Entry And Exit Strategies For Businesses: An Overview
written by Bishak Sharma | July 22, 2021

Entry And Exit Strategies for businesses - An establishment, private in terms of holdings, limited by securities of varying proportions - from equity to preference to debentures, guarantees etc. - carrying along with it differential rights accorded thereof, will, at a certain point of time, look at expansion.
Expansion translates directly into money. More manpower, more office area, more geographical outreach, advanced technology – all of it requires funds that the company, along with its founders, directors, and shareholders, may not exactly be in a position to provide. By definition, a private company is barred from reaching out to the general public to raise any capital required for expansion. The Securities and Exchange Board of India (SEBI), India’s primordial watchdog, has, by its very constitution, sworn to protect the general public from petty unregistered entities looking to make a quick buck while trying to circumvent strict and accurate regulations put in place with the sole objective to safeguard the common man.
Penalties for doing so are extremely harsh, ruthless and has no regard whatsoever for “the corporate veil”. *T.G Venkatesh vs Registrar of Companies*[1], *Ashok J Shah vs the State of Gujarat*[2], amongst many more, are noteworthy examples. This leaves the domestic and the global private sector with no choice but to pursue other options such as financial institutions, individuals with a high net worth or fellow business entrepreneurs interested in funding the company looking to make excellent market profits upon their exit.
While the law governs such an expansion broadly, the tiny but exemplary details involved in such a transaction can only be captured through an adept shareholding agreement that navigates various entry and exit strategies, primarily with due reference to the law and also through safe mechanisms to ensure managerial control, conditions regarding the inflow of funds and profits in terms of both shareholder value as well as year-on-year income from business activities. As the saying goes, it’s all in the details. Such is the importance of a shareholding agreement; it targets the very root of a company’s lifestyle.
Entry Strategies for businesses
Amongst other modes, ownership of a company is best accomplished if it is through its shares. This method (acquisition of ownership of a company

through shares) is the safest and most preferred route, especially when the acquisition is legally backed by the Apex Court (like in the *V.B Rangaraj vs V.B Gopalakrishnan*[3] *case*) that incorporates the terms of a shareholding agreement into the articles of association of the company. This approach creates an environment where the right amount of money can reach the right people for the right jobs. The following points broadly explore some entry scenarios:

- Through loans and advances:
  This particular entry reflects on the accounts and the balance of holdings of the company. The outcome is an asset to the investor, but a liability to the company since it is the company that has to pay off any loans/advances along with interests accrued.
- Through debentures and other debt securities:
  The idea of debt instruments is fixed returns; safe, but also convertible i.e., convertible to shares, carrying voting rights, managerial control etc. Debentures can be convertible or non-convertible amongst many other options. Exercising this mode of entry requires due diligence.
- Through holding shares with attached rights thereof:
  Equity shares guarantee ownership rights over a company proportionate to the holding. Preference shares, however, guarantee returns with a scope for a lot more. Convertible preference shares to equity shares – with a ratio that is induced to maintain control in the larger picture and with conversion ratios being subject to other factors – provide numerous options for both the investor and the company/founders to realise the best capital inflow with high market returns.

During the time of entry into a company, key aspects need to be kept in mind by the investor. What exactly does the investor want to accomplish by taking on such an effort? The following points answer this question:

- Management of the company: The investor might wish to be involved in the daily operations of the company if it is of interest to them. If so, a heightened involvement by the investor in the company’s management means dilution of the founders/existing shareholder’s control.
- Control of the company: The investor might be interested in having more control over the company. Control directly corresponds to the ratio of proportionate shareholding. The higher the holding, the higher the control.
- Returns on investments: The investor might be primarily interested in getting good returns that are greater than prevailing bank rates or achieving higher nominal performance through mutual funds or other such market investments.

The Indian economy has emerging business opportunities rivalled by very few other developing nations. Earlier in 2021, even when India was emerging from a period of historical economic depression caused by the pandemic, declines in FDI inflows were widespread across all G20 economies except for China and India which recorded higher FDI inflows of 14% and 27% respectively, partly reflecting surges in cross-border M&A activity in the second half of the year[4]. Australia, Brazil, the Netherlands, Japan, France, and Canada are close competitors but are unmatched by India’s diversity in terms of business opportunities, including China, which relies mostly on its manufacturing sector.

In this respect, Indian law reflects the same quite adequately. Funding can be sought from foreign individuals, foreign institutions, or foreign limited liability companies alike (with lesser paperwork if the same is accomplished through domestic sources) with due compliance to the Foreign Exchange Management Act 1999 along with various RBI guidelines, notifications, and master directions. The Companies Act 2013, along with rules and regulations, has been strategically amended frequently to make way for easier allotment and placement of securities. The process is relatively quick, transparent and aids the needs of the young and vibrant population of India.

Whichever entry route is employed, each accompanied by certain advantages and intent, the expansion of the company is guaranteed. Too cautious means the company is stagnant and too quick means the company is risky. Advice on how to strike the right tone and balance can be sought from experienced consultants.

Exit Strategies for Businesses

Exit scenarios are trickier. Investors are putting in capital to make 10x, 20x, or 100x their investment. To realize this, there must be an exit. An exit discussion might seem negative, but it needs to be seen as a way to strategize and capitalise on it - to ensure a positive outcome. In short, the following are the main methods of exit for an investor:

- Mergers and Acquisition
- Sell out
- Initial Public Offering
- Liquidation
- Financial buyer – PE/VC purchases
- Recapitalization

Each of these scenarios must be explored both internally and externally by the company. Circumstances determine exit scenarios and exit strategies for businesses. The entire scope of taking on an investor should not be seen as just another exit to be prepared for.

Planning Beyond Entry and Exit Strategies For Businesses

A funding transaction should not include just entry and exit scenarios for an investor (or investors). A typical shareholding agreement leaves room for a lot more. That’s where things get creative. An investor might pull out due to disagreements, while another investor might be convinced of the company’s performance and wants to get on board. Entries and exits might even happen simultaneously. Accordingly, a lot of safeguards will be put in place governing such scenarios. These include:

- Anti-dilution clauses:

  Anti-dilution clauses are built into convertible preferred stocks to help protect investors from an investment potentially losing value. It can occur when the percentage of an owner's stake in a company decreases because of an increase in the total number of shares outstanding.
- Right of First offer and Right of First Refusal:

  A shareholder who wishes to sell his shares must first offer his shares to other shareholders in proportion to their shareholdings, subject to their acceptance and/or refusal. If the other shareholders do not exercise their rights to buy the shares, the selling shareholder may offer these shares to a third party at the same price subject to the same conditions. The onus of discovery of the price of the share, including costs and due diligence thereof (to be conducted only by a Registered Valuer under IBBI guidelines) is the main factor differentiating RoFO and RoFR from pre-emptive rights or a rights issue of shares.
- Drag along and tag along rights:

It is the right of a shareholder who wishes to sell all his shares to a third party to compel the remaining shareholders to sell their shares to the third party purchaser on the same terms. It is also the right of the remaining shareholders to compel the shareholder who wishes to sell to a third party, to get the third party purchaser to purchase their shares on the same terms.

- Voting rights:
  Voting rights allow shareholders of a company to vote on certain managerial aspects, elect members to the board of directors, and approve issuing of new securities or payments thereof. It is governed by the Companies Act 2013 and a shareholding agreement, which must be drafted with relevant reference to the laws, but also to limit the dilution of voting rights.
- Managerial control:
  Voting rights have to be tailored to meet personnel levels of managerial control. Appointments as nominees to the board of directors, appointment of individual directors retiring by rotation etc., are a few such inclusions.
- Periodic vesting of shares:
  This is commonly found in Employee Stock Option Plans (ESOP) and is also a major contributor to founder's agreements and shareholding agreements. Periodic vesting depends on the professional performance of the individual and also creates competition while providing an intrinsic background to a person who holds such shares.
- Share valuation methods:
  It is a system of determining the value of a business by estimating the value of its shares. It can be categorised into two categories: Absolute and Relative. Various laws, practices, customary provisions such as a Company’s Net Asset Value (NAV) method, Discounted Cash Flow (DCF) model, weighted-average method etc., are options to choose from concerning this particular scenario.
- Financial projections and analysis:
  Financial projections use existing or estimated financial data to forecast a company's future income and expenses. They often include different scenarios such as higher sales or lower operating expenses which may affect the company's profitability.
  Summing Up
  A holistic view of requirements and intent is to be crafted in accordance with the objectives of a company. Entry and exit strategies for Businesses play a role right where conflict and profit intersect. Expansion cannot be undertaken without money and money cannot be granted without a strong foundation. Giving considerable thought to the due process is prudent. While this article aims to provide a brief overview of the same, an in-depth

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- [1] 2007 78 SCL 1 AP
- [2] R/CR.MA/5331/1999
- [3] AIR 1992 SC 453
- [4] https://www.oecd.org/investment/FDI-in-Figures-April-2021.pdf
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  Contributed by - Bishak Sharma, Senior Associate (Corporate)