Study on Exit Mechanism for Private Equity Investment

ETUDES SUR LE MECANISME DE SORTIE POUR L'INVESTISSEMENT PRIVE

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Abstract: As a new type of investment and financing method, the private equity investment saw rapid development in China. The private equity investment can not only provide financial support for enterprises, but also can improve the corporate governance structure and management level depending on the advantage of financial management and advisory experts. However, the fundamental purpose of private equity investment institutions is to obtain high income, and whether the high income can be achieved depends on the success of capital withdrawal. Capital withdrawal, i.e. exit is an important part of normal operation for private equity investment. This paper will build an exit mechanism for private equity investment through analysis of the selection of the three factors, which are ways to exit, timing of exit and degree of exit.
Key words: Private equity investment; Way to exit; Timing of exit; Degree of exit

Résumé: En tant qu'un nouveau type de l'investissement et une nouvelle méthode de financement, l'investissement privé a vu un développement rapide en Chine. L'investissement privé peut offrir non seulement du support financier aux entreprises mais aussi améliorer la structure de gestion de l'entreprise et leur niveau de management qui dépend de l'avantage du management financier et des experts-conseils. Pourtant, le but fondamental des institutions d'investissement privé est d'obtenir des revenus élevés, et la réalisation de ces revenus élevés dépend du succès de retrait du capital. Le retrait du capital, c'est-à-dire la sortie est une partie importante de l'opération normale de l'investissement privé. Cet article essayera d'établir un mécanisme de sortie pour l'investissement privé à travers des analyses sur le choix de ces trois facteurs ; les moyens de sortie, le timing de sorite et le degré de sortie.
Mots-Clés: Investissement privé; Moyens pour sortir; Timing de sortie; Degré de sortie

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1. INTRODUCTION

The exit of the private equity investments is referring to the process that the fund managers sell the equity held by themselves through various ways to recover the investment and achieve the investment income. When it comes to the selection of the exit path, the institutional investors must consider three important factors, which are ways to exit, timing of exit and degree of exit. Based on these three factors, this paper will formulate an exit mechanism for private equity investment (**Figure 1**).

2. ANALYSIS OF THE OPTIONS OF THE WAY TO EXIT FOR PRIVATE EQUITY INVESTMENT

2.1 Ways to exit for private equity investment

There are four main ways for private equity to exit. First is packaging the enterprises and going public (initial public offering) then the private equity investment institutions can sell the shares to the public and achieve the profits. Second is stock transfer. Third is alternative public offering, which is between the IPO and MBO financing procedures. It is a new way to exit, which can effectively make up for the drawbacks of IPO and MBO. The fourth method is liquidation. Private equity investment institutions will choose this method only when they are forced to do it.

2.1.1 IPO

IPO is the abbreviation for initial public offering. The private equity investors can try their best to make the invested company go public and then the private equity is converted to public shares. After the market recognizes it, the private equity owners can sell the equity to achieve its real value. In essence, it is the process that the private equity investors promote the invested company from a private held company to a public company, and then the shares can be easily traded, which makes it available for private equity investors to sell their shares in the public market to achieve the capital gains. IPO is the most favorite way that the private equity investors and invested companies want to choose to exit, which represents the recognitions the capital market gives to the companies. This provides the private equity investors with a generous profit and helps them achieve a greater success in the future. On the other hand, for the management of the invested companies, IPO means not only retaining the independence of the enterprise, but also obtaining a new way to finance in the capital market.

IPO is the best way to exit for the private equity investment. However, it is also faced with many problems, such as high cost of exit, long time to exit and the limited market capacity. Except that the financial results and shareholders must meet the conditions of the IPO requirements, there are many factors that can affect the interests of investors, for example, the choice of the stock market, when to make shares public, choice of the financial advisors and so on. At present, when it comes to the selection of the stock market, there are two alternatives. One is domestic market, the other is foreign market. The domestic market includes Shanghai and Shenzhen stock exchange market, as well as the Growth Enterprise Market. The foreign market includes many stock markets, such as Hong Kong stock exchange market, Nasdaq, London AIM market, NYSE, Singapore stock exchange and so on.

As to the IPO exit approach, the choice of timing is also important. Private equity investors must consider three factors regarding it, which include the stock market situation, the operation performance of the invested enterprises, the portfolio and opportunity cost of the private equity investment. However, these three factors can’t reach optimal simultaneously. As a result, it is necessary for the private equity investment institutions to balance the pros and cons of the various factors, and then determine the

appropriate timing of IPO.

2.1.2 Stock transfer

Stock transfer is referring to the fact that private equity investment institutions can transfer its shares or sell its shares to obtain cash according to contract. This method can be divided into two broad categories: stock repurchase and selling to third parties.

Stock repurchase is the enterprises buy back the shares held by the private equity investment institutions according to the established procedures and prices. The private equity investment institutions can obtain cash or negotiable securities through this way to exit, so the operability is strong. According to the different repurchase subjects, the stock repurchase can be classified as management buyout (MBO), employee buyout (EBO) and enterprise repurchase. MBO means the management of the enterprises buys back the shares owned by private equity investment institutions; EBO means the employees of enterprises buy back the shares owned by private equity investment institutions, which has become a widely used incentive system in many countries. Enterprises repurchase is the enterprises themselves as a subject purchase the shares held by the private equity investment institutions.

Another way is to sell to third parties, which means the private equity investment institutions sell the shares to the third parties except the invested enterprises, and then obtain the profit. There are two alternatives along this way to exit: first is selling the shares to another company, second is selling the shares to other investors.

2.1.3 APO

APO is an acronym for Alternative Public Offering, that is, financing type reverse merger, saying that offshore special purpose company signs contract with American OTCBB (non-exchange market regulated by the national association of securities dealers) market shell company to proceed the reverse merger, and at the same time, it can raise funds from the specific international investors so that the initial private equity investment funds can obtain cash and exit from the invested enterprises. APO's principle is using the advantages of low cost and promptness of the private equity investment procedures to complete the financing in three or four months, and the cost paid by the enterprises is about half the cost of IPO. The private equity investment institutions can sell the shares after finishing the financing, and then exit to achieve high returns. For the APO method to be used, the following conditions must be satisfied: first, the company has the audited financial reports approved by the United States Securities and Exchange Commission. Second, the relevant legal documents must be prepared to facilitate the reporting to United States Securities and Exchange Commission. Third, the company is required to complete the reverse merger with a shell company listing in US. Finally, the funds raised from the investors will be given to the company through custody account after the completion of the dealing. For the private equity investment institutions, the shares acquired through APO can be traded quickly and it can effectively avoid the control risk following the IPO.

2.1.4 Liquidation

Liquidation is the behaviors an enterprise takes to distribute residual assets and cancel the registration as a result of bankruptcy and dissolution of the enterprise. This way to exit is the worst one that neither the private equity investor nor the invested enterprise would like to choose, but it is not uncommon that the private equity investment institutions are forced to liquidate and exit because of the failure of the operation. For example, about 32 percent of the enterprises invested by the U.S. venture capital will enter into liquidation procedures, which is a proportion IPOs occupy approximately. Once the private equity investors decide the invested company has no prospect for development or its growth is too slow, so as not for them to obtain the expected high return, they should liquidate the company decisively, withdraw funds, then invest the funds into the next project to improve the investment efficiency. However, this method is not commonly used by the private equity investment funds in China.

2.2 Compare the different ways to exit

Based on the analysis of the ways to exit, I give the advantages and disadvantages of these four methods, as well as the necessary conditions and the period of their application, which are shown in **table 1.**

When choosing the way to exit, in addition to considering the advantages and disadvantages as shown in table 1, we must also consider the following factors:1) the operational performance of the enterprise. If the performance of the company is poor or the industry is in recession, private equity investment institutions must consider choosing liquidation or transfer their shares. If the performance is good and a brighter future can be expected, stock transfer or IPO is better recommended.2) the preference of the private equity investors. This is mainly concerned with the risk preference of the private equity investors.3) economic and financial environment.

Based on the analysis mentioned above, the selection of the way to exit is a dynamic process. The investment is full of uncertainty, so private equity investment institutions should timely change the exit strategy according to the dynamic development of enterprises.

1. TIMING OF EXIT

For private equity investment institutions, the proceeds of a project is not only affected by the efficiency of the different ways to exit, but also affected by the timing of exit. It is hard to get a unified standard about the timing of exit because of the complexity of composition of the investment projects. In this paper, the selection of timing of exit will be analyzed based on three categories, which include choosing according to industry cycle, choosing according to expected return of capital, choosing according to the investment agreement terms.

3.1 Choose the timing of exit according to industry cycle

Industry cycle theory shows that the development of an industry should be divided into five different phases: seed phase, initial phase, growth phase, maturity and decline phase. The private equity investment institutions will invest the company that is in the seed or initial phase, and then exit when the company is in the growth or maturity phase. According to the industry cycle, the selection of the timing of exit is closely related with the operational performance of the enterprises, that is, it largely depends on the value increase level of equity of the enterprise.

3.2 Chose the timing of exit according to the expected return of capital

The fast growing of the company provides a prerequisite for the exit of the private equity investment institution. The fundamental reason why the private equity investment institution is willing to invest in the company is that they have confidence in the enterprise and believe the value increase can be realized in the end. Private equity investment institutions obtain the growth information about the enterprises when they monitor the operation process. Once the enterprises embark on a steady path of development, private equity investment institutions have already achieved their objectives, while at the same time it is no longer necessary for them to continue the investment. Continuous withdrawal of capital and investment in a new project is the nature of private equity investment. The timing of exit should be the time the expected return has been achieved; even it is before IPO can be implemented. The existence of strategic acquisitions also increases the exit opportunities for the private equity investment institutions, If the strategic investors estimate a bigger income during the expected holding period of the project than that expected by the venture capitalists, private equity investment institutions will be able to sell their shares to these investors at a price which is higher than they expected to sell, and then successfully exit in

advance.

3.3 Choose the timing of exit according to investment agreement terms

Generally speaking, it is more difficult to withdraw capital than invest. Therefore, private equity investment institutions have prepared the plan to exit before the investment, and they will propose some specific requirements in the equity investment agreement. Private equity investment agreement is the contract signed between the private equity investment institution and invested enterprise regarding the investment period, timing of exit, timing and way of IPO, and the responsibilities assumed by the invested company if the expected financial objectives are not met.

4. ANALYSIS OF DEGREE OF EXIT

4.1 Partial or Complete Exit

The degree of exit refers to the problem whether private equity investment institutions will adopt complete exit or partial exit. Cumming & MacIntosh studied this problem of complete exit and partial exit about venture capitalists. They pointed out that when there is serious asymmetric information between venture capitalist and the potential buyer, the venture capitalist will choose partial exit, whose purpose is to convey to the potential buyer a signal about the quality of the project, which can reduce the information asymmetry between venture capitalist and buyer. According to their theory, the meaning of partial exit and complete exit is different against the different ways to exit. For the way of IPO, partial exit means the private equity investment institutions sell some of the shares after the company goes public, and hold the remaining portion, while complete exit refers to the fact that the private equity investment institutions sell the entire shares in the market. For the way of stock transfer, partial exit means the private equity investment institutions only sell some of the shares to the buyer in exchange of cash or other shares, at the same time holding the remaining portion, while complete exit refers that private equity investment institutions sell all their shares and get the equivalent cash.

Most of the private equity investment institutions would like to choose partial exit, the main reasons for which are as follows: 1) Retaining some of the shares can convey to the new investors a signal of good quality of the invested enterprise, so as for the private equity investment institutions to make the share transfer price close to the true value of the invested enterprise. 2) For the high-quality enterprises, partial exit can make the private equity investment institutions assume a smaller opportunity loss than complete exit. 3) Partial exit can help the private equity investment institutions establish performance records to attract new capital and keep these capitals so as to obtain a balanced potential profit.

4.2 Analysis of the factors influencing the degree of exit

There are three main factors that can affect the private equity investment institutions' choices between partial or complete exit:

- The growth of private equity funds in private equity investment institutions. Because the private equity investment institutions have shares in the invested enterprises, they will have their own seats at the Board of Directors, providing consulting services to the management to improve the enterprise's value. While the private equity investment institutions raise more and more funds, they do more and more investments and need to provide more and more consulting services to those invested enterprises. However for the private equity investment institutions, the capability of providing the consulting services is not that flexible in the short term. As a result, the private equity investment institutions will partially exit their investment and invest into new projects.
- Changes in the economy. The ever-changing economy has an effect on the degree of exit of private equity investment institutions. When the economy situation can be judged clearly, the

private equity investment institutions are inclined to choose complete quit. When the economic situation is uncertain, so the private equity investment institutions can not effectively predict the future, they will choose partial exit in order to reduce risk.

- Factors of taxes and laws. When private equity investment institutions select the degree of exit, the country's legal and tax factors must be considered since the transaction costs are different under partial exit or complete exit. Partial exit mentioned here is similar to the concept of batch exit, namely, quitting from the invested enterprise step by step.

5. CONCLUSION

The exit of the private equity investment is the necessary and essential part of the operation of private equity investment institutions. In this paper, I outline the three elements of the exit mechanism for private equity, which include way to exit, timing of exit, and degree of exit. However, in the actual operation of the private equity investment institutions, the selection of the ways to exit is a dynamic process which is full of uncertainty, so private equity investment institutions should timely change the exit strategy according to the operation performance of the invested enterprise, the economic and political environment.

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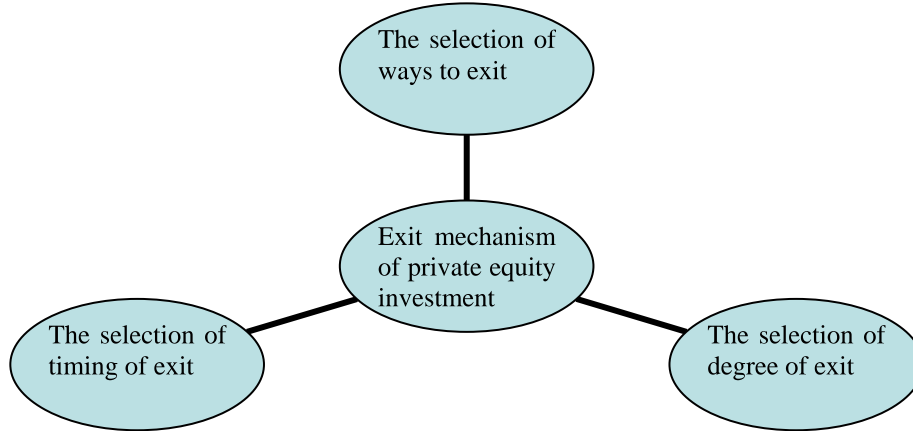

Figure 1. The exit mechanism for private equity investment

Table 1. Comparison among the four ways to exit

Way to exit	IPO	Stock transfer	APO	Liquidation
Advantages	1. Return is high and continuous investment can be obtained. 2. A good reputation for private equity investment institutions can be established. 3. Stability of management and the independence of an enterprise can be kept.	1. Holding period is short. 2. Strong flexibility and low risk can be obtained. 3. Costs are low.	1. Risk is lower compared with IPO. 2. Period to complete the project is shorter. 3. P-E ratio is higher.	1. Further loss and low efficiency is to be prevented.
Disadvantages	1. Going public is not easy and information reporting responsibility has to be assumed. 2. Procedures are complicated, costs are higher and many limitations are imposed. 3. It is easy to be affected by stock market fluctuations.	1. Return is relatively lower. 2. Less can be controlled in the course of negotiation.	1. Financing capability is limited in the market. 2. It is hard to find a partner.	2. Private equity investment institutions can't obtain profit or incur a big loss. 3. Process is complicated and procedures are plenty.
Necessary conditions	Capital market is well-developed and the enterprise meets the listing conditions.	Property right for enterprise is established.	The enterprises can provide the financial reports recognized by the SEC and a proper American public company as a partner can be found.	The law and the relevant agreements must be followed.
Applicable period	Maturity phase of an enterprise	Growth or maturity phase of an enterprise	Growth or maturity phase of an enterprise	When the enterprise fails