



**BACHELOR OF FINANCIAL SERVICES
END OF SEMESTER EXAMINATION**

BFS 3202: VENTURE CAPITAL AND PRIVATE EQUITY

Date: 7th December 2023

Time: 13:00-15:00

INSTRUCTION:

1. Question in compulsory
2. Answer any TWO questions choosing from question two to five

QUESTION ONE (30 Marks)

Mr. Spencer, a high net worth individual, is considering investing in a Private Equity Company. He is not sure whether to invest in venture capital or buyout (mature). The only information he provides is the fact that he wants to avoid as much risk as possible.

(a) Using THREE attributes, distinguish between a venture capital and buyout and suggest the better option for Mr. Spence. **(7 Marks)**

(b) To avoid the risk of PE investing, Mr. Spencer goes ahead and decides to use a Private Equity Fund to invest.

Required;

Highlight FOUR issues that Mr. Spencer will need to consider before using a PE fund. **(4 Marks)**

(c) Azure limited started operations in 2018, to process organic foods for supply to local and foreign markets. The founders had approached Regent Capital Fund (PE Fund) to provide early-stage funding, more specifically start up and first stage. Regent provided Preference Share capital and debt.

As the business was beginning to pick up in demand and therefore sales, Covid 19 pandemic adversely affected operations, occasioning losses and making it difficult to operate well. As at 30 June 2022, the following statement of financial position was prepared by the company.

Azure Limited		
Statement of Financial Position as at 30 June 2022		
Assets	Sh.000	Sh.000
<u>Noncurrent Assets</u>		
Land and Buildings		11,250.00
Furniture and Equipment		4,750.00
Patents		1,500.00
Motor Vehicles		2,500.00
Software		<u>2,200.00</u>
		22,200.00

<u>Current Assets</u>		
Inventory	4,500.00	
Trade Receivables	6,800.00	
Cash in Hand	<u>100.00</u>	<u>11,400.00</u>
Total Assets		<u>33,600.00</u>
Ordinary Share Capital (sh.100 each)		10,000.00
10% Preference Share Capital (Sh.200)		7,500.00
Revaluation Reserve		1,200.00
Accumulated Losses		<u>(8,450.00)</u>
		10,250.00
<u>Noncurrent Liabilities</u>		
10% Debt		15,000.00
<u>Current Liabilities</u>		
Bank Ovedrafts	1,450.00	
Trade Payables	6,500.00	
Unpaid expenses	<u>400.00</u>	<u>8,350.00</u>
Total Liabilities		<u>23,350.00</u>
Total Capital Liabilities		<u>33,600.00</u>

Regent and the founders are worried about the performance and the financial position of Azure and are evaluating what should be the way forward.

Two options are considered. A financial restructuring and liquidation.

Financial restructuring:

1. Revalue buildings downwards by sh1 million.
2. Revalue furniture and equipment downwards by sh.1.5 million.
3. Patents have no value and need to be written off.

4. Software should be written down to sh.1.2 million.
5. Inventory is written down its net realizable value of sh.4.3 million.
6. Sh.2 million of the 10% Preference Share capital is to be retired and will no longer be payable. The balance will now be earning dividends at 12%.
7. The accumulated loss, including any other losses of assets will be charged to the founders' equity.
8. Sh. 5 million of the PE funds debt will be converted to ordinary Share capital. The balance will be retained but at 8% interest.
9. The Founder to inject additional cash of sh.2 million to pay the overdraft. This will be credited to the founder's equity after adjusting for the losses.
10. Some trade payables have agreed to give discounts of sh.400,000.
11. The unpaid expenses include salaries in arrears of sh.250,000, which will be paid in full.

Liquidation:

This will have majority of the assets converted to cash in order to pay the various claimants. The following are estimates of the proceeds that will be realised:

	Sh.000
Land and Buildings	11,000.00
Furniture & Fitting	2,250.00
Motor Vehicles	1,000.00
Inventory	4,300.00
Trade Receivables	6,000.00

It is estimated that Azure will use the services of an auctioneer, who will be paid an estimate of sh.2,500,000. After settling the auctioneers, the claimants will be paid as follows according to the law:

- The 10% debt to PE fund which is secured as a floating charge.
- The bank overdraft
- The Trade Payables (who will give a discount of 5% for early settlement)
- Unpaid expense
- The Preference Share Capital to PE fund.
- The founders' equity.

Required:

- (i) Prepare a revised statement of financial position having effected the financial restructuring. **(8 Marks)**
- (ii) Prepare a schedule showing how the cash available from liquidating the assets will be distributed to each of the parties. **(6 Marks)**

(iii) Justify which strategy is the PE fund and founders should select between financial restructuring and liquidation. What needs to be done to support the financial restructuring if this strategy is selected? **(5 Marks)**

QUESTION TWO (20 Marks)

(a) Distinguish between Venture capital and Leveraged Buyout methods of valuing Private Equity Companies. **(4 Marks)**

(b) Fedex Startup is seeking financing from a venture capital fund by the name of Leader Ventures. The founders of Fedex expect to be able to sell the company for \$40 million in five years. At this point they need to raise \$5 million. Leader Ventures considers this a risky business and wants to apply a discount rate of 40% to be adequately compensated for the risk they will bear. The entrepreneurs own 1 million shares.

Required

Compute the following:

- The Post-Money Valuation **(2 Marks)**
- The Pre-Money Valuation **(2 Marks)**
- The Ownership Fraction **(2 Marks)**
- The Number of Shares **(2 Marks)**
- The Price per Shares **(2 Mark)**

(c) Suppose a PE Company is valued at \$1,000 million and has the following characteristics (amounts are in millions of dollars):

- Exit occurs in five years at a projected multiple of 1.80 of the firm's initial cost.
- It is financed with 60% debt and 40% equity.
- The \$400 equity investment is composed of:
 - \$310 in preference shares held by the private equity firm.
 - \$80 in equity held by the private equity firm.
 - \$10 in equity held by management equity participation (MEP).
- Preference shares are guaranteed a 14% compound annual return payable at exit.
- The equity of the private equity firm is promised 90% of the firm's residual value at exit after creditors and preference shares are paid.
- Management equity receives the other 10% residual value.
- By exit, the firm will have paid off \$350 of the initial \$600 in debt using operating cash flow.

Required;

Calculate the payoff for the firm's claimants and the internal rate of return (IRR) and payoff multiple for the equity claimants. **(6 Marks)**

QUESTION THREE (20 Marks)

(a) Explain THREE approaches the Private Equity Fund can enhance the value of a Private Equity Company. **(6 Marks)**

(b) Suppose Mellanie fund has committed capital of \$200 million and carried interest of 20%. An investment of \$80 million is made. Later in the year, the fund exits the investment and earns a profit of \$44 million.

Required:

Determine whether the GP receives any carried interest under the three distribution waterfall methods. **(6 Marks)**

(c) Assume in the second year, Mellanie fund makes another investment of \$50 million, which is exited and results in a loss of \$8 million. Assume the deal-by-deal method and a claw-back with annual true-up apply.

Determine whether the GP must return any former profits to the: LPs. **(4 Marks)**

(d) Explain TWO benefits and TWO challenges of Initial Public Offer (IPO) as an exit strategy from a Private Equity Company by a PE fund. **(4 Marks)**

QUESTION FOUR (20 Marks)

(a) Discuss FOUR components of due diligence of a Private Equity Company. **(8 Marks)**

(b) Before a venture company is formed, i.e. at the foundation stage, the Private Equity Fund may need to undertake a feasibility study. Highlight EIGHT components of a feasibility report. **(8 Marks)**

(c) Impact Investing has received considerable attention by Private Equity Funds and Private Equity Investors. Explain the meaning of Impact Investing in the context of private equity and provide TWO examples of Private Equity Companies that are considered to fall within the category of impact investments. **(4 Marks)**

QUESTION FIVE (20 Marks)

(a) Discuss FIVE roles of big data analytics in Private Equity Investing. **(10 Marks)**

(b) Mr. Spencer in Question One, is not sure about the features of private equity investing and the role that private equity investing play in a portfolio.

Required;

(i) Highlight the SIX features of private equity investing. **(6 Marks)**

(ii) Briefly explain the role of private equities in a portfolio. **(4 Marks)**