relevance for private equity companies. They are an attractive exit channel in economic boom times, but due to low investor confidence often an impossible way to divest companies in recession times. Also they said that trade sales do not have to be the second-best option. The sales proceeds for a specific portfolio company might also be significantly higher compared to an IPO in favorable economic times. The reason usually is that strategic investors can include cost or revenue synergies in their valuation, which increases the value and thus the proceeds for the private equity company.

Schmidt *et al.* (2010) [5] analysed how the internal rate of return (IRR) influences the decision of choosing the exit route. The results show that only the most profitable ventures are taken public.

Suli (2009) [9] looks at the adequacy of the exit channel, the timing, and the degree of exit as key factors for the success of an exit strategy.

Valliere (2008) [6] conducted an investigation to study the effects that prior relationships between buyer and target firm have on the purchase price paid. They found out that specific combinations of prior relationship type are positively associated with higher prices. The results also suggested that relationships at different levels of analysis can act to mitigate information asymmetries in a value-creating manner and also provide practitioner guidance on strategies to increase value in M&A exits.

The choice of exit channel can be influenced by agency costs, the ability to deal with asymmetric information, and grandstanding effects (Povaly 2007) [10].

Neveling (2006) [8] in the article "Doubts over IPO bonanza" reported on the use of Alternative Investment Market (AIM) as an exit route for private equity. In this article, Clive Brook a corporate finance partner at PKF suggested that the risks associated with a float meant that private equity firms preferred the security of a trade buyer exit. An IPO may be a way to exit, but no float is guaranteed to work. He also added that the lack of flexibility following a listing was another deterrent to an exit through IPO. If trade buyers enter the picture, private equity firms would be more inclined to follow that route. In the same article, Mat Bhagrath, a corporate finance partner at Grant Thompson, said that although IPOs did provide the opportunity to receive a higher price, due to the way stock markets value companies on future earnings, the costs of a listing are onerous.

Gompers and Lerner (2004) [11] evaluate Initial Public Offerings (IPOs) as the best exits in terms of agency costs.

Das, Jagannathan, and Sarin (2003) [12] and Cochrane (2005) [13] also offer empirical evidence that IPOs generate the highest rate of returns.

Another major advantage of the trade sale over an IPO is that 100% ofthe owned shares can be sold, which with an IPO exit is often not possible due to a lock-up period (Pindur 2007) [14].

Anson (2004) [15] proposes a general correlation between increasing capital inflows into private equity and the volume of secondary sales.

Peterman and Lai (2009) [16] stress the importance of acquisition exits as a source of liquidity, among other advantages.

Wright, Robbie, and Albrighton (2000) [17] argue that secondary exits happen when better exit opportunities do not exist.

The trade sale does not represent the most attractive exit channel, as IPOs often result in higher returns (e.g., Cochrane [2005] [13], Gompers and Lerner [2004] [11], and Nikoskelainen and Wright [2007] [18].

Should an IPO not be an option, for example because of bad capital market conditions such as those found during the current financial crisis, secondary markets are often chosen as the preferred route to divest the portfolio company (Peterman and Lai [2009]) [16].

Due to the fact that financial investors usually value the target company on a stand-alone basis without including any cost or revenue synergies, and private equity investors expect an attractive return on investment, the valuation of the portfolio company is often lower than with either a trade sale or IPO (Pindur [2007]) [14]. According to Wall Smith [1997] [19], a secondary sale is therefore, in general, the third-best option for divesting a portfolio company. But it is the second-most-common route to exit after trade sales (Kaplan and Strömberg [2009]) [20].

Objective of the research

A comparative analysis of popularity of different exit routes followed by private equity players in India.

Hypothesis

H0: There is no significant difference in average returns generated by PE/VC using different exit routes.

H1: There is a significant difference in average returns generated by PE/VC using different exit routes

Research Design
"Descriptive Research Design" is used to analyse, interpret and arrive at appropriate conclusion based on empirical study.
Data collection Method: Secondary data taken from Venture Intelligence Database.
Data collected was compiled and used to analyse the popularity of different exit route used by VC/PE players. Jan 2010 to December 2015 (Clear Data) were considered to calculate the average returns generated to PE funding from various exit modes.
The objective of this paper is to understand whether there is any significant relationship between the returns generated and the type of exit mode used by private equity players.

Tools for Analysis
SPSS ver 23.0

Descriptives								
Return Multiple								
	N	Mean	Std. Deviation	Std. Error	95% Confidence Interval for Mean		Minimum	Maximum
					Lower Bound	Upper Bound		
1	89	3.0281	3.88959	.41230	2.2087	3.8474	.03	25.00
2	255	3.1074	3.91288	.24503	2.6248	3.5899	.18	31.40
3	429	2.6469	3.12848	.15104	2.3500	2.9438	.03	28.00
Total	773	2.8427	3.49808	.12582	2.5957	3.0897	.03	31.40

1. IPO Exit route 2. Mergers & Acquisitions 3. Public Market

ANOVA					
Return Multiple					
	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	37.373	2	18.686	1.529	.217
Within Groups	9409.251	770	12.220		
Total	9446.624	772			

One Way Analysis of Variance (ANOVA) is a statistical tool used for comparing means of more than two groups with a categorical independent variable influencing the scaled dependent variable. The effects of treatment variable on the scaled dependent variable is interpreted using F value statistic which is the ratio between column variance to within column variance.
As the term analysis of variance suggests, the problem requires comparing variances to make inferences about the means.
In our present research paper, the primary focus was to understand whether there is any significant difference in average returns generated by PE/VC when they are adopting different exit routes.

Analysis & Interpretations
Using the data collected, the average returns were calculated and then one way ANOVA was conducted

Descriptive Analysis: As is clear from the table above, the average returns generated by using IPO as exit route is 3.02, using Mergers & Acquisitions is 3.10 and using Public Markets is 2.65.
At significance level of 5%, calculated value of F is 1.529 which is far lower than table value (3.01) and p value is .217 which is greater than .05. Thus there is no reason to reject Null hypothesis at 5% significance level.

Conclusion
From the above analysis, it can reasonably be concluded that there is no significant difference in average returns generated by PE using different exit routes.

Limitations
During the data collection, some sectors could not be considered because of less popularity of VC/PE funding. Only last five years data has been taken.

Scope for Further Research
If sector-wise decomposition and analysis of different exit modes used by PE/VC players is conducted, the output may differ.

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