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MONGOLIAN PRIVATE EQUITY FUND FEASIBILITY STUDY, SECOND STAGE

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ABBREVIATIONS

ADB	Asian Development Bank
BOM	Bank of Mongolia
CEO	Chief Executive Officer
EBRD	European Bank for Reconstruction and Development
EPRC	Economic Policy Reform & Competitiveness Project
GDNT	General Department of National Taxation
GDP	Gross Domestic Product
GP	General Partner
GTZ	German Development Agency
IAFRS	International Accounting and Financial Reporting Standards
IFC	International Finance Corporation
IFI	International Financial Institution
IPO	Initial Public Offering
IRR	Internal Rate of Return
JICA	Japanese International Cooperation Agency
JSC	Joint Stock Company
KFW	KFW Development Bank
LLC	Limited Liability Company
LP	Limited Partner
MNCCI	Mongolian National Chamber of Commerce and Industry
MNT	Mongolian National Tugrik
MoFE	Ministry of Finance and Economy
MSE	Mongolian Stock Exchange
MSEC	Mongolian Securities and Exchange Commission
MT	Mongolian Telecom
NBER	National Bureau of Economic Research
NBFI	Non-Bank Financial Institution
NGO	Non-Government Organization
NSO	National Statistics Office
OSF	Open Society Forum
SFS	Summary Fact Sheet
SME	Small and Medium Enterprises
USAID	United States Agency for International Development
USD	United States Dollar
VAT	Value added tax
WTO	World Trade Organization

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EXECUTIVE SUMMARY

Based on the preliminary findings of a first stage feasibility study for the establishment of a private equity venture capital fund, this second stage analysis focuses on the conduct of a due diligence analysis of firms in Mongolia with investment opportunities that would be attractive to private equity investors. The initial study posited a staged approach leading to the potential establishment of the fund:

1. Country profile, country risk and initial analysis of deal flow and investors' interest
2. Detailed analysis of deal flow, legal and regulatory environment
3. Fund management company and grant-funded technical assistance design and preparation of Fund Offering Memorandum
4. Fund capitalization and legal and regulatory environment reform.

As the initial study yielded positive results for stage one, this second stage analysis concentrates on examining the quality and size of potential deal flow for a traditional private equity fund.

We searched for "Investee Candidates" or companies that posed a significant investment opportunity and that met the following basic criteria:

1. Strong management team
2. Large and growing market for goods or services that could offer an investor their required rate of return
3. Planned exit (explicit)
4. Would allow participation and board membership
5. Founder's ongoing commitment
6. Well prepared documentation and financial statements

We conducted due diligence on twenty-four companies, eight of which showed enough promise to warrant a more extensive due diligence. Most of the companies reviewed fell into the size requirement that we had set: $1 million in revenue and a $500,000 capital need. There were companies that were below this threshold that were included in the due diligence because we deemed they might offer a potentially viable investment opportunity.

One could argue that we did not review enough companies to come to a definitive conclusion on the efficacy of private equity in the Mongolian market. This could be correct. However, a great effort in the screening process was made, and we believe that deals sourced to us and deals we found on our own were the best sampling and representation of what the market currently has to offer.

There may be companies that could meet the basic criteria of a private equity investor, and indeed we did meet with companies that seemed, based on information provided in initial meetings, to offer reasonable investment opportunities; however, those companies chose not to allow further due diligence. Many of the most promising companies in Mongolia that might be attractive investment opportunities—many are foreign owned—already have access to alternate sources of capital and have no need for capital from a locally based private equity fund.

From a strict private equity investor's viewpoint, we summarize our findings as follows:

1. *Companies' management***.** Many management teams/owners we met were impressive, especially given the nascence of the markets and their businesses. However, private equity investors tend to prefer management teams with richer and more extensive experience and with a greater number of "success stories." Management of the companies examined must be applauded for the great efforts and strides they have made in such challenging environments. Lack of experience in these developing markets is not uncommon and private equity funds that have a focus on the developing markets understand this well and some have the ability to make up for investee's lack of experience. Most though, will make this consideration only when other investors' criteria are amply met. We found that most of the management teams/owners we met with were forthcoming in providing information; however, it takes more than a few meetings to determine transparency and integrity.

2. *Required rate of return*. Establishing a required rate of return is fraught with difficulties given different investors' risk perceptions. Based on information supplied by the companies but not independently validated, findings from this stage indicate that internal rates of return (IRRs) of potential equity investments vary from -2 percent to 47 percent among the eight companies for which a due diligence analysis was performed. While there is promise, the potential pipe line of deal flow for traditional, "pure" private equity instruments appears weak. It is possible that given more time for the conduct of the due diligence analysis additional companies may surface that are potentially attractive to traditional private equity investors but this is not guaranteed. We feel confident that the companies examined provide a reasonable sample of "top-tier" companies in Mongolia at this time. In particular, only four of the eight companies achieved a projected IRR of 25 percent or higher.

Company	IRR
A	25%
B	3%
C	41%
D	n/a*
E	36%
F	47%
G	21%
H	-2%

3. *Exit.* A key requirement for making a private equity investment in developing markets such as Mongolia is finding a way out of the investment—the exit—so that the return on investment can be realized. Exiting via the public market is not a viable possibility in Mongolia at this time. Whether this will be a likely option a few years from now remains to be seen and is contingent upon the development of the infant stock market. Under these circumstances, options for exiting from private equity investments are more restrictive and dependent upon management buy-outs, finding strategic investors, LBOs, and the like. These exit restrictions increase risk.

4. *Participation and board membership.* In our assessment of management teams/owners, we found mixed feelings in regards to the investors required participation in the development of the company and board membership. Approximately half of the companies we reviewed were highly receptive of the idea of accepting guidance from a private equity investor. Some were quite eager get help from a technical point of view as well as from a financial standpoint. But some companies saw an investor's requirement for participation as an intrusion and maybe did not fully understand the value an investor brings to the table besides their capital.

5. *Founder's commitment*. The challenge we saw on this issue was that many of the companies we reviewed were part of a group of companies. Private equity investors are generally adverse to investing in a company within a group. They prefer to work directly with a founder who has invested the vast majority of his/her net worth in the business.

6. *Business documentation.* While some companies made a respectable attempt at presenting proper documentation—business plans, financial statements, etc.—none had what a private equity investor would normally require. This is to be expected in an emerging market such as Mongolia.

Findings from this stage indicate that while there are companies in Mongolia that do show promise, none of the companies scrutinized in this study could meet the stringent criteria that a "pure" traditional private equity investor would require. Therefore, our recommendations suggest the exploration of alternatives to the traditional private equity structure. Quasi-equity instruments or "shareholder loan funds" may be ideally suited to the Mongolian context.

Specific recommendations include the following:

1. *Conduct of a market study for a quasi-equity fund*. If the establishment of a *pure* private equity fund is unsupported by these findings, the market for quasi-equity instruments needs to be explored. As this second stage the feasibility study focused exclusively on deal flow quality and size for traditional private equity instruments; the market for quasi-equity instruments targeted to small and medium enterprises (SMEs) was not examined. Lower transaction costs of quasi-equity instruments, greater ease of structuring, and lower average investment make them ideal for increasing the array of capital financing instruments for SMEs. Also known as "Shareholder Loan Funds," a quasi-equity fund combines a low-interest loan with minority equity participation and "royalties"—a percentage of sales to achieve commercial returns to investors. Terms of the loan vary between three and six years and the interest rate is set at or

below the prevailing market rate. Collateral requirements for the loan are typically no less than 25 percent in pledges of business, personal assets pledges and shares, with no requirement for 100 percent collateral. The "royalties" or percentage of sales are set between one and five percent and the equity share varies between 15 and 49 percent—new shares, no dividends paid. Exit from the investment is achieved through owner buyback of the shares at a pre-determined multiple of purchase price or sales agreed upon in advance. The typically vexing problem of exit and owner's loss of company control is obviated. A technical assistance facility, provided through grant financing by the fund or by third parties, provides non-financial assistance in establishing financial controls at the company, strategic planning, market analysis, cost accounting and pricing, etc., as needed. Following the successful model of collaboration with other partners for the feasibility analysis of a private equity fund, EPRC could seek collaboration of the *Open Society Forum* and others for the conduct of market analysis for a the potential establishment of a quasi-equity fund .

2. *Conduct of a legal and regulatory analysis*. It is recommended that, parallel to the market study, an analysis of the legal and regulatory environment be carried out to adapt and design, as necessary, appropriate legal instruments for use in Mongolia in the potential implementation of such a fund. The "legal tool kit" in use in other countries needs to be adapted to the Mongolian legal and regulatory environment. EPRC could seek to partner with the *Asian Development Bank* (ADB) to carry out this analysis. As a potential fund investor, ADB has manifested keen interest in this collaboration.

3. *Preparation of a concept paper on alternative designs of the grant-financed technical assistance component*. Provided the market and the legal and regulatory analyses yield positive results, EPRC and partners should prepare a concept paper on the mechanisms to be used to provide technical non-financial assistance to potential investee firms. Mechanisms are already in place in Mongolia to provide this assistance. The Enterprise Restructuring Project and EPRC's Business Development Services already provide this assistance. These projects could work closely with the proposed fund, at least in the initial stages, to provide sources of deals, prepare companies for investment, and assist with the installation of needed core business systems at the firm level. There is an obvious synergy between the programs of business development assistance provided by these projects and the needs of the fund. For these projects, the fund would provide another potential source of finance for their client companies; for the fund, these projects would provide the needed technical assistance mechanism.

4. *Support intermediation.* Intermediation functions as a conduit between investors and entrepreneurs. An intermediary typically either represents a company seeking capital or represents an investor seeking investment opportunities. We believe that there is a great need for intermediation in Mongolia. Few companies here have the know-how for presenting themselves to the financial markets. Many companies not only need help in "packaging" themselves for presentation to capital sources, they need help in making themselves into investment opportunities. They need guidance in creating business strategies for capturing market opportunities, and they need help in translating those strategies into growing and sustainable cash flows. They need help in financial management and operational management of their businesses as well as technical expertise. These areas of assistance can be covered through intermediation.

   Intermediation can come in different forms. The most important for Mongolia are:

   > *Investment banking*: Investment banking can be performed by individuals or institutions which act as underwriters or agents for companies (and municipalities) raising capital or seeking to provide capital to, merge with or acquire another company. While many investment banks also maintain broker/dealer operations, maintain markets for previously issued securities, here in Mongolia the most needed role they can play is in raising capital in the debt and private equity markets and in offering advisory services to business owners and to investors. Investment bankers also typically provide corporate restructuring advisory services. Unlike commercial banks, they do not accept deposits from and provide loans to individuals or businesses. They focus mainly on functioning as a conduit between business owners

and investors and in advising companies on business development. Project finance and structures are current needs in Mongolia.

Merchant banking. Merchant banks are similar to investment banks with the added feature of being able to "run" their own money; this means that they have the ability to make private equity investments in addition to all the other services an investment bank would provide. The advantage that these banks have is that they are in a position to identify private equity investment opportunities from the other services they provide.

Other forms of intermediation. Other forms of intermediation needed in Mongolia include access to private equity funds that have in their charter the mandate to invest in Asia. These funds are scattered throughout Asia and come in different forms and sizes. While not all of these Asian funds can or will invest in Mongolia, it is believed that there are funds that could consider investment opportunities in Mongolia.

Access to "angel investors" is another form of intermediation needed in Mongolia. Angels in the developed economies fund 30 percent – 40 percent more early-stage ventures than private equity funds. Angel investors offer greater flexibility than private equity funds and have many other advantages over funds. There are local Mongolian Angels that, through intermediation, could be well positioned to provide capital for local investment opportunities – on an individualized and case by case basis, rather than via a fund mechanism. A conduit for this activity is needed. An investment/merchant banker can represent either the investment opportunity ("sell-side") or the investor ("buy-side"). Intermediation between these two has obvious positive implications for the economy of Mongolia.

Forums can be efficient venues for bringing entrepreneurs and investors together in an open-dialogue fashion where both parties are able to get exposure to the market – to each other. They can be a particularly effective way to get angel investors identified and engaged in dialogue with entrepreneurs. A typical forum activity is to have a regularly scheduled gathering at a public facility, such as a hotel conference hall or dining area, where entrepreneurs are allowed to give a brief presentation on their company and for investors to make presentations themselves. Afterwards there is generally a reception or "mixer" where the two groups can mingle. Another important element that can be included is an educational presentation, such as a talk or workshop on the process of raising capital in the private equity markets and/or teaching investors the nuances of making private equity investments.

Projects such as EPRC could more actively support intermediation by using a client co-payment scheme to help cover intermediation fees and include a share of performance fees to be paid back to the project upon successful closure of a transaction.

5. *Explore venture leasing*. Venture leasing is a vehicle that allows start-up and early-stage companies to finance certain infrastructure and equipment needs. Venture leasing helps young companies cut down on their cash burn rates and focus their capital on their core business needs (e.g. working capital). Venture leasing is simply a hybrid of traditional leasing and venture capital meant specifically to address a certain market segment: the early stage company who needs to conserve as much equity capital as it can without diverting it to costs for equipment and infrastructure and without having to dilute their equity positions by seeking private equity investment. In a typical venture-leasing transaction, the lessor will lease equipment such as computers and office equipment to early stage companies at a certain interest rate for three to four years. The lessors will also customarily seek warrants for stock in addition to the lease payments, a back-end compensation intended to compensate the lessor for the additional risk in lending to a new company that would otherwise find it impossible to qualify for conventional bank or leasing firm financing. For the early stage company, there are many benefits to such an arrangement.

First, there is a large cash savings that the company might otherwise have had to spend on the purchase of the leased assets. It allows the company to use precious cash for core purposes such as research and development, sales and marketing.

Second, venture leasing provides a source of financing when a company doesn't qualify for bank or traditional leasing financing and/or when private equity capital is unavailable (as is the case in Mongolia).

Third, venture leases typically only require the leased asset as the sole or primary collateral for the lease, as opposed to a commitment of all of a company's assets.

For early stage companies that have already acquired assets and are looking to obtain more cash, venture leasing can also accommodate "sale/leaseback" arrangements, giving a start-up a way of drawing working capital out of assets it already owns by selling them in exchange for a cash infusion and a lease of the same assets.

We think that further effort is warranted in the exploration of venture leasing in Mongolia.

6. *Support education and training on financial instruments and markets, equity, quasi equity, and intermediation.* Entrepreneurs, bankers, and accountants in Mongolia need further exposure to current financial instruments, financial engineering, and financial markets. EPRC and partners should seek to exploit any available opportunity to get these groups together.

Section I of this report summarizes the purpose and scope of the study. Section II describes the methodology used in the due diligence process and Section III provides a summary of findings and recommendations. A series of appendices provide copies of instruments used in the due diligence process. Appendix E, *Summary Fact Sheet*, provides a specimen of companies' summaries. These write-ups on the companies analyzed include:

I. Confidentiality Agreement – To be signed and executed by any reader of the confidential information.
II. Important Notice – Addresses important legal issues and caveats.
III. Summary Fact Sheet - A one-page "snapshot" of the company.
IV. Executive Summary
   a. Overview
   b. Special considerations
      i. Growth record
      ii. Demand
      iii. Core business opportunity
      iv. Profit potential
      v. Diversified product offering
      vi. Market financing terms
      vii. Reputation in the marketplace
      viii. Customer base
      ix. Management team
      x. Barriers to entry
      xi. Risk factors
      xii. Reason for the transaction and anticipated form
V. Selected Financial Information – Derived from the financial model
VI. Analysis
   a. Free cash flows & IRR
   b. Ratio analysis
   c. Assumptions
VII. Conclusion

Confidentiality was of paramount importance. No *Company Summary Fact Sheets* will be part of this report, nor will any confidential information on any companies that were met in this process be included. There must be, now and in the future, tight limitations on who would have access to this confidential company information. Given this extreme importance of confidentiality of Investee Candidates' company information, the Summary Fact Sheets and any supporting documentation for each company are available only to the EPRC team of analysts who participated in the study and signed confidentiality agreements.

Only upon written consent from Investee Candidates and with signed confidentiality agreements will EPRC provide access to this confidential information to related parties that may be involved in potential transactions with the Investee Candidates or companies.

SECTION I: INTRODUCTION, PURPOSE, AND OBJECTIVES

Introduction

Mongolia is facing a tremendous challenge in financing private sector growth, yet it is this private sector growth, specifically the growth of small to medium sized enterprises that the economy of Mongolia is dependant on for sustainable long-term growth. The normal universe of capital sources that exist in more developed economies which grease the wheels of economic growth doesn't exist in Mongolia. Bank and non-bank financial institutions (NBFIs) debt providers are virtually the only sources of capital available, albeit at an extraordinarily high cost and with very restrictive covenants, leaving a huge gap in the market whose void would normally be filled by equity sources of capital (i.e. Angel, private equity, venture capital, non-financial corporate investors and public equity markets).

There is a need for alternative sources of capital in Mongolia, especially equity sources of capital and the expertise and business acumen that these bring to the table along with capital they provide. The purpose of this second stage feasibility study is to examine whether or not the market in Mongolia offers the investment opportunities that private equity investors seek.

This study was conducted over a two-month period, 17 January 2005 to 18 March 2005 and was financed by EPRC and the Open Society Forum (OSF). Mr. Bruce Norlund acted as team leader with assistance from Ms. Ashidmaa Dashnyam, a Finance and Business Specialist at EPRC, Mr. Sodnompil Baljinnyam and Mr. Tsetsen Dashtseren, Financial Analysts at EPRC and Ms. Munkhsoyol Baatarjav, a Project Manager at OSF.

Purpose and objectives

The purpose of this assignment was to follow-up on the initial feasibility study (it is recommended that this report be read in conjunction with the initial feasibility study) that was conducted in the fall of 2004 which was to help determine the efficacy of establishing a private equity fund in Mongolia as a new source of equity capital for potential investment opportunities that may exist in Mongolia.

The study conducted last fall addressed four general areas of concern:

- *Deal flow*. Gather initial data on potential deal flow of transactions that a local private equity fund may engage in; in particular, is there a sufficient number of companies and ventures with high-growth potential that could yield competitive returns to the fund and benefit from equity and quasi-equity investments;

- *Fund capitalization*. Canvass potential investors—individuals and institutional—for interest in capitalizing the fund, assessing their expectations for rates of return, risk perceptions and risk mitigation measures, preferences for sectors, size of investment, term, and exit strategies;

- *Grant-funded technical assistance fund (TAF)*. Assess donors and international financial institutions' (IFIs) perceptions and interest in contributing to the establishment of a companion, grant-funded technical assistance fund (TAF) to prepare companies for fund equity investments, provide assistance in transaction structuring, supervise fund investments, assist invested companies with execution, and exit strategies;

- *Preliminary analysis of the legal and regulatory environment and fund design requirements*. If, and only if the first three objectives yield reasonably satisfactory results, provide an initial assessment of the legal and regulatory environment and fund design requirements.

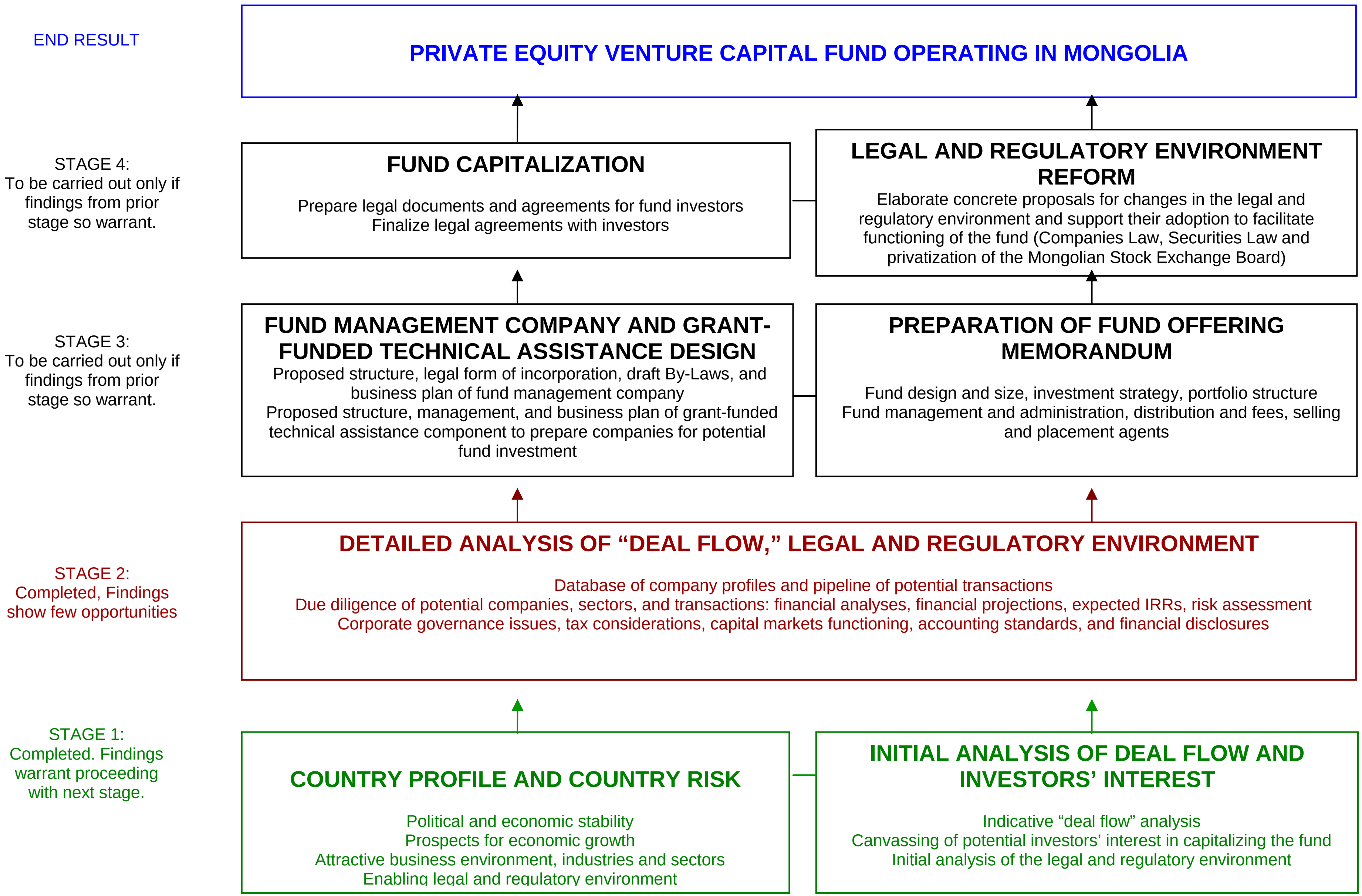
Based on the preliminary findings of the initial study, it was agreed that further effort was warranted to determine if there are investment opportunities in Mongolia that would be attractive to private equity investors. This was the impetus for the “Second Stage” of the overall study (see Exhibit I-1 below). Exhibit I-1, which was developed during the first stage of the study, provides a staged approach for the establishment of a private equity fund in Mongolia. The approach provides four broad stages or steps leading to the establishment of the fund:

1. Country profile, country risk and initial analysis of deal flow and investors’ interest
2. Detailed analysis of deal flow, legal and regulatory environment
3. Fund management company and grant-funded technical assistance design and preparation of Fund Offering Memorandum
4. Fund capitalization and legal and regulatory environment reform.

The essence of this second stage of the feasibility study was to conduct a due diligence analysis of companies interested in an equity investment that could present an investment opportunity attractive to private equity investors. The study focused on deal flow—one of the elements of the second stage of the process identified in Exhibit I-1 (shown in red).

Section II describes the methodology and process of due diligence followed. Section III summarizes the findings and recommendations.

Exhibit I-1: Staged approach for the establishment of a private equity venture capital fund in Mongolia



SECTION II: DUE DILIGENCE

A. Methodology

We took an "investor's view" in our due diligence process. We went about this mandate as though we were a General Partner ("GP") putting together an argument for the raising of a fund. We attempted to build a hypothetical portfolio of "Investee Candidates," (or "Candidates") as we named them, that would include at least 10 such Candidates or companies. Each of these Candidates would have to meet the basic criteria that any prudent private equity investor would require of a portfolio company in a developing market such as Mongolia.

Taking a portfolio theory approach, we sought to include those companies whose businesses were as negatively correlated as possible in an effort to mitigate risk. However, given the size of the market, this was difficult to accomplish. It is important to note that a "bottom-up" approach was taken in our search as opposed to a "top-down" approach. In a "thin market," such as Mongolia, we felt it was important to focus on promising "businesses" first, sectors second.

A1. Investor requirements

We searched for Investee Candidates that posed a significant investment opportunity, one in which the following basic criteria (see also Annex F: Process of Raising Private Equity) had to be met:

1. *Strong management team*. We looked for management teams that had extensive experience not only in managing profitable businesses but extensive experience in the industry in which they operate. It was very important to ascertain whether the management was transparent and honest. Furthermore, we asked ourselves whether we thought the management team could work synergistically with an investor or not. Experience has shown that businesses are quite eager to receive capital from private equity investors, but not so eager to have the investor help in the development of the business. These determinations cannot be made in just one, two or three meetings, thus we must indicate an important caveat: Judgments on managements were made based on only a few meetings and on "word on the street." For those management teams we viewed favorably, it must be noted that we could have been "fooled," and management teams would certainly need to be more thoroughly scrutinized before any investment is made.

2. *Large and growing market for goods or services – HIGH RETURN.* For any company that could be part of our portfolio, there had to be a strong growth story. Furthermore, it was important to determine the extent to which management of investee candidates ("management") could clearly describe their strategy to capture a significant market opportunity and how that strategy translated into cash flows. It was important for us to determine the intimacy management had with their numbers. We made a great effort to work with managements to determine their projected free cash flows over the next five years. We relied on historical accounting data as a reality check against projections. A very important caveat is that given the inconsistencies and errors and omissions in the non-IAFRS, un-audited historical financial statements that were provided to us by managements, we could only receive them and utilize

them at "face value." We had neither the time nor the wherewithal to attempt to validate the efficacy of such material financial information. We need to remind the reader that much of the information management provides during the initial due diligence meetings is normally taken at "face value." Only if and when an investor becomes intrigued by the "big picture" of an investment opportunity will he/she conduct a more comprehensive due diligence that will require greater validation of the numbers and may even include an audit by a reputable third-party auditing firm.

Required rate of return. This is one of the more difficult investor requirements to assess. Typical private equity required rates of return in a developed economy are generally very high, ranging from 20% to 60% (annualized returns – realized at exit) - depending on the stage of the company and typical risk factors. It is important to keep in mind that a private equity investor has no security such as a bank has in the form of collateral when giving a loan; an investor does not get paid a set interest. In a developing economy such as Mongolia, after accounting for the additional risks that are inherent in such an economy, such as legal risk, currency risk, political risk, etc., these required rates of return become even higher. When a required rate of return is higher than say 60%, an investor generally views the likelihood of such a high return being realized as being so small that the investment cannot be made.

3. *Planned exit (explicit).* Another mandatory requirement that must be met is how an investor will realize his/her return. Investors only realize their return when they are able to sell their shares—"exiting." A private equity investor, particularly in the developing markets, typically plans to be in any investment for a period of three to five years, seven at best. An investor cannot and will not make an investment unless there is a clear plan for how they are going to exit the investment and realize their return.

   The most common exit strategies are: 1) Via the public markets (IPO), 2) Through a strategic sale (selling to a corporation in a similar line of business), 3) By management buy-out (MBO) or share repurchase, 4) Through another institutional investor. For each investee candidate we analyzed, we tried to assess the viability of any of these possible ways of exiting the potential investment.

4. *Participation and board membership.* Private equity investors bring more to the table than just cash. Investors typically want to have a say in how the business is run in order to maximize value and returns; they also typically bring in management experience and expertise, as well as relationships (banking, accounting, legal, investment banking, etc) into a company. "Chemistry" (synergy) is paramount in the relationship between the candidate and the investor. Through our due diligence process, we tried to gauge how receptive the candidate would be to having the investor active in the management of the company.

5. *Founder's ongoing commitment.* Investors also prefer to see a founder who has a *substantial* portion of his/her net worth invested in the company and devotes

most of the time to it. Investors don't like conglomerates or conspicuous consumption on the part of founders. A key reason the investor wants to see this commitment is that he/she doesn't want to get stuck with a non-performing company (or worse) when things have gone bad and the owner has run off.

We attempted to assess this commitment along with the shareholding structure of the company—especially to see if it was part of a conglomerate.

6. *Well prepared documentation and financial statements.* This is always a challenging requirement for companies in the developing markets to meet; for most companies simply have not had the proper training in IAFRS and business planning. This presented a great challenge for our team. We did not have the luxury of time to do much in the way of accounting translations and as mentioned above, we had to take a lot of the information presented to us on "face value."

   It must be kept in mind that this list of requirements is not all inclusive. But, if these most critical requirements are not met, it is highly unlikely that a private equity investor would make an investment.

A2. Screening parameters

We did not want to impose overly strict screening parameters on the deals we were to look at. We wanted to look at companies that had at least some critical mass with a foundation that could be readily built up. We focused on companies that had at least $1 million in revenues and had a capital need of at least $500,000. No profit parameters were indicated for three main reasons, one being that we were mostly dealing with non-IAFRS statements and did not have time for accounting translations; secondly being because of the current tax situation in Mongolia; and thirdly because of the leveraged situations many Mongolian companies are in.

The key reason why we set such parameters is due primarily to the fact that transaction costs (including opportunity costs) are so high on private equity transactions and that smaller deals simply cannot justify this high cost.

We wanted to avoid companies in a conglomerate, but the reality dictated that this would not be entirely possible. This is partly to be blamed on the progressive tax system that is currently in place. This progressive tax rate compels many companies to break-up into smaller companies once they have reached the 100,000,000MNT (approximately $83,000) earnings before taxes (EBT) threshold because growing EBT further in the same company would double their tax burden. We also tried to steer away from start-ups, however we did include one start-up operation in our due diligence.

The above parameters were not hard-and-fast rules. There were companies that we reviewed that were below the parameters mentioned.

B. Deal sourcing

We met with several deal sources such as bankers, lawyers, accountants, advisors and other intermediaries. These deal sources helped in our pre-screening process. Given the time constraints, we had to get leads coming in very quickly as to allow us as much time as possible to conduct a "reasonable," though certainly not comprehensive due diligence, as any investor would conduct before committing capital to any investee candidate.

We were grateful for the eagerness of many of these sources to send leads our way. Over twenty-four companies were sourced of which eight became part of our portfolio and with whom we conducted a deeper due diligence.

C. Due diligence process employed

C1. Initial meeting

After receiving leads from either our deal sources or from our own searches and after pre-screening (as much as possible) those leads to see if they fit our basic screening parameters, we scheduled the initial due diligence meeting with the candidate. Our aim was to meet with the principal shareholders (decision makers) of the companies as well as the financial and operational managers. The purpose of the initial meeting was primarily to get a big picture of the companies' main business and opportunities. Most initial meetings were held "off-company campus."

A good deal of time was spent in each meeting explaining private equity as a capital source. Few of the companies we met with were familiar with equity capital sources and the private equity investment process. Unless the principals clearly understood the concepts and mechanics of private equity, it was going to be next to impossible to proceed with the due diligence process. As one can imagine, it was a lot of information for entrepreneurs to absorb in such a short time frame. This was one of the compelling reasons for us holding a four-hour seminar on raising capital in the private equity market (see Annexes F & G: Process of Raising Private Equity) for which all investee candidates were invited. We felt it was vital to provide more comprehensive information on this capital source.

After going over some of the basics of private equity, we then needed to discuss the issue of confidentiality, an issue that was of paramount importance to the candidate and to us.

If a candidate did not have their own confidentiality agreement (see Annex B: Confidentiality Agreement), we provided them one that was drawn up by EPRC to ensure the candidate that any information provided by the company would be held and used in the strictest of confidence. More importantly, as it was explained to the candidate, was the fact that regardless of the legal formality of a confidentiality agreement, the reputation risk of EPRC and all parties involved in this due diligence process was so high that all are compelled professionally not to breach confidentiality. Any breaches would cause irreparable damage. We were impressed with the number of companies that were quite forthcoming with their information—a clear indication of their interest in alternative capital sources.

We indicated that the information the companies provided could very well help us pose the argument that there are enough investment opportunities in Mongolia to justify the establishment of a private equity fund locally. The challenge however, was that we indeed were not sitting across the table from them as an investor, only as advisors who *might* be instrumental in bringing private equity into the market. It was difficult to ask for intimate details of a company when you are not a principal investor. Given this, we were pleased with and thankful to those who did indeed volunteer to participate in the due diligence process.

It was emphasized to the candidate that their effort would not be for naught and that regardless of whether or not we would be able to create a compelling argument for the development of a private equity fund in Mongolia based on our findings, that there would be alternative ways in which EPRC and other parties would endeavor to assist the candidates—*i.e.*, through intermediation, business development services, alternate financing methods, etc.

After this, the candidate then explained the background of his/her company and of his/her personal background (education, experience, successes, etc.) which was then followed by us asking some basic questions to determine whether the company warranted further due diligence. The primary queries made in the initial meeting were geared towards getting a clear picture of the capital structure of the company, the size of the company in revenues, the number of employees, the facilities owned/leased, and basic historical financial information (sales growth, gross margins, etc). We tried to get a sense of where the company was going in the future; projected sales growth, gross margins and issues related to their general plans for capturing market share. We also asked them to explain the dynamics of the industries and markets they were in.

C2. Decision to go further

If we had a general sense that the merits of the company we saw in our initial meeting seemed as if they *might* possibly be in line with those criteria listed in the Investor Requirements sections above, then we would ask to meet the company again to go further with the due diligence process.

We made it clear to the companies that if we decided not to pursue further due diligence on their company, that that was NOT a negative judgment on their business, but rather that their company was not yet at a stage that would be attractive to a private equity investor. It was reemphasized that there might be other ways in which EPRC (et al) might be able to help them. There were several companies that showed great promise, and while they might not be candidates for private equity investment at this time, they were well poised for other financing and assistance.

If a second meeting was to be held with a company, prior to the meeting, confidentiality agreements were sent to the company (both in English and Mongolian with the English version being the enforceable contract) to allow them to review and amend if necessary. Customarily a company would issue their own confidentiality agreement that their legal counsel has drawn up; however, this legal formality is a relatively new concept in Mongolia and many companies did not have confidentiality agreements of their own. We believed the exposing these companies to the issues of confidentiality and the legal issues of enforceable confidentiality agreements (that include non-compete clauses) was of benefit to the companies, and it is hoped that these companies will be encouraged to insist on initiating such agreements in the future. As mentioned in the seminar conducted (see Annexes F & G: Process of Raising Private Equity), the more sophistication companies show in their dealings with investors, the greater chance they have of securing investment.

Once the confidentiality agreements were signed by both parties and secured, then we would proceed to send the company the abridged due diligence list (see Annex C: Abridged Due Diligence List) we employed. The due diligence list we drew up was not meant to be comprehensive or all encompassing as would be used when an investor has serious interest in a candidate (and certainly used when they have signed a letter of commitment). This abridged list was used to help us gather the minimal information needed to make some “ball park” assessments as to the viability and efficacy of the investment opportunity we were analyzing. Again, time being at a premium, we had to minimize the information sought and make the process as efficient as was possible.

It would not be expected that the companies would be able to answer all questions on the due diligence list. It was given ahead of the second meeting so that the company could get familiar with the information that was going to be needed. The typical due diligence process entails a lot of back and forth questions and answers. It is not feasible to get all necessary information in one or two meetings.

The second meeting would take place at the companies’ facilities. The team leader attended all second meetings. The main purpose of the second meeting was to ask follow-up questions to the first meeting and to lay out the next steps of the due diligence process. The second meeting would also entail touring the plant and facilities to view actual operations and to make a cursory analysis of the company’s property, plant and equipment (PP&E). If any “red flags” (insurmountable challenges that would preclude a private equity investor from proceeding with due diligence) appeared during the second meeting, the meeting would likely be cordially called to a close. If information learned and facilities viewed passed a first-screening test, then one of the team’s analysts would be assigned to carry on the due diligence by working with principals and finance/accounting/operating staff to collect the necessary data. This back-and-forth process of data collection would take several more meetings over a several week period.

C3. Data inputs and preparation of financial statements

The analysts were responsible for the collection of financial data on each candidate and then creating financial statements (in IAFRS fashion as best as was possible) to analyze the company’s historical performance. The analyst then created the forecasted financial statements, based either solely on the information provided by management or based on the communal effort between the analyst and management.

C4. Financial analysis

We utilized a simplified financial model for our analysis purposes (see Annex D: Financial Statement Analysis Model). Using any more of a complex model would be folly for this exercise. The key issues that needed to be analyzed were [historical and future] sales growth, gross margins, operating margins, profit margins, debt/equity ratios, return on assets, return on equity, asset turnover, debt and tax burden, liquidity, interest coverage.

Extensive ratio analysis could not prove very valuable (few benchmarks and comparables plus potentially inaccurate data). The focus was identifying a growth “story” and what that story translated into a projected free cash flow from which the IRRs were calculated.

Time did not permit conducting elaborate scenario analysis. Rather than conducting scenario analysis (which is ideal in order to derive ranges of returns), the most conservative estimates were used in forecasting.

If a company could not indicate some semblance of a growth story that would translate into a significant return, then it would cease being an attractive candidate for a private equity investor and further analysis was not warranted.

C5. Development of Summary Fact Sheets (SFSs)

As the company information and financial data is coming in from the candidate, the Summary Fact Sheets ("SFSs") (see Annex E: Summary Fact Sheet Specimen) are developed. These write-ups on the companies analyzed include:

I. Confidentiality Agreement – To be signed and executed by any reader of the confidential information.
II. Important Notice – Addresses important legal issues and caveats.
III. Summary Fact Sheet - A one-page "snapshot" of the company.
IV. Executive Summary
    a. Overview
    b. Special considerations
        i. Growth record
        ii. Demand
        iii. Core business opportunity
        iv. Profit potential
        v. Diversified product offering
        vi. Market financing terms
        vii. Reputation in the marketplace
        viii. Customer base
        ix. Management team
        x. Barriers to entry
        xi. Risk factors
        xii. Reason for the transaction and anticipated form
V. Selected Financial Information – Derived from the financial model
VI. Analysis
    a. Free cash flows & IRR
    b. Ratio analysis
    c. Assumptions
VII. Conclusion

The conclusions section of the SFSs is meant to encapsulate briefly the team's opinions on whether or not the company poses a significant investment opportunity to a private equity investor.

D. Confidentiality

Confidentiality was of paramount importance. There must be, now and in the future, tight limitations on who would have access to this confidential company information. Given this extreme importance of confidentiality of Investee Candidates' company information, the Summary Fact Sheets and any supporting documentation for each company can not and will not be provided to the public or any other party outside of immediate analyst team at EPRC. The damage done by the slightest breach of confidentiality would be overwhelmingly detrimental to Investee Candidates, EPRC, USAID and all other parties involved (or interested) in this due diligence process. No SFSs will be part of this report, nor will any confidential information on any companies that were met in this process be included in this report.

In addition to confidentiality agreements initiated between EPRC and Investee Candidates, confidentiality agreements for EPRC staff and related parties involved in this due diligence process and any recipients of Investee Candidate confidential information have been initiated as well.

E. Challenges encountered

As is typical in any due diligence assignment, time considerations become an issue. It is not always easy to get the information that one requires and often times the information provided needs to be reworked or otherwise modified or translated, thus causing lengthy delays. Most companies have never presented themselves to investors before, so it is understandable that many do not have the experience and/or know-how in preparing proper business plans and financial statements.

F. Documentation Used

I. Confidentiality Agreements (see Annexes A & B)

II. Abridged Due Diligence list (see Annex C)

III. Financial Statement Analysis Model (see Annex D)

IV. Summary Fact Sheets (see Annex E for specimen)

SECTION III: FINDINGS AND RECOMMENDATIONS

A. Findings

Most of the companies reviewed fell into the size requirement that we had set: $1 million in revenue and a $500,000 capital need. There were companies that were below this threshold that were included in the due diligence because we deemed they might offer a potentially viable investment opportunity.

One could argue that we did not review enough companies to come to a definitive conclusion on the efficacy of private equity in the Mongolian market. This could be correct. However, a great effort in the screening process was made and we believe that deals sourced to us and deals we found on our own were the best sampling and representation of what the market currently has to offer.

There may be companies that could meet the basic criteria of a private equity investor, and indeed we did meet with companies that seemed (based on information provided in initial meetings) to offer a reasonable investment opportunities, however, those companies chose not to allow further due diligence. Many of the most promising companies in Mongolia that might be attractive investment opportunities (many are foreign owned) already have access to alternate sources of capital and have no need for capital from a locally based private equity fund.

From a strict private equity investor's viewpoint, we summarize our findings as follows:

Company	IRR
A	25%
B	3%
C	41%
D	n/a*
E	36%
F	47%
G	21%
H	-2%

1. *Companies' management***.** Many management teams/owners we met were impressive, especially given the nascence of the markets and their businesses. However, private equity investors tend to prefer management teams with richer and more extensive experience and with a greater number of "success stories." Management of the companies examined must be applauded for the great efforts and strides they have made in such challenging environments. Lack of experience in these developing markets is not uncommon and private equity funds that have a focus on the developing markets understand this well and some have the ability to make up for investee's lack of experience. Most though, will make this consideration only when other investors' criteria are amply met. We found that most of the management teams/owners we met with were forthcoming in providing information; however, it takes more than a few meetings to determine transparency and integrity.

2. *Required rate of return*. Establishing a required rate of return is fraught with difficulties given different investors' risk perceptions. Based on information supplied by the companies but not independently validated, findings from this stage indicate that internal rates of return (IRRs) of potential equity investments vary from -2% to 47% among the eight companies for which a due diligence analysis was performed. While there is promise, the potential pipe line of deal flow for traditional, "pure" private equity instruments appears weak. It is possible that given more

time for the conduct of the due diligence analysis additional companies may surface that are potentially attractive to traditional private equity investors but this is not guaranteed. We feel confident that the companies examined provide a reasonable sample of "top-tier" companies in Mongolia at this time. In particular, only four of the eight companies achieved a projected IRR of 25 percent or higher.

3. *Exit.* A key requirement for making a private equity investment in developing markets such as Mongolia is finding a way out of the investment—the exit—so that the return on investment can be realized. Exiting via the public market is not a viable possibility in Mongolia at this time. Whether this will be a likely option a few years from now remains to be seen and is contingent upon the development of the infant stock market. Under these circumstances, options for exiting from private equity investments are more restrictive and dependent upon management buy-outs, finding strategic investors, LBOs, and the like. These exit restrictions increase risk.

4. *Participation and board membership.* In our assessment of management teams/owners, we found mixed feelings in regards to the investors required participation in the development of the company and board membership. Approximately half of the companies we reviewed were highly receptive of the idea of accepting guidance from a private equity investor. Some were quite eager get help from a technical point of view as well as from a financial standpoint. But some companies saw an investor's requirement for participation as an intrusion and maybe did not fully understand the value an investor brings to the table besides their capital.

5. *Founder's commitment*. The challenge we saw on this issue was that many of the companies we reviewed were part of a group of companies. Private equity investors are generally adverse to investing in a company within a group. They prefer to work directly with a founder who has invested the vast majority of his/her net worth in the business.

6. *Business documentation.* While some companies made a respectable attempt at presenting proper documentation—business plans, financial statements, etc.—none had what a private equity investor would normally require. This is to be expected in an emerging market such as Mongolia.

B. Recommendations

1. *Conduct of a market study for a quasi-equity fund*. If the establishment of a *pure* private equity fund is unsupported by these findings, the market for quasi-equity instruments needs to be explored. As this second stage feasibility study focused exclusively on deal flow quality and size for traditional private equity instruments, the market for quasi-equity instruments targeted to small and medium enterprises (SMEs) was not examined. Lower transaction costs of quasi-equity instruments, greater ease of structuring, and lower average investment make them ideal for increasing the array of capital financing instruments for SMEs. Also known as "Shareholder Loan Funds," a quasi-equity fund combines a low-interest loan with minority equity participation, and "royalties"—a percentage of sales to achieve commercial returns to

investors. Terms of the loan vary between three and six years and the interest rate is set at or below the prevailing market rate. Collateral requirements for the loan are typically no less than 25 percent in pledges of business, personal assets pledges and shares, with no requirement for 100 percent collateral. The "royalties" or percentage of sales are set between one and five percent and the equity share varies between 15 and 49 percent—new shares, no dividends paid. Exit from the investment is achieved through owner buyback of the shares at a pre-determined multiple of purchase price or sales agreed upon in advance. The typically vexing problem of exit and owner's loss of company control is obviated. A technical assistance facility, provided through grant financing by the fund or by third parties, provides non-financial assistance in establishing financial controls at the company, strategic planning, market analysis, cost accounting and pricing, etc., as needed. Following the successful model of collaboration with other partners for the feasibility analysis of a private equity fund, EPRC could seek collaboration of the *Open Society Forum* and others for the conduct of market analysis for a the potential establishment of a quasi-equity fund .

2. *Conduct of a legal and regulatory analysis*. It is recommended that, parallel to the market study, an analysis of the legal and regulatory environment be carried out to adapt and design, as necessary, appropriate legal instruments for use in Mongolia in the potential implementation of such a fund. The "legal tool kit" in use in other countries needs to be adapted to the Mongolian legal and regulatory environment. EPRC could seek to partner with the *Asian Development Bank* (ADB) to carry out this analysis. As a potential fund investor, ADB has manifested keen interest in this collaboration.

3. *Preparation of a concept paper on alternative designs of the grant-financed technical assistance component*. Provided the market and the legal and regulatory analyses yield positive results, EPRC and partners should prepare a concept paper on the mechanisms to be used to provide technical non-financial assistance to potential investee firms. Mechanisms are already in place in Mongolia to provide this assistance. The Enterprise Restructuring Project and EPRC's Business Development Services already provide this assistance. These projects could work closely with the proposed fund, at least in the initial stages, to provide sources of deals, prepare companies for investment, and assist with the installation of needed core business systems at the firm level. There is an obvious synergy between the programs of business development assistance provided by these projects and the needs of the fund. For these projects, the fund would provide another potential source of finance for their client companies; for the fund, these projects would provide the needed technical assistance mechanism.

4. *Support intermediation.* Intermediation functions as a conduit between investors and entrepreneurs. An intermediary typically either represents a company seeking capital or represents an investor seeking investment opportunities. We believe that there is a great need for intermediation in Mongolia. Few companies here have the know-how for presenting themselves to the financial markets. Many companies not only need help in "packaging" themselves for presentation to capital sources, they need help in making themselves into investment opportunities. They need guidance in creating business strategies for capturing market opportunities, and they need help in translating those strategies into growing and sustainable cash flows. They need

help in financial management and operational management of their businesses as well as technical expertise. These areas of assistance can be covered through intermediation.

Intermediation can come in different forms. The most important for Mongolia are:

Investment banking: Investment banking can be performed by individuals or institutions which act as underwriters or agents for companies (and municipalities) raising capital or seeking to provide capital to, merge with or acquire another company. While many investment banks also maintain broker/dealer operations, maintain markets for previously issued securities, here in Mongolia the most needed role they can play is in raising capital in the debt and private equity markets and in offering advisory services to business owners and to investors. Investment bankers also typically provide corporate restructuring advisory services. Unlike commercial banks, they do not accept deposits from and provide loans to individuals or businesses. They focus mainly on functioning as a conduit between business owners and investors and in advising companies on business development. Project finance and structured are current needs in Mongolia.

Merchant banking. Merchant banks are similar to investment banks with the added feature of being able to "run" their own money; this means that they have the ability to make private equity investments in addition to all the other services an investment bank would provide. The advantage that these banks have is that they are in a position to identify private equity investment opportunities from the other services they provide.

Other forms of intermediation. Other forms of intermediation needed in Mongolia include access to private equity funds that have in their charter the mandate to invest in Asia. These funds are scattered throughout Asia and come in different forms and sizes. While not all of these Asian funds can or will invest in Mongolia, it is believed that there are funds that could consider investment opportunities in Mongolia.

Access to "angel investors" is another form of intermediation needed in Mongolia. Angels in the developed economies fund 30% - 40% more early-stage ventures than private equity funds. Angel investors offer greater flexibility than private equity funds and have many other advantages over funds. There are local Mongolian Angels that, through intermediation, could be well positioned to provide capital for local investment opportunities – on an individualized and case by case basis, rather than via a fund mechanism. A conduit for this activity is needed. An investment/merchant banker can represent either the investment opportunity ("sell-side") or the investor ("buy-side"). Intermediation between these two has obvious positive implications for the economy of Mongolia.

Forums can be efficient venues for bringing entrepreneurs and investors together in an open-dialogue fashion where both parties are able to get exposure to the market – to each other. They can be a particularly effective way to get angel investors identified and engaged in dialogue with entrepreneurs. A typical forum activity is to have a regularly scheduled gathering at a public facility, such as a hotel conference hall or dining area, where entrepreneurs are allowed to give a brief presentation on their company and for investors to make presentations themselves. Afterwards there is generally a reception or “mixer” where the two groups can mingle. Another important element that can be included is an educational presentation, such as a talk or workshop on the process of raising capital in the private equity markets and/or teaching investors the nuances of making private equity investments.

Projects such as EPRC could more actively support intermediation by using a client co-payment scheme to help cover intermediation fees and include a share of performance fees to be paid back to the project upon successful closure of a transaction.

5. *Explore venture leasing*. Venture leasing is a vehicle that allows start-up and early-stage companies to finance certain infrastructure and equipment needs. Venture leasing helps young companies cut down on their cash burn rates and focus their capital on their core business needs (e.g. working capital). Venture leasing is simply a hybrid of traditional leasing and venture capital meant specifically to address a certain market segment: the early stage company who needs to conserve as much equity capital as it can without diverting it to costs for equipment and infrastructure and without having to dilute their equity positions by seeking private equity investment. In a typical venture-leasing transaction, the lessor will lease equipment such as computers and office equipment to early stage companies at a certain interest rate for three to four years. The lessors will also customarily seek warrants for stock in addition to the lease payments, a back-end compensation intended to compensate the lessor for the additional risk in lending to a new company that would otherwise find it impossible to qualify for conventional bank or leasing firm financing. For the early stage company, there are many benefits to such an arrangement.

   First, there is a large cash savings that the company might otherwise have had to spend on the purchase of the leased assets. It allows the company to use precious cash for core purposes such as research and development, sales and marketing.

   Second, venture leasing provides a source of financing when a company does not qualify for bank or traditional leasing financing and/or when private equity capital is unavailable (as is the case in Mongolia).

   Third, venture leases typically only require the leased asset as the sole or primary collateral for the lease, as opposed to a commitment of all of a company's assets.

   For early stage companies that have already acquired assets and are looking to obtain more cash, venture leasing can also accommodate "sale/leaseback" arrangements, giving a start-up a way of drawing working capital out of assets it already owns by selling them in exchange for a cash infusion and a lease of the same assets.

We think that further effort is warranted in the exploration of venture leasing in Mongolia.

6. *Support education and training on financial instruments and markets, equity, quasi equity, and intermediation.* Entrepreneurs, bankers, and accountants in Mongolia need further exposure to current financial instruments, financial engineering, and financial markets. EPRC and partners should seek to exploit any available opportunity to get these groups together.

ANNEX A: CONFIDENTIALITY AGREEMENT - FOR EMPLOYEES OF EPRC

CONFIDENTIALITY AGREEMENT
For
Employees of and Consultants with
Chemonics International Inc. ("Chemonics") or with any of Chemonics' Subcontracting Companies
(herein considered "Chemonics")

In consideration of my employment with Chemonics, I will be exposed to information and materials which are confidential and proprietary and of vital importance to the economic well-being and reputation of Chemonics, its clients, and beneficiaries. I will not at any time disclose or use, either during or subsequent to my employment, any information, knowledge, or data which I receive or develop during my employment which is considered proprietary and/or confidential by Chemonics. This specifically includes information submitted to Chemonics by clients, prospective clients, affiliates and any other beneficiaries of Chemonics' services.

Such information, knowledge or data includes the following which is by example only: processes, know-how, designs, drawings, diagrams, formulas, test data, accounting or financial data, pricing or salary data, marketing data, business plans and strategies, negotiations and contracts, research, customer or vendor lists, inventions, and discoveries ['trade secrets'].

I further agree that upon termination of my employment with Chemonics, I shall promptly return any and all documents containing the above information, knowledge or data, or relating thereto, to Chemonics. This agreement shall be binding upon my successors, heirs, assigns, and personal representatives and shall be for the benefit of the successors and assigns of Chemonics.

In the event that a dispute arises concerning this agreement and a lawsuit is filed, the prevailing party shall be entitled to reasonable attorney's fees and costs. I acknowledge that the proprietary information and trade secrets are created at substantial cost and expense (both financial and non-financial) to Chemonics and that unauthorized use or disclosure would cause irreparable injury to Chemonics.

I hereby consent to the order of an immediate injunction, without bond, from any court of competent jurisdiction, enjoining and restraining me from violating or threatening to violate this provision. I understand that my continued employment with Chemonics is contingent upon my compliance with this agreement.

Governing law
This Agreement shall be governed and construed in accordance with the laws of Mongolia.

____
Employee's (Consultant's) Signature

____
Employee's (Consultant's) Name

____
Date

File: Chemonics Confidentiality Agreement 3 Feb 05.doc
Revised: 3 Feb 05

ANNEX B: CONFIDENTIALITY AGREEMENT - FOR INVESTEE CANDIDATES

CONFIDENTIALITY AGREEMENT

This Confidentiality Agreement ("Agreement") is made and effective on [day, month, year} by and between ____ ("Owner") and the *Economic Policy Reform and Competitiveness Project* (EPRC) financed by *the United States Agency for International Development* (USAID) represented by *Chemonics International Inc*. ("Recipient").

WHEREAS in the course of meetings and discussions held between Owner and Recipient concerning business development services and transaction support that Recipient may provide Owner may reveal to Recipient certain confidential information pertaining to Owner's business plans, clients, suppliers, financial and operating data, services, products and product development plans;

WHEREAS Owner wishes to protect certain exclusive rights and avoid non-authorized disclosure of such information;

WHEREAS the parties declare their intention to prevent knowledge by non-authorized third parties of such "confidential information" as defined further on in this Agreement.

NOW, THEREFOR, intending to be legally bound, the parties hereto agree as follows:

1. Definition of Confidential Information
Owner proposes to disclose certain of its confidential and proprietary information (the "Confidential Information") to Recipient. Confidential Information relates to products, processes, services, materials, technology, computer programs, specifications, manuals, business plans, software, marketing plans, business plans, financial information and commercial activities and shall include information relating to research, development, manufacturing, purchasing, accounting, engineering, marketing, merchandising, pricing and selling, including the identities of actual and prospective customers, the identity of key employees, pending bids and proposals, and present and future product lines and programs and notes, data, and records whether in hard copy or electronic form. Confidential Information disclosed orally shall be immediately identified as such. Nothing herein shall require Owner to disclose any of its information.

Recipient shall have no obligation under this Agreement with respect to Confidential Information which is or becomes publicly available without breach of this Agreement by Recipient; is rightfully received by Recipient without obligations of confidentiality; or is developed by Recipient without breach of this Agreement.

2. Use of Confidential Information
Recipient shall use Confidential Information provided by Owner solely and exclusively for the purpose of evaluating potential business development assistance and transaction support with interested third parties as authorized by Owner. Recipient shall not use nor cause to use such information to compete directly or indirectly with Owner's business. Recipient undertakes to protect such Confidential Information as if it were his own and exercise due care to prevent its theft, use or copy by its personnel not directly involved in negotiations with parties authorized by Owner.

3. Exclusive rights
All Confidential Information provided by Owner to Recipient shall remain the sole and exclusive property of Owner and Recipient shall return or destroy Confidential Information at the request of Owner. Nothing contained herein shall be construed as granting or conferring any rights by license or otherwise in any Confidential Information.

4. Legally mandated disclosure
At the petition of a government agency acting in a legal capacity Recipient may need to disclose Confidential Information provided by the Owner. Recipient shall provide written notice to Owner of such request to reveal Confidential Information. Recipient shall also advise the government agency that the information to be disclosed has been designated by the Owner as confidential and proprietary business information and is subject to this Confidentiality Agreement.

5. Term
This Agreement shall be effective for two years from the date of its signature unless terminated earlier and in writing by the parties.

6. Final Agreement
This Agreement terminates and supersedes all prior understandings or agreements on the subject matter hereof. This Agreement may be modified only by a further writing that is duly executed by both parties.

7. No Assignment
Recipient may not assign this Agreement or any interest herein without Owner's express prior written consent.

8. Severability
If any term of this Agreement is held by a court of competent jurisdiction to be invalid or unenforceable, then this Agreement, including all of the remaining terms, will remain in full force and effect as if such invalid or unenforceable term had never been included.

9. Governing law
This Agreement shall be governed and construed in accordance with the laws of Mongolia.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first above written.

CHEMONICS INTERNATIONAL INC., representing the *Economic Policy Reform and Competitiveness Project*, “RECIPIENT”:

Name:	______________________________
Address:	Chemonics International Inc. Tavan Bogd Plaza, Second Floor Eronhii said Amar Street-2 Ulaanbaatar, Mongolia
Telephone:	239-3439
Fax:	239-4188

Authorized signature of RECIPIENT: ______________________________

Name of OWNER:	______________________________
Address:	______________________________ ______________________________ ______________________________
Telephone:	______________________________
Fax:	______________________________
E-mail address:	______________________________

Authorized signature of OWNER: ______________________________

File: EPRC Confidentiality Ag 31-Jan-05.doc
Revised: 31-Jan-05

ANNEX C: ABRIDGED DUE DILIGENCE LIST

ANNEX C: ABRIDGED DUE DILIGENCE LIST

Contents

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1. Location and description of plant or plants and property (proximity to transportation facilities, materials sources and labor supply, availability and usage of utilities, title to realty, insurance coverage)	
2. Land information (acreage, market (appraised) value)	
3. Principal machinery and equipment (age and condition, technological obsolescence, accumulated depreciation, location and departmental use)	
4. Any surplus and idle buildings and equipment	
5. Estimated future plant, machinery and equipment requirements?	
PRODUCTION	
1. Nature of the manufacturing process (e.g., assembly, machine shop, extraction, metal forming)	
2. Important elements in the manufacturing process (e.g., capital investment, know how, design of plant, skilled labor, pool of available labor)?	
3. Production methods, efficiency and layout, storage and inventory requirements and warehousing facilities, major and critical raw materials, their availability and price prospects, make or buy practices, purchasing and inventory controls and subcontracting done by others	
4. General elements of production costs (materials, direct labor, indirect labor, manufacturing expenses)	
5. Factors that might lead to an increase in production costs	
6. Efficiency of the company's production process in relation to the industry	
PURCHASING	
1. Principal raw materials or products required, future price trends, market conditions, raw materials supply, competitors' activity and general economic conditions in suppliers' industries	
2. Sources of supply for critical materials (multiple or monopoly suppliers)	
3. Purchasing practice (long-term contract, bidding, etc.)	

INVENTORIES AND COSTING	
1. Trends in inventory levels, seasonal inventory fluctuations	
2. Factors and risks related to inventory (inventory security, insurance coverage)	
3. Inventory cost accounting procedures	
LABOR ISSUES	
1. Number of employees grouped into production, sales, purchasing, engineering and administration	
2. Employment contracts, employment recruiting and personnel policies and procedures	
3. Pay and incentive policies and procedures	
4. General labor market conditions, availability of skilled workers, turnover of personnel	
5. Information on management personnel:	
A. The organization of management functions and responsibilities	
B. Management and key employees, including position, career path, age, compensation, retention outlook and management training received	
C. Any employment agreements or unwritten understandings	
D. Key personnel retention policies	
E. The character and attitude of key personnel	
6. Employee benefit programs (any stock option or stock bonus plans)	
FINANCIAL DATA	
1. Have you obtained:	
A. Comparative financial results by major division?	
B. The most recent financial statements?	
C. Projected operating and financial statements?	
2. Have you examined operating results analyzing:	
A. Determine growth rates.	
B. The cost of goods sold, selling expenses and general and administrative expenses?	
C. All extraordinary and nonrecurring expenses for the periods reviewed? Schedule significant items in other income and expenses.	

D. Annual interest expense and other fixed charges?	
BALANCE SHEET REVIEW	
1. Have you reviewed cash position present and projected including:	
A. Listing banks where the company maintains accounts and related balances at balance sheet date?	
B. Reviewing monthly cash balances and inquiring about unusual fluctuations?	
C. Determining whether seasonal bank borrowings are required?	
2. For accounts receivable have you:	
A. Obtained an analysis of the total receivable balance for amounts due from customers, officers, employees and others?	
B. Accounts receivable agings? General history?	
C. Inquired about customer receivables including:	
- Terms of sales?	
- The number of customers?	
- The names of large customers and volume of annual sales to each by product line? Find out if there are any unusual arrangements with any of these customers.	
D. Ascertained the purpose and repayment terms of loans (other than minor amounts) to officers and employees?	
E. Evaluated the collection efforts?	
3. Concerning environmental regulations, do you know:	
A. Any environmental issues/liabilities?	
B. Any other liabilities?	
FINANCING AND CAPITAL STRUCTURE	
1. Total financial liabilities, including short- and long-term borrowings, collateral requirements, guarantees)	
2. Track record of loan repayment, any default	
3. Common stockholders' equity, shareholding structure, dividend policy	
4. Reinvestment policy, the extent to which the	

company's growth has been financed by internally generated cash	
5. Financial needs (Capital Expenditure, Working Capital)	
6. The company's capital budgeting procedures, planned sources of funds	
7. Existing debt repayment schedule vs operating cash flow	
FORECASTS	
1. Does the company forecast on a regular basis?	
2. Whether the company does projections of earnings and cash flow (worst, best and most probable scenarios) based on financial forecasts	
3. Key assumptions used in the company's financial forecasts	
4. Consideration of inflation, industry and overall business expectations, historical growth trends, industry conditions and known factors	
5. Cash flow projections	
FINANCIAL MANAGEMENT	
1. Financial accounting and reporting of the company	
2. Is the company audited by an independent accounting firm?	
3. Internal auditing controls and procedures of the company	
4. Whether interim reports / financial statements are prepared on a consolidated basis or only by autonomous entities	
IT	
1. Computerization of all significant accounting and operational functions	
2. Whether Enterprise Resource Management is developed and installed	
INSURANCE	
1. Availability of adequate insurance coverage	
2. Loss and claim experience	
TAX ISSUES	
1. Principal taxes	
2. The company's effective tax rate for the past three to five years	
3. Areas of concern regarding tax deductibility of	

business expenses (investment tax credit)	
4. Any problems with taxes to which the company is subject (e.g., property tax, excise tax, VAT)	
5. Tax records of items such as the tax basis of depreciable assets, basis of subsidiaries, accumulated earnings and profits and deferred taxes?	
CUSTOMS ISSUES	
1. The extent to which the company is vulnerable to customs policies and procedures	
2. Any problems and issues with the customs authorities, negative impact on the company's operations and results	
PLANNING	
1. Whether the company develops long-range as well as annual planning	
2. Who in the company is responsible for short- and long-range plans?	
3. Are the plans documented and communicated to the people responsible for implementing them?	
4. Do long-range plans reflect competitive reactions?	
5. Do plans include alternative strategies?	
6. Has the company a history of meeting its goals?	
7. Is actual compared to budget and is there a formal procedure for documenting variances?	
8. Is the budget regularly updated?	
9. Do you know what procedures are used to monitor the marketplace such as:	
A. Market share?	
B. Activities of competition?	
C. Attitudes of customers?	
INTERNAL CONTROLS	
1. Internal control policies and procedures	
2. Any cost reduction or profit improvement programs	
RESEARCH, DEVELOPMENT AND ENGINEERING	
1. The company's policy on research and development, percentage of sales that has been spent on research and development, any significant new products under development and the known RED activities of competitors	

2. Proprietary rights on products under development adequately secured to the company	
3. Any patents and trademarks held or that have been applied for	
LEGAL MATTERS	
1. Legal and regulatory environment where the company operates (whether the industry is regulated, licensing and certification requirements)	
2. Are any charges and litigation pending against the company	
3. Does the company have in-house counsel	
4. Compliance with specific regulatory requirements, including environmental, safety, health, occupational safety	
5. Any outstanding legal matters involving shareholders, incorporation and ownership issues	

ANNEX D: FINANCIAL STATEMENT ANALYSIS MODEL

ANNEX D: FINANCIAL STATEMENT ANALYSIS MODEL

The following are screen shots from the rudimentary financial model that was created. The following is only a sample and the numbers are fictitious:

	A	B	C	D	E	F	G	H
1	**Control Panel**							
2								
3								
4	Company:				Scenarios	Explain Scenario here:		
5					Worst Case			
6	COMPANY NAME CODE (Type over this)				Base Case			
7	Industry (Type over this)				Best Case			
8								
9								
10	**Assumptions:**							
11								
12	**Income Statement**							
13								
14	Sales Growth	20%	From 2005 forward					
15	COGS Growth	17%						
16	S,G & A Expense Growth	17%						
17	Other Operating Expense Growth	17%						
18								
19	Interest Expense (Annual int % x debt level)		(Annualized - very difficult to forecast)					
20	Non-operating income growth rate							
21	Non-operating expense growth rate							
22								
23	Income Tax		Effective Tax Rate					
24								
25	Earnings retention							
26								
27								
28	**Balance Sheet**							
29								
30	Cash and cash equivalents							
31	Accounts receivables, net		Greater than rate of Sales growth due to increase in credit extentions					
32	Inventories							
33	Other current assets							
34								
35	Property, plant and equipment							
36	Other non-current assets							
37								
38	Trade and other payables							
39	Other current & acrrued liabilities							
40	Short-term debt							
41	Provisions for liabilities and charges							
42								
43	Long term debt							
44								
45	Dividend Payout	0%						
46								

	A	B	C	D	E	G	H	I	J	K	L
1	***Selected Financial Information***										
2			**COMPANY NAME CODE (Type over this)**								
3			**Pro Forma Unaudited Financial Statements**								
4											
5			**For the periods ending December 31,**								
6			All USD in thousands								
7	**INCOME STATEMENT:**		**2002**	**2003**	**2004**	**2005E**	**2006P**	**2007P**	**2008P**	**2009P**	**2010P**
8											
9	Revenues		10,000	20,000	40,000	10,000	12,000	14,400	17,280	20,736	24,883
10	Cost of goods sold		5,000	10,000	20,000	5,000	5,850	6,845	8,008	9,369	10,962
11	**Gross margin**		5,000	10,000	20,000	5,000	6,150	7,556	9,272	11,367	13,921
12											
13	Selling, gen.and admin.expenses		1,000	1,100	1,200	1,400	1,638	1,916	2,242	2,623	3,069
14	Other operating expenses		30	40	60	70	82	82	82	82	82
15	**EBITDA**		3,970	8,860	18,740	3,530	4,430	5,557	6,948	8,661	10,770
16											
17	Depreciation & Amortization		500	500	500	500	500	500	500	500	500
18	**EBIT**		3,470	8,360	18,240	3,030	3,930	5,057	6,448	8,161	10,270
19											
20	Interest Expense		700	700	700	700	700	700	700	700	700
21	Non operating incomes/(expenses)		50	50	50	50	50	50	50	50	50
22	**EBT**		2,720	7,610	17,490	2,280	3,180	4,307	5,698	7,411	9,520
23											
24	Income tax		200	200	200	1,280	200	200	200	200	300
25	**Net Profit / (loss)**		2,520	7,410	17,290	1,000	2,980	4,107	5,498	7,211	9,220

	A	B	C	D	E	G	H	I	J	K	L
26											
27			**For the periods ending December 31,**								
28			All USD in thousands								
29	**BALANCE SHEET:**		**2002**	**2003**	**2004**	**2005E**	**2006P**	**2007P**	**2008P**	**2009P**	**2010P**
30	**ASSETS**										
31	**Currrent assets**										
32	Cash and cash equivalents		-	-	-	-	-	-	-	-	-
33	Accounts receivables, net		-	-	-	-	-	-	-	-	-
34	Inventories		-	-	-	-	-	-	-	-	-
35	Other current assets		-	-	-	-	-	-	-	-	-
36	**Total currrent assets**		-	-	-	-	-	-	-	-	-
37											
38	**Non-current assets**										
39	Property, plant and equipment		-	-	-	300,000	300,000	300,000	300,000	300,000	300,000
40	Other non-current assets		-	-	-	-	-	-	-	-	-
41	**Total non-current assets**		-	-	-	**300,000**	**300,000**	**300,000**	**300,000**	**300,000**	**300,000**
42											
43											
44	**TOTAL ASSETS**		-	-	-	**300,000**	**300,000**	**300,000**	**300,000**	**300,000**	**300,000**
45											
46	**LIABILITIES & EQUITY**										
47											
48	**Current liabilities**										
49	Trade and other payables		-	-	-	-	-	-	-	-	-
50	Other current & accrued liabilities		-	-	-	-	-	-	-	-	-
51	Short-term loans		-	-	-	-	-	-	-	-	-
52	Provisions for liabilities and charges		-	-	-	-	-	-	-	-	-
53	**Total current liabilities**		-	-	-	-	-	-	-	-	-
54											
55	**Non-current liabilities**										
56	Long term debt		-	-	-	-	-	-	-	-	-
57	**Total non-current liabilities**		-	-	-	-	-	-	-	-	-
58											
59	**Total liabilities**		-	-	-	-	-	-	-	-	-
60											
61	**Stockholders' equity & reserves**										
62	Ordinary shares		-	-	-	-	-	-	-	-	-
63	Reserves and funds		-	-	-	-	-	-	-	-	-
64	Retained Earnings		-	-	-	1,000	2,980	4,107	5,498	7,211	9,220
65	**Total equity and reserves**		-	-	-	**1,000**	**2,980**	**4,107**	**5,498**	**7,211**	**9,220**
66											
67	**TOTAL LIABILITIES & EQUITY**		-	-	-	**1,000**	**2,980**	**4,107**	**5,498**	**7,211**	**9,220**
68											
69	**Footnotes:**										
70	[1] CAGR for Historical Figures										
71	E = Estimated										
72	P = Projected										

	A	B	C	D	E	F	G	H	I	J	K	L
1												
2			COMPANY NAME CODE (Type over this)									
3			Pro Forma Unaudited Financial Statements									
4												
5			For the periods ending December 31,									
6			All USD in thousands									
7	**INCOME STATEMENT:**		2002	2003	2004	CAGR[1]	2005E	2006P	2007P	2008P	2009P	2010P
8												
9	Revenues		$ 10,000	$ 20,000	$ 40,000	100%	$ 10,000	$ 12,000	$ 14,400	$ 17,280	$ 20,736	$ 24,883
10	Cost of goods sold		5,000	10,000	20,000	100%	5,000	5,850	6,845	8,008	9,369	10,962
11	**Gross margin**		5,000	10,000	20,000	100%	5,000	6,150	7,556	9,272	11,367	13,921
12												
13	Selling, gen.and admin.expenses		1,000	1,100	1,200	10%	1,400	1,638	1,916	2,242	2,623	3,069
14	Other operating expenses		30	40	60	41%	70	82	82	82	82	82
15	**EBITDA**		3,970	8,860	18,740	117%	3,530	4,430	5,557	6,948	8,661	10,770
16												
17	Depreciation & Amortization		500	500	500	0%	500	500	500	500	500	500
18	**EBIT**		3,470	8,360	18,240	129%	3,030	3,930	5,057	6,448	8,161	10,270
19												
20	Interest Expense		700	700	700	0%	700	700	700	700	700	700
21	Non operating expenses/(income)		50	50	50	0%	50	50	50	50	50	50
22	**EBT**		2,720	7,610	17,490	154%	2,280	3,180	4,307	5,698	7,411	9,520
23												
24	Income tax		200	200	200	0%	1,280	200	200	200	200	300
25	**Net Income / (loss)**		$ 2,520	$ 7,410	$ 17,290	162%	$ 1,000	$ 2,980	$ 4,107	$ 5,498	$ 7,211	$ 9,220
26												
27	Footnotes:											
28	[1] CAGR for Historical Figures											

	A	B	C	D	E	F	G	H	I	J	K	L
1												
2			COMPANY NAME CODE (Type over this)									
3			Pro Forma Unaudited Financial Statements									
4												
5			For the periods ending December 31,									
6			All USD in thousands									
7	**BALANCE SHEET:**		2002	2003	2004	CAGR[1]	2005E	2006P	2007P	2008P	2009P	2010P
8	**ASSETS**											
9	**Currrent assets**											
10	Cash and cash equivalents		-	-	-	#DIV/0!	-	-	-	-	-	-
11	Accounts receivables, net		-	-	-	#DIV/0!	-	-	-	-	-	-
12	Inventories		-	-	-	#DIV/0!	-	-	-	-	-	-
13	Other current assets		-	-	-	#DIV/0!	-	-	-	-	-	-
14	**Total current assets**		-	-	-	#####	-	-	-	-	-	-
15												
16	**Non-current assets**											
17	Property, plant and equipment		-	-	-	#DIV/0!	#####	#####	300,000	300,000	300,000	300,000
18	Other non-current assets		-	-	-	#DIV/0!	-	-	-	-	-	-
19	**Total non-current assets**		-	-	-	#####	####	####	#####	#####	#####	#####
20												
21												
22	**TOTAL ASSETS**		-	-	-	#####	####	####	#####	#####	#####	#####
23												
24	**LIABILITIES & EQUITY**					#DIV/0!						
25												
26	**Current liabilities**											
27	Trade and other payables		-	-	-	#DIV/0!	-	-	-	-	-	-
28	Other current & accrued liabilities		-	-	-	#DIV/0!	-	-	-	-	-	-
29	Short-term debt		-	-	-	#DIV/0!	-	-	-	-	-	-
30	Provisions for liabilities and charges		-	-	-	#DIV/0!	-	-	-	-	-	-
31	**Total current liabilities**		-	-	-	#####	-	-	-	-	-	-
32												
33	**Non-current liabilities**											
34	Long term debt		-	-	-	#DIV/0!	-	-	-	-	-	-
35	**Total non-current liabilities**		-	-	-	#####	-	-	-	-	-	-
36												
37	**Total liabilities**		-	-	-	#####	-	-	-	-	-	-
38												
39	**Stockholders' equity & reserves**											
40	Ordinary shares		-	-	-	#DIV/0!	-	-	-	-	-	-
41	Reserves and funds		-	-	-	#DIV/0!	-	-	-	-	-	-
42	Retained Earnings		-	-	-	#DIV/0!	1,000	2,980	4,107	5,498	7,211	9,220
43	**Total equity and reserves**		-	-	-	#####	1,000	2,980	4,107	5,498	7,211	9,220
44												
45	**TOTAL LIABILITIES & EQUITY**		-	-	-	#####	1,000	2,980	4,107	5,498	7,211	9,220
46												
48												
49												
50	Footnotes:											
51	[1] CAGR for Historical Figures											

COMPANY NAME CODE (Type over this)
Pro Forma Projected Statement of Cashflows

For the Periods Ending December 31,
(All dollars in thousands)

Statement of Cash Flows	2005E	2006P	2007P	2008P	2009P	2010P
Net Income	1,000	2,980	4,107	5,498	7,211	9,220
Add: Non Cash Charges to Income Statement						
Depreciation & Ammortization	500	500	500	500	500	500
Deferred Taxes	0	0	0	0	0	0
Gross Cash Flow	1,500	3,480	4,607	5,998	7,711	9,720
Cash (Used)/Generated from Working Capital:						
Accounts Receivable	0	0	0	0	0	0
Inventory	0	0	0	0	0	0
Other Current Assets	0	0	0	0	0	0
Accounts Payable	0	0	0	0	0	0
Accrued Income Taxes Payable and Other Liabilities	0	0	0	0	0	0
Total Cash (Used)/Generated from Working Capi	0	0	0	0	0	0
Cash (Used)/Generated from Investing Activities:						
Capital Expenditures	(300,000)	0	0	0	0	0
Other Non Current Asset Changes	0	0	0	0	0	0
Total Cash (Used)/Generated from Investing Activ	(300,000)	0	0	0	0	0
Cash Generated/(used) from Financing Activities:						
Short-term debt	0	0	0	0	0	0
Provisions for liabilities and charges	0	0	0	0	0	0
Long-term debt	0	0	0	0	0	0
Total Cash Generated/(Used) from Financing Acti	0	0	0	0	0	0
Net Cash Provided/(Consumed)	(298,500)	3,480	4,607	5,998	7,711	9,720
Beginning Period Cash	0	0	0	0	0	0
Ending Period Cash	(298,500)	3,480	4,607	5,998	7,711	9,720

Calculating Free Cash Flows of the Unlevered Firm
Using the EBIT Method

COMPANY NAME CODE (Type over this)
Pro Forma Free Cash Flows

For the periods ending December 31,
All USD in thousands

	2005E	2006P	2007P	2008P	2009P	2010P
EBIT	3,030	3,930	5,057	6,448	8,161	10,270
Add: Depreciation	500	500	500	500	500	500
Subtract Cash Tax Payments	1,280	200	200	200	200	300
Subtract Net Capital Expenditures	(300,000)	-	-	-	-	-
Subtract Increases (add decreases) in required Net Working Capital	-	-	-	-	-	-
Free Cash Flows of Unlevered Firm	$ (295,190)	$ 4,630	$ 5,757	$ 7,148	$ 8,861	$ 11,070
IRR	#NUM!					

	A	B	C	D	E	F	G	H	I	J	K
4	**Profitability:**										
5	Gross Margin	50%	50%	50%	100%	50%	51%	52%	54%	55%	56%
7	Operating Margin	35%	42%	46%		30%	33%	35%	37%	39%	41%
9	Net Profit Margin	25%	37%	43%		10%	25%	29%	32%	35%	37%
13	**Dupont Analysis:**										
14	Operating Margin	35%	42%	46%		30%	33%	35%	37%	39%	41%
15	Asset Turnover	#DIV/0!	#DIV/0!	#DIV/0!		0.03	0.04	0.048	0.0576	0.06912	0.08294
16	Leverage	#DIV/0!	#DIV/0!	#DIV/0!		300	100.668	73.0435	54.5675	41.6018	32.5393
17	Interest Burden	0.78	0.91	0.96		0.75	0.81	0.85	0.88	0.91	0.93
18	Tax Burden	0.93	0.97	0.99		0.44	0.94	0.95	0.96	0.97	0.97
20	**ROA**	#DIV/0!	#DIV/0!	#DIV/0!		0.01	0.01	0.01686	0.02149	0.0272	0.03423
21	**ROE**	#DIV/0!	#DIV/0!	#DIV/0!		1	1	1	1	1	1
41	**Liquidity**										
42	Current Ratio (Current Assets/Current Liab)	#DIV/0!	#DIV/0!	#DIV/0!		#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!
44	Leverage										
45	Interest Coverage	5.0	11.9	26.1		4.3	5.6	7.2	9.2	11.7	14.7
46	Debt/Total Capital	#DIV/0!	#DIV/0!	#DIV/0!		0	0	0	0	0	0
47	Debt/Equity	#DIV/0!	#DIV/0!	#DIV/0!		0	0	0	0	0	0

$$ROE = \overbrace{\frac{\text{Net Profit}}{\text{Pretax Profit}}}^{\text{Tax Burden}} \times \overbrace{\frac{\text{Pretax Profit}}{\text{EBIT}}}^{\text{Interest Burden}} \times \underbrace{\overbrace{\frac{\text{EBIT}}{\text{Sales}}}^{\text{Return on Sales*}} \times \overbrace{\frac{\text{Sales}}{\text{Assets}}}^{\text{Total Asset Turn-over}}}_{\text{ROA}} \times \overbrace{\frac{\text{Assets}}{\text{Equity}}}^{\text{Leverage}}$$

ANNEX E: SUMMARY FACT SHEET SPECIMEN

Economic Policy Reform
and Competitiveness Project

Open Society Forum

CONFIDENTIAL

SUMMARY FACT SHEET

MEMORANDUM

SPECIMEN

Company No. xx

(FICTITIOUS COMPANY USED FOR EXPLANATION PURPOSES ONLY)

Economic Policy Reform and Competitiveness
Project
Chemonics
Ulaanbaatar, Mongolia

28 April 2005

USAID Contract No. 438-C-00-03-00021-00

CHEMONICS

TABLE OF CONTENTS

I. CONFIDENTIALITY AGREEMENT

This Confidentiality Agreement ("Agreement") is made and effective on [day, month, year] by and between *Economic Policy Reform and Competitiveness Project* (EPRC) financed by *the United States Agency for International Development* (USAID) represented by *Chemonics International Inc*. ("Owner") and ____of ____________________________

(the "Recipient").

WHEREAS in the course of meetings and discussions held and written information exchanged between Owner and Recipient concerning investment opportunities researched by the Owner that may reveal to the Recipient certain confidential information pertaining to Owner's research, Summary Fact Sheets written on investment opportunities, and any information obtained from Owner's discussions with potential investee candidates for a proposed private equity fund;

WHEREAS Owner wishes to protect certain exclusive rights and avoid non-authorized disclosure of such information;

WHEREAS the parties declare their intention to prevent knowledge by non-authorized third parties of such "confidential information" as defined further on in this Agreement.

NOW, THEREFOR, intending to be legally bound, the parties hereto agree as follows:

1. Definition of Confidential Information

Owner proposes to disclose certain of its confidential and proprietary information (the "Confidential Information") to Recipient. Confidential Information relates to products, processes, services, materials, technology, computer programs, specifications, manuals, business plans, software, marketing plans, business plans, financial information and commercial activities and shall include information relating to research, development, manufacturing, purchasing, accounting, engineering, marketing, merchandising, pricing and selling, including the identities of actual and prospective customers, the identity of key employees, pending bids and proposals, and present and future product lines and programs and notes, data, and records whether in hard copy or electronic form. Confidential Information disclosed orally shall be immediately identified as such. Nothing herein shall require Owner to disclose any of its information.

Recipient shall have no obligation under this Agreement with respect to Confidential Information which is or becomes publicly available without breach of this Agreement by Recipient; is rightfully received by Recipient without obligations of confidentiality; or is developed by Recipient without breach of this Agreement.

2. Use of Confidential Information

Recipient shall use Confidential Information provided by Owner solely and exclusively for the purpose of evaluating potential investment opportunities and to assess the viability of investment into these opportunities. Recipient shall not use nor cause to use such information to compete directly or indirectly with Owner's business. Recipient undertakes to protect such Confidential Information as if it were his own and exercise due care to prevent its theft, use or copy by its personnel not directly involved in negotiations with parties authorized by Owner.

3. Exclusive rights

All Confidential Information provided by Owner to Recipient shall remain the sole and exclusive property of Owner and Recipient shall return or destroy Confidential Information at the request of Owner. Nothing contained herein shall be construed as granting or conferring any rights by license or otherwise in any Confidential Information.

4. Legally mandated disclosure
At the petition of a government agency acting in a legal capacity Recipient may need to disclose Confidential Information provided by the Owner. Recipient shall provide written notice to Owner of such request to reveal Confidential Information. Recipient shall also advise the government agency that the information to be disclosed has been designated by the Owner as confidential and proprietary business information and is subject to this Confidentiality Agreement.

5. Term
This Agreement shall be effective for two years from the date of its signature unless terminated earlier and in writing by the parties.

6. Final Agreement
This Agreement terminates and supersedes all prior understandings or agreements on the subject matter hereof. This Agreement may be modified only by a further writing that is duly executed by both parties.

7. No Assignment
Recipient may not assign this Agreement or any interest herein without Owner's express prior written consent.

8. Severability
If any term of this Agreement is held by a court of competent jurisdiction to be invalid or unenforceable, then this Agreement, including all of the remaining terms, will remain in full force and effect as if such invalid or unenforceable term had never been included.

9. Governing law
This Agreement shall be governed and construed in accordance with the laws of Mongolia.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first above written.

________________________________ the "RECIPIENT":

Name: ________________________________
Address:

Telephone:
Fax:

Authorized signature of RECIPIENT: ________________________________

Name of "Owner": ________________________________
Address: Chemonics International Inc.
Tavan Bogd Plaza, Second Floor
Eronhii said Amar Street-2
Ulaanbaatar, Mongolia
Telephone: 239-3439
Fax: 239-4188

Authorized signature of OWNER: ________________________________

File: EPRC Confidentiality Ag 31-Jan-05.doc
Revised: 31-Jan-05

II. IMPORTANT NOTICE

This Confidential Summary Fact Sheet together with any appendices and/or accompanying electronic information (jointly referred to as the "Memorandum") has been compiled the Economic Policy Reform and Competitiveness Project ("EPRC") on the basis of information supplied and prepared by Company XX ("Company XX" or "the Company") and the Company's Management ("Management").

The information contained herein has been prepared solely to assist EPRC in deciding whether to proceed with an in-depth, comprehensive due diligence investigation of the Company for the prospective purpose of assessing the economic merits the Company possesses and the investment opportunity the Company may present to an investor. This Memorandum does not purport to contain all of the information that EPRC or any prudent investor would normally require when making an investment decision. In fact, this Summary Fact Sheet provides only limited information as to the efficacy of the Company's financial strength and the business opportunities Management portends to exploit, orally or in writing.

EPRC has not independently verified any of the information contained herein, or undertaken an audit. EPRC, nor any persons who are or were at the relevant time their partners, directors, representatives, officials, employees, consultants or agents ("Partners Involved") make any representation or warranty as to the accuracy or completeness of the Memorandum and shall have no responsibility or liability for any representations or statements (expressed or implied) contained in, or for any omissions from, the Memorandum or any other written or oral communications transmitted to EPRC in the course of its evaluation of the Company.

This Memorandum includes certain statements, estimates and projections provided by the Company with respect to the anticipated future performance of the Company. Such statements, estimates and projections reflect various assumptions concerning anticipated results, which assumptions may or may not prove to be correct and involve subjective determinations. No representations are made as to the accuracy or attainment of such statements, estimates or projections.

By accepting this Memorandum, the Recipient acknowledges and agrees that: (a) all of the information contained herein is subject to the Confidentiality Agreement executed between the Recipient and EPRC in respect to information pertaining to the Company; (b) the contents of this Memorandum and any other information relating to the Company provided to the Recipient shall remain the sole property of the Company and EPRC (and any successors thereto), and shall not be copied, reproduced or distributed (electronically or otherwise) to others without the prior written consent of the Company and EPRC; and (c) the Company and EPRC, on behalf of the Company, may require the return or destruction/deletion (in the case of electronically-transmitted information) of the Memorandum together with any other material relating to the Company which the Recipient may have received from the Company or EPRC at any time.

All inquiries regarding this Company and any requests for information about the Company should be directed to EPRC whose coordinates are as follows:

Economic Policy Reform and Competitiveness Project
Tavan Bogd Plaza, Second Floor
Eronkhii Said Amar Street, Sukhbaatar District
Ulaanbaatar, Mongolia

Telephone: +976 (11) 32 13 75 Fax: +976 (11) 32 78 25
"Due Diligence Team"
Bruce Norlund- Consultant
bnorlund@eprc-chemonics.biz

Ashidmaa Dashnyam	Sodnompil Baljinnyam	Tsetsen Dashtseren
ashidmaa@eprc-chemonics.biz	sodnompil@eprc-chemonics.biz	Tsetsen@eprc-chemonics.biz

III. SUMMARY FACT SHEET

COMPANY: Company No. XX — **INDUSTRY: XX**

Street
Ulaanbaatar, Mongolia

REFERRAL SOURCE:
ANALYST:

BUSINESS: Company XX is one of the largest printing and packaging companies in Mongolia. The Company offers a broad product line and an array of services that include graphic design, pre-press, printing and packaging (cardboard, paper and labels), printed media (books, magazines, flyers, brochures and newspapers) and auxiliary activities (binding, cutting, etc). The Company is known for providing high-quality, timely delivered products and services.

The Company is seeking funds for both the expansion of its core business capacity and for entry into the flexible printing and packaging market. The Company is presently operating at full capacity and wishes to increase this current capacity in order to satisfy the existing and projected demand for Company XX's products and services. In addition to this, the Company plans to enter into the much larger flexible printing and packaging market, estimated to be around $ • in Mongolia and in which 90% of flexible packing product are being imported. The Company estimates that it will be able to capture 10% of this market in the first two years and an additional 5% in the following • years.

FACILITIES: The Company maintains its principal sales and administrative office in a 2,200 square meter office in the Industrial Zone in UB at the address above. In addition, the Company has six other sales and marketing offices, which have been started or acquired generally since 1997, in China, Russia, and in Thailand.

OWNERSHIP: The Company is wholly owned by the following individuals (as of February 2005:

Name	Shares Owned	Percent of Common Ownership
XX	XX	XX%
XX	XX	XX%
XX	XX	XX%
XX	XX	XX%
Total	XX	100%

EMPLOYEES: As of _______________, the Company had • employees. None of the employees are unionized, nor has the Company ever experienced a strike or work stoppage.

Summary Financial Data
(Dollars in Thousands)

	Year ending December 31, (a)								
	2002	2003	2004	2005E	2006P	2007P	2008P	2009P	2010P
Revenues	10,000	20,000	40,000	10,000	12,000	14,400	17,280	20,736	24,883
Gross Margin	5,000	10,000	20,000	5,000	6,150	7,556	9,272	11,367	13,921
Operating Income	3,470	8,360	18,240	3,030	3,930	5,057	6,448	8,161	10,270
Net Income	2,520	7,410	17,290	1,000	2,980	4,107	5,498	7,211	9,220

E = Estimated
P = Projected

IV. EXECUTIVE SUMMARY

A. Overview

Company No. XX is one of the largest packaging and printing companies in the country. The Company offers a broad product line and an array of services including graphic design, pre-press, printing, auxiliary activities (binding, cutting, etc). The Company conducts its operations from its UB headquarters and six field offices throughout the country. Company No. XX's management team and apparent market reputation with its customers has led to a record of growth and achievement. The Company seems to have succeeded to evolve in a highly competitive market, and, in spite of the general difficulties of the country's economy.

Company No. XX seems well positioned with products and personnel to capitalize on a variety of the emerging market opportunities that exist in Mongolia. Operating as a small business in 1994, Company No. XX was founded as a small printing shop for one color printing (flyers). In the 1995, when new printing equipment was acquired, Company No. XX progressed with the industry to become an important supplier of packaging mainly for Antibiotic UB, on of the largest antibiotics producers in Asia. Also in 1995 the company became a preferred supplier of packaging for a national brand of soups, with facilities in UB. The Company has opened six regional offices since 1997.

Throughout its history, the Company has maintained a relatively strong position as a quality producer and has made efforts to offer the best quality services and diverse product lines in accordance with its clients needs (diversification of printing – colors number, embossing, folio). In keeping with industry changes and increasing product and customer sophistication, Company No. XX consists of three basic segments:

- Cardboard packaging for pharmaceutical products, sweets, cosmetics, industrial components (e.g., electric bulbs);
- Paper packaging and labels (mainly for food products, drinks, etc); and
- Book and magazine printing.

The Company's management team seems to have significant experience (over 40 years of collective industry experience. Company No. XX has 216 non-union employees in the operations, sales, support and administrative areas for the corporate and field offices.

B. Special Considerations

Growth Record

Company No. XX has been able to achieve market share growth despite competitive marketplace (it currently has 8% market share). For fiscal 2001, the Company has experienced a • % rate of growth in the first six months of operations of 2001 compared to 2000 and expects an annual increase of • %.

Demand

Based on the demand from the Company's primary clients, expanding into the production of flexographic printing can bring significant growth. Management believes it has a strong reputation and formula for continued revenue growth for the future.

Core Business Opportunity

Company No. XX has developed a respectable client base and achieved recognition as a quality provider in the marketplace. Management believes Company No. XX's critical mass, operating philosophy, and management strength offers the Investor a substantial platform to become the leading printing and packaging producer in Mongolia. Management is aware of certain opportunities in the marketplace to execute this strategy especially in the flexible packaging arena.

Profit Potential

For the first six months of 2001, Company No. XX has experienced rapid profit growth as the Company developed its processing capacities, increased the size of its value added services segment, and refined its operating procedures. The Company's operating profits have increased • % for the first six months of 2001 on a sales increase of • %.

Diversified Product Offering

Company No. XX offers a large range of products from printed paper and cardboard, printed labels, leaflets, brochures, posters, specialized cardboard packaging for medical drugs, food products, industrial goods, books and magazine printing, in a large range of paper weights or types, with special procedures as embossing or folio. All paper and cardboard supply is quality paper that is imported.

Favorable Market Financing Terms

Because of the Company’s capabilities and historical reputation, Company No. XX is privy to favorable financing terms on its inventory purchased from suppliers and on its bank revolving credits.

Reputation in the Marketplace

Company No. XX has earned an positive reputation in the marketplace with their customers and suppliers. The Company considers its customer retention and repeat purchase rates to be strong.

Customer Base

Company No. XX has a stable and prominent customer base. The Company has approximately 28 major active customers, which includes leading private businesses, multinationals, educational institutions and governmental agencies in Mongolia, many of whom have been customers of Company No. XX for more than four years.

Management Team

Company No. XX possesses an experienced and professional management team. Officers of the Company possess over 40 years of cumulative industry experience. All specialists, including line workers, were trained by industry specialists - many of them abroad (e.g. Germany, Spain). The Company believes it has the requisite personnel to achieve the forecast included herein.

Barriers to Entry

Company No. XX's reputation and size within the marketplace offers it a significant market position. The Company believes the investment requirements in people, facilities, technology, and vendor and customer relations make new entry to the marketplace difficult. The industry is very capital intensive. In addition to this, clients’ individual demands tend to be highly inelastic. Once clients are satisfied with the initial products or services purchased, they have a strong propensity to remain clients of the Company on a long-term basis.

Risk Factors

The Company is subject to various risks such as economic recession, competitive forces within the marketplace, supply of quality products and labor and business budgets. The marketplace for the Company's services is highly competitive. The Company relies mainly on its reputation, level of service and innovative abilities to develop and maintain its market position.

C. Reason for the Transaction and Anticipated Form

The CEO and principal shareholder of Company No. XX, Mr. Soko Doe, wishes to raise capital, $2 million, in the private equity market to cover the capital expenditures necessary for expanding his business into the flexible printing and packaging industry, which is greatly underserved in Mongolia. The monies will be used to purchase additional printing and packaging equipment in order to supply this market.

V. *Selected Financial Information*

COMPANY NAME CODE (Type over this)

Pro Forma Unaudited Financial Statements

For the periods ending December 31, All USD in thousands

INCOME STATEMENT:	2002	2003	2004	2005E	2006P	2007P	2008P	2009P	2010P
Revenues	10,000	20,000	40,000	10,000	12,000	14,400	17,280	20,736	24,883
Cost of goods sold	5,000	10,000	20,000	5,000	5,850	6,845	8,008	9,369	10,962
Gross margin	5,000	10,000	20,000	5,000	6,150	7,556	9,272	11,367	13,921
Selling, gen.and admin.expenses	1,000	1,100	1,200	1,400	1,638	1,916	2,242	2,623	3,069
Other operating expenses	30	40	60	70	82	82	82	82	82
EBITDA	3,970	8,860	18,740	3,530	4,430	5,557	6,948	8,661	10,770
Depreciation & Amortization	500	500	500	500	500	500	500	500	500
EBIT	3,470	8,360	18,240	3,030	3,930	5,057	6,448	8,161	10,270
Interest Expense	700	700	700	700	700	700	700	700	700
Non operating incomes/(expenses)	50	50	50	50	50	50	50	50	50
EBT	2,720	7,610	17,490	2,280	3,180	4,307	5,698	7,411	9,520
Income tax	200	200	200	1,280	200	200	200	200	300
Net Profit / (loss)	2,520	7,410	17,290	1,000	2,980	4,107	5,498	7,211	9,220

For the periods ending December 31, All USD in thousands

BALANCE SHEET:	2002	2003	2004	2005E	2006P	2007P	2008P	2009P	2010P
ASSETS									
Currrent assets									
Cash and cash equivalents	-	-	-	-	-	-	-	-	-
Accounts receivables, net	-	-	-	-	-	-	-	-	-
Inventories	-	-	-	-	-	-	-	-	-
Other current assets	-	-	-	-	-	-	-	-	-
Total currrent assets	-	-	-	-	-	-	-	-	-
Non-current assets									
Property, plant and equipment	-	-	-	300,000	300,000	300,000	300,000	300,000	300,000
Other non-current assets	-	-	-	-	-	-	-	-	-
Total non-current assets	-	-	-	**300,000**	**300,000**	**300,000**	**300,000**	**300,000**	**300,000**
TOTAL ASSETS	-	-	-	**300,000**	**300,000**	**300,000**	**300,000**	**300,000**	**300,000**
LIABILITIES & EQUITY									
Current liabilities									
Trade and other payables	-	-	-	-	-	-	-	-	-
Other current & acrrued liabilities	-	-	-	-	-	-	-	-	-
Short-term loans	-	-	-	-	-	-	-	-	-
Provisions for liabilities and charges	-	-	-	-	-	-	-	-	-
Total current liabilities	-	-	-	-	-	-	-	-	-
Non-current liabilities									
Long term debt	-	-	-	-	-	-	-	-	-
Total non-current liabilities	-	-	-	-	-	-	-	-	-
Total liabilities	-	-	-	-	-	-	-	-	-
Stockholders' equity & reserves									
Ordinary shares	-	-	-	-	-	-	-	-	-
Reserves and funds	-	-	-	-	-	-	-	-	-
Retained Earnings	-	-	-	1,000	2,980	4,107	5,498	7,211	9,220
Total equity and reserves	-	-	-	**1,000**	**2,980**	**4,107**	**5,498**	**7,211**	**9,220**
TOTAL LIABILITIES & EQUITY	-	-	-	**1,000**	**2,980**	**4,107**	**5,498**	**7,211**	**9,220**

Footnotes:

E = Estimated

P = Projected

VI. Analysis

Based on the information provided by management, the Due Diligence Team ……

A. FREE CASH FLOWS & IRR

Calculating Free Cash Flows of the Unlevered Firm
Using the EBIT Method

COMPANY NAME CODE (Type over this)
Pro Forma Free Cash Flows

For the periods ending December 31,
All USD in thousands

	2005E	2006P	2007P	2008P	2009P	2010P
EBIT	3,030	3,930	5,057	6,448	8,161	10,270
Add: Depreciation	500	500	500	500	500	500
Subtract Cash Tax Payments	1,280	200	200	200	200	300
Subtract Net Capital Expenditures	(300,000)	-	-	-	-	-
Subtract Increases (add decreases) in required Net Working Capital	-	-	-	-	-	-
Free Cash Flows of Unlevered Firm	$ (295,190)	$ 4,630	$ 5,757	$ 7,148	$ 8,861	$ 11,070

IRR	#NUM!

B. RATIO ANALYSIS

Scenario - Base Case										
Ratios:	**2002**	**2003**	**2004**	**CAGR[1]**	**2005E**	**2006P**	**2007P**	**2008P**	**2009P**	**2010P**
Profitability:										
Gross Margin	50%	50%	50%	100%	50%	51%	52%	54%	55%	56%
Operating Margin	35%	42%	46%		30%	33%	35%	37%	39%	41%
Net Profit Margin	25%	37%	43%		10%	25%	29%	32%	35%	37%
Dupont Analysis:										
Operating Margin	35%	42%	46%		30%	33%	35%	37%	39%	41%
Asset Turnover	#DIV/0!	#DIV/0!	#DIV/0!		0.03	0.04	0.048	0.0576	0.06912	0.082944
Leverage	#DIV/0!	#DIV/0!	#DIV/0!		300	100.6678	73.04353	54.56751	41.60183	32.53926
Interest Burden	0.78	0.91	0.96		0.75	0.81	0.85	0.88	0.91	0.93
Tax Burden	0.93	0.97	0.99		0.44	0.94	0.95	0.96	0.97	0.97
ROA	#DIV/0!	#DIV/0!	#DIV/0!		0.01	0.01	0.016857	0.021493	0.027204	0.034232
ROE	#DIV/0!	#DIV/0!	#DIV/0!		1	1	1	1	1	1

$$ROE = \overbrace{\frac{Net\ Profit}{Pretax\ Profit}}^{Tax\ Burden} \times \overbrace{\frac{Pretax\ Profit}{EBIT}}^{Interest\ Burden} \times \underbrace{\overbrace{\frac{EBIT}{Sales}}^{Return\ on\ Sales*} \times \overbrace{\frac{Sales}{Assets}}^{Total\ Asset\ Turn\text{-}over}}_{ROA} \times \overbrace{\frac{Assets}{Equity}}^{Leverage}$$

	2002	2003	2004	CAGR[1]	2005E	2006P	2007P	2008P	2009P	2010P
Liquidity										
Current Ratio (Current Assets/Current Liab)	#DIV/0!	#DIV/0!	#DIV/0!		#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!
Leverage										
Interest Coverage	5.0	11.9	26.1		4.3	5.6	7.2	9.2	11.7	14.7
Debt/Total Capital	#DIV/0!	#DIV/0!	#DIV/0!		0	0	0	0	0	0
Debt/Equity	#DIV/0!	#DIV/0!	#DIV/0!		0	0	0	0	0	0

VII. Assumptions

The accompanying Five Year Financial Forecast included in the Selected Financial Statements (above) was prepared by Management using their best estimate as a result of their intended courses of action and expected future operations of the Company.

VIII. Conclusion

Exhibit A. Financial Forecast

Exhibit B. Management Biographies

ANNEX F: PROCESS OF RAISING PRIVATE EQUITY - SEMINAR - TOPICS COVERED

ANNEX F: PROCESS OF RAISING PRIVATE EQUITY - SEMINAR - TOPICS COVERED

A. Importance

A great effort needed be made in the education of entrepreneurs in order for the due diligence process to work. Furthermore, it was important to have everyone that would ultimately be involved in this due diligence process understand the fundamentals of what private equity investment entailed. When a market is mostly familiar only with debt capital, myths and misconceptions about equity capital become pervasive. In order to dispel these myths and misconceptions, training and hand-holding must be made to help elevate the level of entrepreneurial savvy and financial sophistication.

B. Private Equity Seminar

Given that there was such an educational need, we decided that a seminar would be a good forum for getting all players who were interested in the subject of raising capital in the private equity market together in an interactive workshop environment.

On February 18th 2005, Mr. Norlund held a 4-hour seminar on the process of raising capital in the private equity market. The seminar was directed towards entrepreneurs, bankers, accountant, lawyers, advisors and intermediaries in Mongolia in an effort to increase the level of understanding of private equity as a source of capital and to illustrate what is required of businesses in order to attract private equity investment.

Key topics covered in the seminar:

1. **Universe of capital sources and the role private equity plays in the market** - For many companies, one of the only sources of capital that they are familiar with are the commercial banks. The purpose of this section was to expose the participant to the full array of capital sources. Before discussing the sources, bootstrapping techniques were addresses as well as the effect of putting off capital raising as long as possible and the importance of bootstrapping to investors. Sources covered were:

    a. **Founder, Family, Friends –** One important aspect here is that any potential investor is going to be concerned with what percentage of the founders' wealth is invested in their company.
    b. **Micro-lending –** Focused on the vital function micro-lenders are serving in the developing economies.
    c. **Angels –** Covered details on this widely available, but elusive capital source. Discussed the number and amounts annually transacted through Angels, the importance of this source for Mongolian companies and the difficulties in finding Angels.
    d. **Private Equity Funds –** Here the various types of funds were addressed:
        i. Venture capital funds
        ii. Buy-out funds
        iii. Merchant banking funds
        iv. Fund-of-funds
        v. Mezzanine funds

    e. **Non-financial corporations –** This source tends to get little attention, yet it can be a viable source of equity and quasi-equity financing.
    f. **Public equity markets –** On this topic, there was a brief discussion on the challenges that any nascent market faces not just the Mongolian market.

g. **Commercial banks** – Every Mongolian business owner is familiar with the commercial lending predicament that Mongolia is in. Here we discussed briefly certain issues with commercial banks and how alternative capital sources can "grease" the wheels of Mongolia's developing economy.

Also discussed were the amounts of money available in the private equity market and the ever important risk/reward profiles of each capital source to help explain varying costs of capital/required rates of return.

2. **Structure of the private equity industry** – This topic addressed the "where" the money is found and "what flavor" the money comes in. The variety of private equity funds in the market were discussed as well as who the investors in the funds are, such as fund-of-funds, insurance companies, pension funds, divisions of merchant banks, corporations, Angels, et al. How to FIND private equity investors, something that is very important to companies here in Mongolia, was also covered.

3. **How a private equity fund works** – The basics of how private equity funds work was illustrated. This included:
   a. The initial search for investment opportunities – to justify the establishment of a fund. This is basically the "why" of a fund's initiation.
   b. General partners & limited partners – Here the discussion focused on who are the people involved in a fund and who has money at risk.
   c. Raising money (for the fund) – Here the Private Placement Memorandum ("PPM"), capital commitments were talked about.
   d. Making investments – This is where fund restrictions, policies, mandates, profiles and funds' strategies were covered.

4. **Investor criteria** – Probably the most important aspect of the seminar was to clearly show businesspeople what investors are looking for in an investment opportunity. The list presented below (and in the seminar) is not comprehensive, but they are the most important requirements, which are:

   a. **Strong Management Team** – Detail was given as to the meaning of "strong" management. It was emphasized that above and beyond anything else, management had to be HONEST and TRANSPARENT. Furthermore, it was noted that they must have extensive experience in managing profitable companies and must have a willingness to work in a synergistic relationship with investors.

   b. **Large and growing market for goods or services** – HIGH RETURN ON INVESTMENT – Again the risk/reward trade-off was addressed emphasizing the level of return an investor is "requiring" to be compensated for the risk he/she it taking.

      i. Compounded annual rates of return that investors typically expect, based on the stage of the venture:

1.	Start-up	50%-70%	- No revenues
2.	First Stage	40%-60%	- Starting to generate revenues
3.	Second Stage	30%-40%	- Starting to generate profits
4.	Third Stage	10%-30%	- Strong market position – ready to expand further

The audience was reminded that these required rates of return could be significantly higher in the emerging markets, such as Mongolia, to account for the additional currency, legal, political, and other risks that are inherent in a developing market.

c. **Planned exit (explicit)** – The third most important criteria to an investor that was discussed is HOW an investor will be able to sell his/her shares in the investee. Here is where an investor's time horizon is covered which is generally between 3 and 7 years (3-5 more typically). It was explained "why" an investor has a time horizon (relating to required rate of return and "realization" of return) and why it is paramount that the investor have a CLEAR strategy for exiting (selling his/her shares of the investee company) the investment.

   Exit strategies were discussed as well as the challenges that investors will face when trying to exit investments in Mongolia.

   It was in this section where it was illustrated how an investor realizes his/her return and clearly showed how "ideally" an investor makes their money.

d. Participation and board membership – The main point made on this issue is that investors bring much more to the table than just "cash." They bring a great deal of experience and a rather extensive network to the table. It was emphasized

e. **Founder's ongoing commitment** – Here it was emphasized the importance to an investor that the founder remain not just WITH the company, but remained motivated to achieve the goals set. Various incentive mechanisms such as vesting were discussed.

f. **Well prepared documentation and financials** – This is one of the areas that take little effort, but can make a big difference. It was indicated that approximately only 1% of business plans/offering memorandums get looked at seriously by fund managers. This is not because there was no true investment opportunity. It was because most companies don't know how to prepare their information in an internationally accepted fashion.

5. <u>Business planning and cash flow forecasting</u> – The key issues covered in this section were:
   a. Key elements of the business plans that are often overlooked
   b. Differences between a business plan and an "offering memorandum"
   c. Why and what is a "free cash flow"
   d. Translating a business strategy into free cash flows

6. <u>Valuation</u> – Here it was stressed "how" a company is valued by professional investors and how they derive a range of intrinsic values of a company vs. the asset value or book value of a company. Issues addressed were:
   a. Need for valuation
   b. Valuation methods
   c. Cost of capital/Required rate of return
   d. Challenges in valuation
   e. Wealth creation

7. <u>The 8 definitive steps in the capital raising process</u> – Each of the 8 steps in the capital raising process were covered, which included:
   Step 1 – Strategy

Step 2 – Preparation of the Information Memorandum
Step 3 – Targeting Investors
Step 4 – Presentation to Investors
Step 5 – Negotiation with Investors
Step 6 – Structuring the Transaction
Step 7 – Investor Due Diligence
Step 8 – Closing

8. **Legal issues** – The following legal issues were addressed:
    a. Documentation
    b. Public company issues
    c. Financial assistance and other regulatory issues
    d. Monitoring

9. **Government policies** - The final subject covered was what investors look for in governmental policies. It was emphasized that investors look for “pro-business” governments with policies that have the following attributes:
    a. Established a strong and sensible regulatory framework
    b. Conducive to the conduct of business
    c. Assurance of investor’s rights
    d. IAFRS and Internationally accepted laws
    e. Corporate Governance
    f. Must be far-sighted
    g. Gov’t that do not OVER GOVERN
    h. Bankruptcy laws
    i. Ongoing development of the country’s human capital
    j. Constantly upgrading to prepare people to operate in a Global Economy through training
    k. FAIR taxation
    l. Low bureaucracy
    m. Legitimate business licensing
    n. A government that LISTENS to business

Four hours was not enough time to go into great depth into any of these topics, but it was hoped that this would be a good introduction to a capital source that is fairly new to many businesspeople in Mongolia. Throughout the workshop, specific challenges Mongolian firms face in trying to attract private equity investment were addressed. The presentation was followed by an active question and answer session. Approximately 100 people attended the seminar, many of whom requested more courses and workshops on these subjects be conducted.

ANNEX G: PROCESS OF RAISING PRIVATE EQUITY - SEMINAR – PRESENTATION

ANNEX G: PROCESS OF RAISING PRIVATE EQUITY - SEMINAR - PRESENTATION

Raising Capital Through

Private Equity and Venture Capital

Presentation

by

Bruce Norlund

of

Economic Policy Reform & Competitiveness – Chemonics

Ulaanbaatar, Mongolia

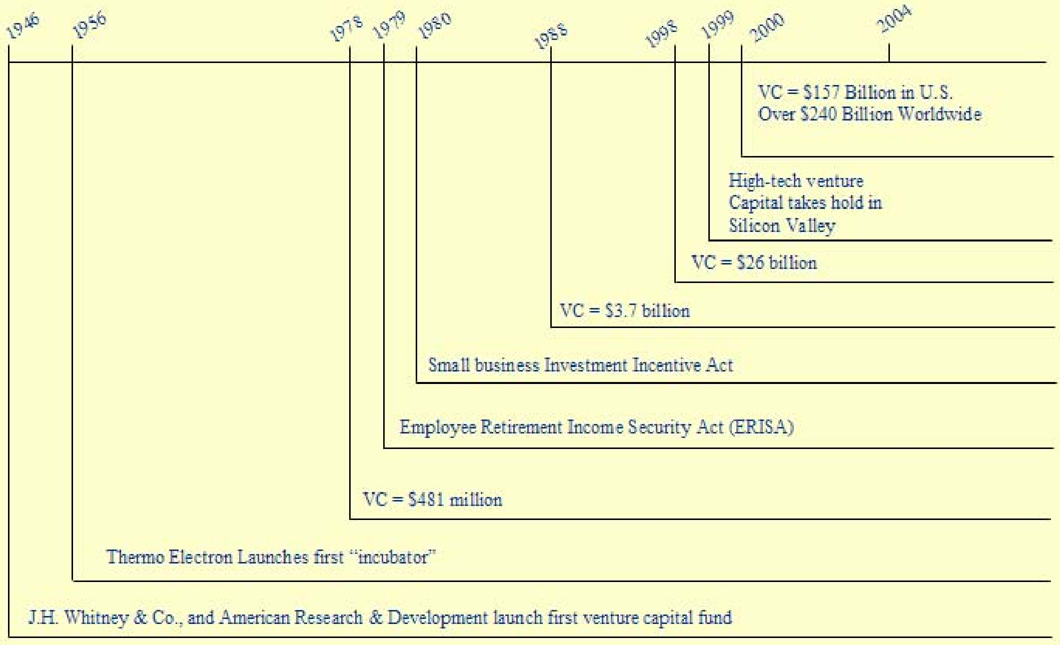
Topics Covered

- History and structure of the private equity industry
- Stages in venture capital financing
- Building a winning business plan
- Cash flow forecasting
- Valuation
- Deal structuring
- Legal, regulatory and control issues
- Question and Answer Session

Origins, History and Development of the Private Equity Industry

- Private "Risk Capital" is not new
  - Marcus Crassus of Ancient Rome
  - Christopher Columbus
- "Professional" Venture Capital Investing fairly recent phenomenon

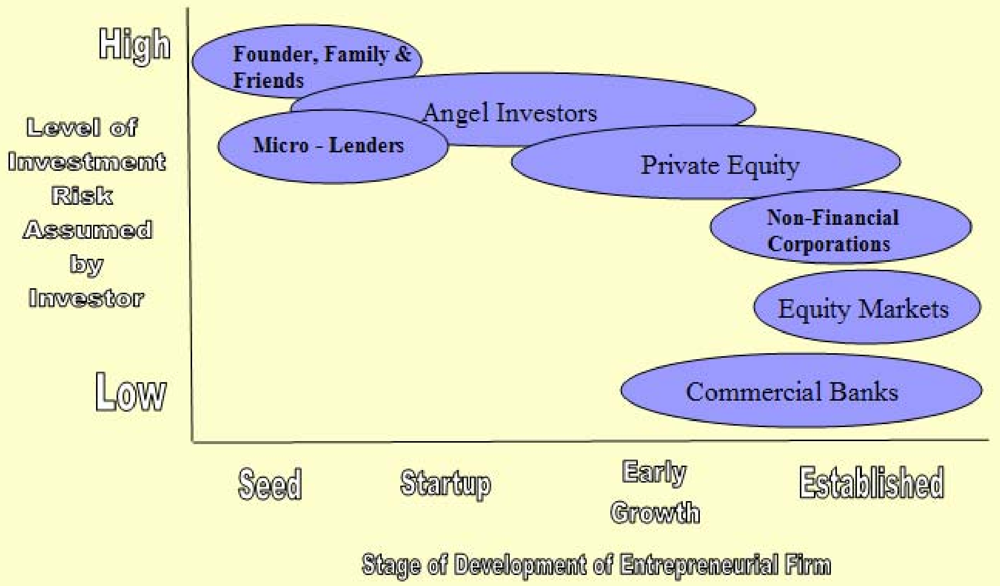
Modern History



Bootstrapping

- Avoid seeking capital as long as possible
- Techniques:
  - Prepaid licenses, royalties or advances from customers
  - Development of product while working else ware
  - Customer funded research
  - Free access to hardware
  - Business alliances

Participants in the Industry

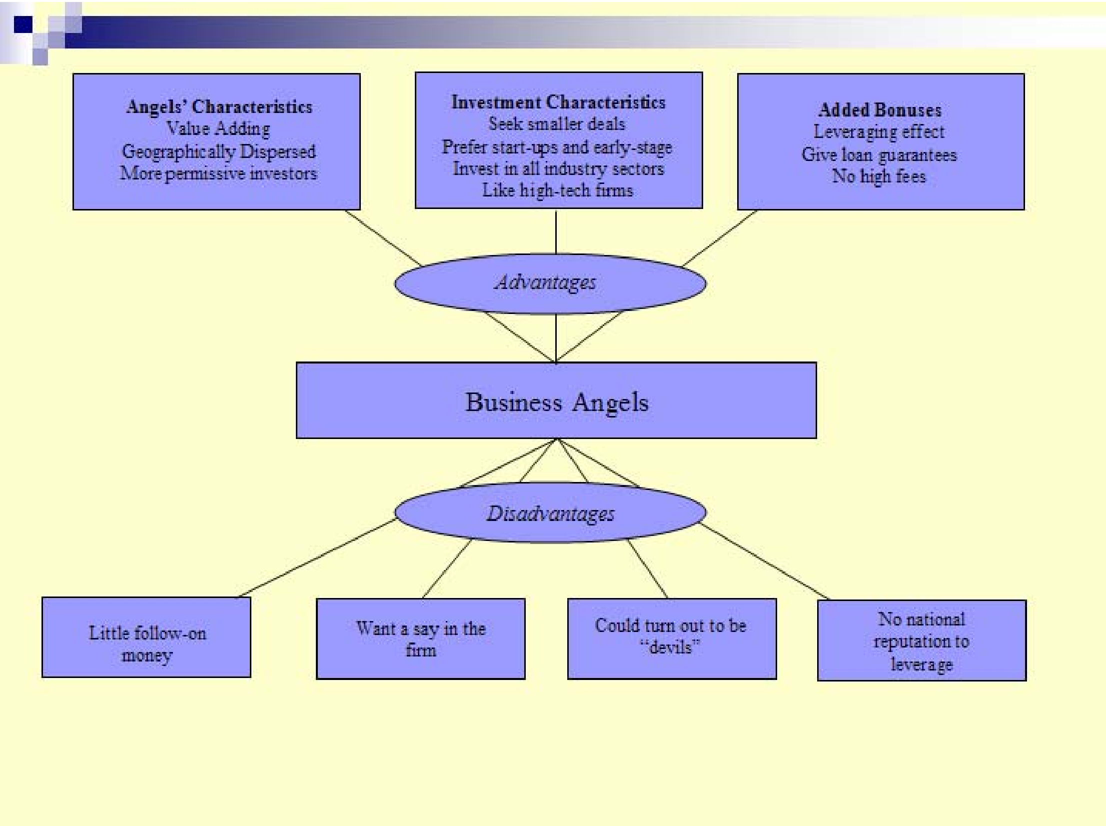


Angel Investors

- Wealthy individuals
- Business people who have "cashed out"
- Angel Syndicates

Angels continued

- Oldest, largest and most often used source of outside funds for entrepreneurial firms
- In the U.S. alone – 3 million angels – investing $50 Billion every year
- Fund 30-40 times as many firms as formal venture capital funds
- Ford, Apple, Amazon.com
- Bring many advantages to their investments
- Difficult to find
- Market may double in next decade



Venture Capitalists

- Venture Capital Funds
- Insurance Companies
- Pension Funds
- Divisions of Merchant Banks
- Corporations

VCs in Asia

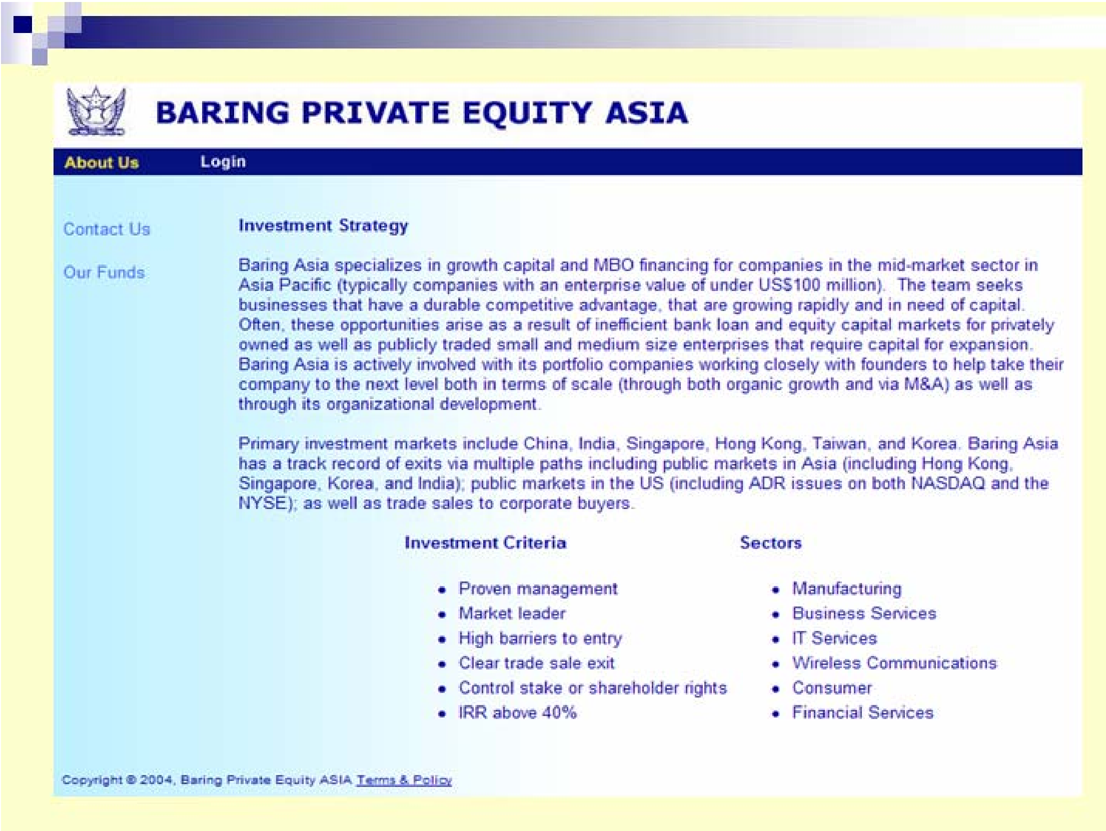
OPIC Asia Fund	Canadian World Fund Limited	Saffron Fund
JP Morgan Partners (Asia Opportunity Fund)	China Fund	Scudder New Asia Fund
H&Q Asia Pacific	Emerging Markets Telecommunication	Templeton China World Fund
HSBC	Gabelli Global Multimedia Trust	Templeton Dragon Fund
Baring Private Equity Asia	Greater China Fund	Templeton Emerging Markets Fund
Olympus Capital	Jardine Fleming China Region Fund	Pantheon Capital (Asia)
Central Asia Small Enterprise Fund	Korea Equity Fund	Carlyle Group
Schroder Capital Partners (Asia) Ltd.	Latin America Equity Fund	Prudential (Asia)
AsiaTech Ventures Ltd	Latin American Discovery Fund	Warburg Pincus
PPM Ventures (Asia) Ltd	Morgan Stanley Asia Pacific Fund	Asia Pacific Fund
Latitude Capital Group	Morgan Stanley Emerging Markets	Asia Tigers Fund

Investors' Criteria

- Strong Management Team
- Large and growing market for goods or services – good IDEAS
- Compounded annual rates of return that investors typically expect, based on the stage of the venture:

Start-up	50%-70%	- No revenues
First Stage	40%-60%	- Starting to generate revenues
Second Stage	30%-40%	- Starting to generate profits
Third Stage	10%-30%	- Strong market position – ready to expand further

- Planned exit (explicit)
- Participation and board membership
- Founder's ongoing commitment
- Well prepared documentation and financials


BARING PRIVATE EQUITY ASIA
About Us
Login
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Our Funds
Investment Strategy
Baring Asia specializes in growth capital and MBO financing for companies in the mid-market sector in Asia Pacific (typically companies with an enterprise value of under US$100 million). The team seeks businesses that have a durable competitive advantage, that are growing rapidly and in need of capital. Often, these opportunities arise as a result of inefficient bank loan and equity capital markets for privately owned as well as publicly traded small and medium size enterprises that require capital for expansion. Baring Asia is actively involved with its portfolio companies working closely with founders to help take their company to the next level both in terms of scale (through both organic growth and via M&A) as well as through its organizational development.
Primary investment markets include China, India, Singapore, Hong Kong, Taiwan, and Korea. Baring Asia has a track record of exits via multiple paths including public markets in Asia (including Hong Kong, Singapore, Korea, and India); public markets in the US (including ADR issues on both NASDAQ and the NYSE); as well as trade sales to corporate buyers.
Investment Criteria
Proven management
Market leader
High barriers to entry
Clear trade sale exit
Control stake or shareholder rights
IRR above 40%
Sectors
Manufacturing
Business Services
IT Services
Wireless Communications
Consumer
Financial Services
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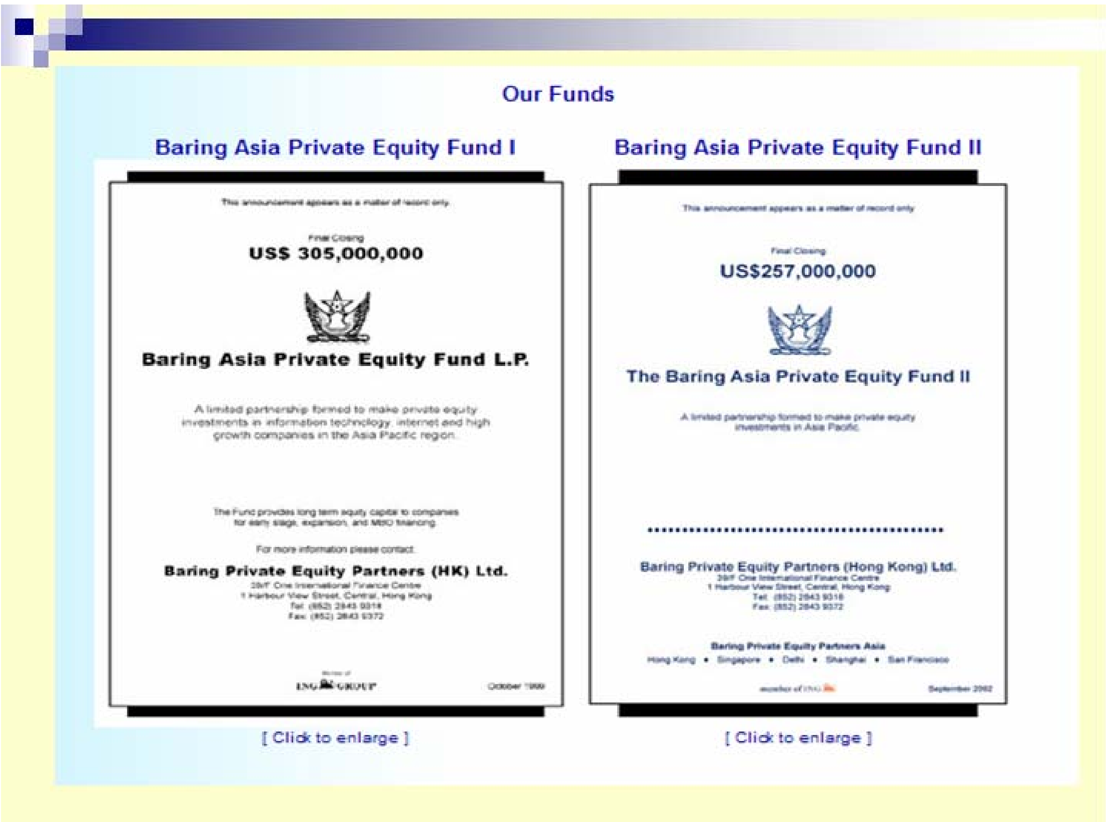

Our Funds
Baring Asia Private Equity Fund I
Baring Asia Private Equity Fund II
This announcement appears as a matter of record only.
Final Closing
US$ 305,000,000
Baring Asia Private Equity Fund L.P.
A limited partnership formed to make private equity investments in information technology, internet and high growth companies in the Asia Pacific region.
For more information please contact
Baring Private Equity Partners (HK) Ltd.
October 1999
This announcement appears as a matter of record only
Final Closing
US$257,000,000
The Baring Asia Private Equity Fund II
A limited partnership formed to make private equity investments in Asia Pacific
Baring Private Equity Partners (Hong Kong) Ltd.
Baring Private Equity Partners Asia
September 2002
[Click to enlarge]
[Click to enlarge]

Transaction types

- Depends on the “Stage” of the Deal
- Traditional Start-up
- Growth-Equity
- Turn-Around Investment
- Leveraged or Management Buyout
- Industry Consolidation
- Exits

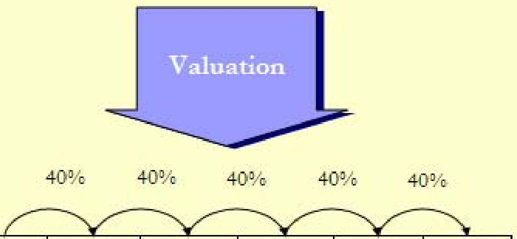
Stages in Venture Capital Financing

- “Start-Up” or First Round
- Development or Second Round
- Expansion or Third Round
- Growth or Fourth Round
- Leverage Buy-Outs
- Turnaround Situations
- Public Offerings

"Private Equity"… a Real Alternative for Companies That Want to Grow

- Term – typically 3 – 7 years
- No interest payable, the investor may prefer no dividends to be paid out.
- Money is injected into the company via a share capital increase.
- The new investor takes no guarantees or collateral, but shares in the risks and rewards of ownership.

How PE Finance Works



		2001	2002	2003	2004	2005	2006	
Value of the Company		USDm	USDm	USDm	USDm	USDm	USDm	
Value of founder's shares	(67%)	2.00	2.80	3.92	5.49	7.68	10.76	
Value of new investor's shares	(33%)	1.00	1.40	1.96	2.74	3.84	5.38	
Total	(100%)	3.00	4.20	5.88	8.23	11.52	16.13	+40% pa

Raising Capital Process Overview

- Step 1 – Strategy
- Step 2 – Preparation of the Information Memorandum
- Step 3 – Targeting Investors
- Step 4 – Presentation to Investors
- Step 5 – Negotiation with Investors
- Step 6 – Structuring the Transaction
- Step 7 – Investor Due Diligence
- Step 8 – Closing

Building a Winning Business Plan and Information Memorandum

- Management team
- Market Opportunity
- Business Strategy – Determines Future Cash Flows and Capital Need
- Risk – a reality check
- Due diligence – being thorough and prepared

Cash Flow Forecasting

- Principles of forecasting
- Constructing the forecasts
  - Studying the market
  - Knowing your capacity to capture market share
- Sensitivity analysis

Fundamental Analysis

- Overview of firm and its strategies
- Evaluate the structure of the industry
- Evaluate firm's current economic position
- Predict future course of firm

Valuation

- Discounted Cash Flow (DCF) method
- Earnings based (multiples) methods
- Asset based methods
- EVA (Economic Value Added)
- Industry specific methods

The Need For Company Valuations

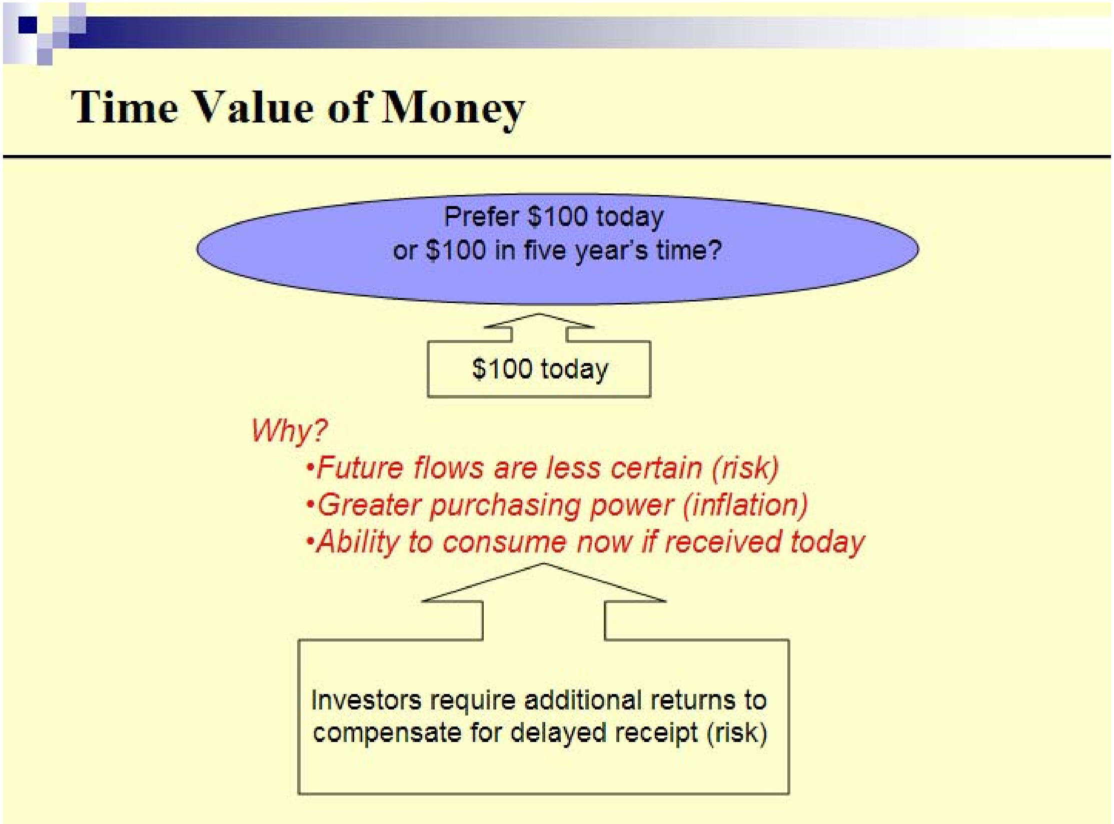
- To support company owners seeking additional equity finance
- To guide stock market investors
- To guide strategic buyers
- To support company owners "Cashing Out"

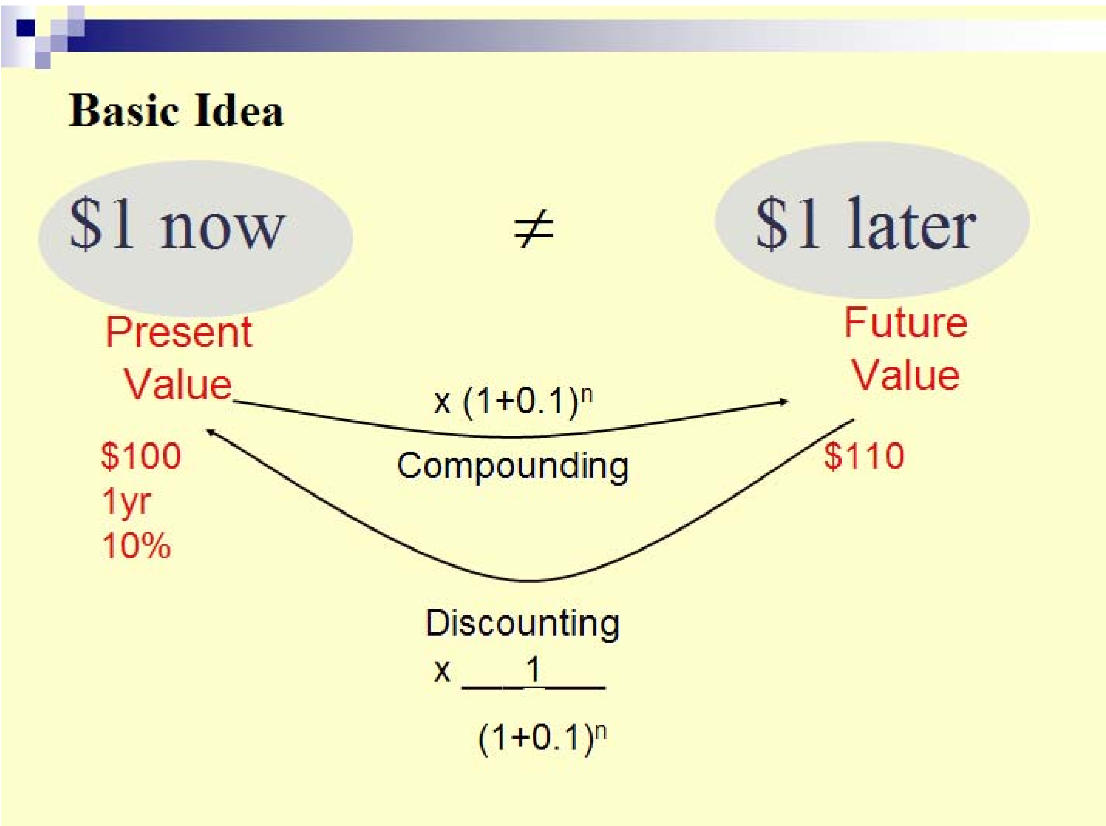
Discounted Cash Flow Method (DCF)

- DCF relies on the principle "Time Value of Money"
- Based on the overwhelming evidence that a company's value is strongly correlated to the sum of its discounted cash flows.
- All the cash flows including capital expenditure are discounted over a chosen period of time.

Discounting and the

Time Value of Money


Time Value of Money
Prefer $100 today
or $100 in five year's time?
$100 today
Why?
•Future flows are less certain (risk)
•Greater purchasing power (inflation)
•Ability to consume now if received today
Investors require additional returns to
compensate for delayed receipt (risk)


Basic Idea
$1 now
≠
$1 later
Present
Value
Future
Value
x (1+0.1)^n
Compounding
$100
1yr
10%
$110
Discounting
x 1
(1+0.1)^n

Compounding

To calculate the future value (FV) of a single future cash flow

$$\text{Present Value } t_0 \times (1 + r)^n = \text{Future Value } t_n$$

Compound Factor

r = required return/time value of money/discount rate
n = number of time periods form today

Simple FV Example

Question 1

What is the Future Value (FV) in 3 years of $1000 deposited today in a bank at an interest rate of 10%?

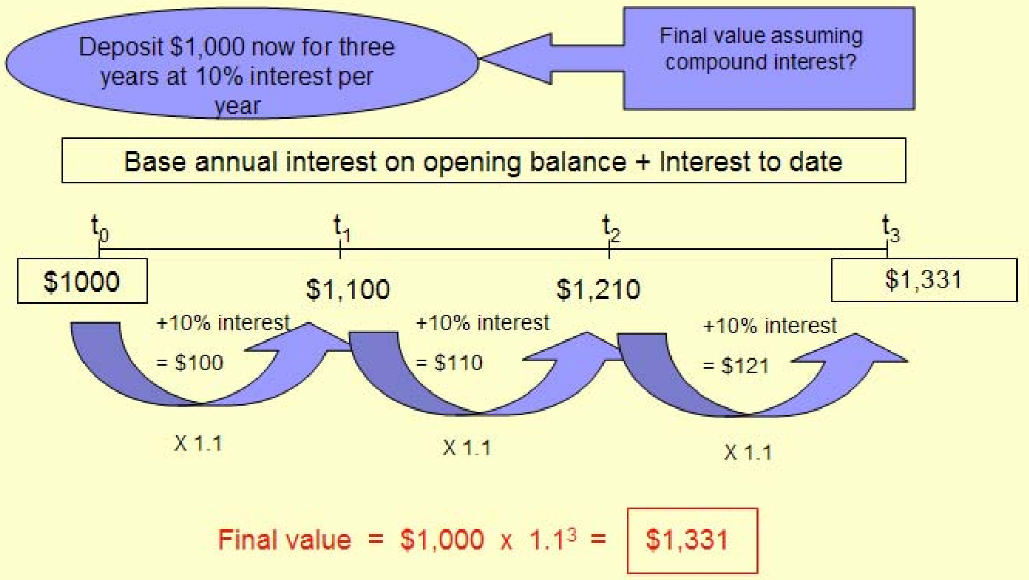
First – Break apart the question:

PV	= $1000
Rate	= 10%
Time	= 3 Years

Future Value Table

FVIF $_{i,n}$ or the Compound Sum of $1										
n	**1%**	**2%**	**3%**	**4%**	**5%**	**6%**	**7%**	**8%**	**9%**	**10%**
1	1.01	1.02	1.03	1.04	1.05	1.06	1.07	1.08	1.09	1.1
2	1.02	1.04	1.061	1.082	1.102	1.124	1.145	1.166	1.188	1.21
3	1.03	1.061	1.093	1.125	1.158	1.191	1.225	1.26	1.295	1.331
4	1.041	1.082	1.126	1.17	1.216	1.262	1.311	1.36	1.412	1.464
5	1.051	1.104	1.159	1.217	1.276	1.338	1.403	1.469	1.539	1.611
6	1.062	1.126	1.194	1.265	1.34	1.419	1.501	1.587	1.677	1.772
7	1.072	1.149	1.23	1.316	1.407	1.504	1.606	1.714	1.828	1.949
8	1.083	1.172	1.267	1.369	1.477	1.594	1.718	1.851	1.993	2.144
9	1.094	1.195	1.305	1.423	1.551	1.689	1.838	1.999	2.172	2.358
10	1.105	1.219	1.344	1.48	1.629	1.791	1.967	2.159	2.367	2.594
11	1.116	1.243	1.384	1.539	1.71	1.898	2.105	2.332	2.58	2.853
12	1.127	1.268	1.426	1.601	1.796	2.012	2.252	2.518	2.813	3.138
13	1.138	1.294	1.469	1.665	1.886	2.133	2.41	2.72	3.066	3.452
14	1.149	1.319	1.513	1.732	1.98	2.261	2.579	2.937	3.342	3.797
15	1.161	1.346	1.558	1.801	2.079	2.397	2.759	3.172	3.642	4.177

Compounding Interest



Discount Factors

To calculate the present value (PV) of a single future cash flow

$$\text{Cash flow at } t_n \quad X \quad \boxed{\frac{1}{(1+r)^n}} \quad = \text{Present Value } t_0$$

Discount Factor

r = required return/time value of money/discount rate
n = number of time periods form today

Simple PV Example

<u>Question 2</u>

What is the Present Value (PV) of <u>$100</u> paid to us <u>10 years</u> from now with a discount rate of <u>10%</u>?

First – Break apart the question:

FV	= $100
Rate	= 10%
Time	= Year 10

Present Value Interest Factor Table

Periods/Interest Rate	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%	15%	16%
1	0.99	0.9803	0.9708	0.9615	0.9523	0.9433	0.9346	0.9259	0.9174	0.909	0.9009	0.8928	0.8849	0.8771	0.8696	0.862
2	0.9802	0.9611	0.9425	0.9246	0.907	0.8899	0.8734	0.8573	0.8416	0.8264	0.8116	0.7971	0.7831	0.7694	0.7561	0.7431
3	0.9705	0.9423	0.9151	0.8889	0.8638	0.8396	0.8162	0.7938	0.7721	0.7513	0.7311	0.7117	0.693	0.6749	0.6575	0.6406
4	0.9609	0.9238	0.8884	0.8548	0.8227	0.792	0.7628	0.735	0.7084	0.683	0.6587	0.6355	0.6133	0.592	0.5717	0.5522
5	0.9514	0.9057	0.8626	0.8219	0.7835	0.7472	0.7129	0.6806	0.6499	0.6209	0.5934	0.5674	0.5427	0.5193	0.4971	0.4761
6	0.942	0.8879	0.8374	0.7903	0.7462	0.7049	0.6663	0.6301	0.5962	0.5644	0.5346	0.5066	0.4803	0.4555	0.4323	0.4104
7	0.9327	0.8705	0.813	0.7599	0.7106	0.665	0.6227	0.5834	0.547	0.5131	0.4816	0.4523	0.425	0.3996	0.3759	0.3538
8	0.9234	0.8534	0.7894	0.7306	0.6768	0.6274	0.582	0.5402	0.5018	0.4665	0.4339	0.4038	0.3761	0.3505	0.3269	0.305
9	0.9143	0.8367	0.7664	0.7025	0.6446	0.5918	0.5439	0.5002	0.4604	0.424	0.3909	0.3606	0.3328	0.3075	0.2842	0.2629
10	0.9052	0.8203	0.744	0.6755	0.6139	0.5583	0.5083	0.4631	0.4224	0.3855	0.3521	0.3219	0.2945	0.2697	0.2471	0.2266
11	0.8963	0.8042	0.7224	0.6496	0.5846	0.5267	0.475	0.4288	0.3875	0.3504	0.3172	0.2874	0.2606	0.2366	0.2149	0.1954
12	0.8874	0.7884	0.7013	0.6245	0.5568	0.4969	0.444	0.3971	0.3555	0.3186	0.2858	0.2566	0.2307	0.2075	0.1869	0.1684
13	0.8786	0.773	0.6809	0.6005	0.5303	0.4688	0.4149	0.3676	0.3261	0.2896	0.2575	0.2291	0.2041	0.182	0.1625	0.1452
14	0.8699	0.7578	0.6611	0.5774	0.505	0.4423	0.3878	0.3404	0.2992	0.2633	0.2319	0.2046	0.1806	0.1597	0.1413	0.1251
15	0.8613	0.743	0.6418	0.5552	0.481	0.4172	0.3624	0.3152	0.2745	0.2393	0.209	0.1826	0.1598	0.14	0.1228	0.1079
16	0.8528	0.7284	0.6231	0.5339	0.4581	0.3936	0.3387	0.2918	0.2518	0.2176	0.1882	0.1631	0.1414	0.1228	0.1068	0.093
17	0.8443	0.7141	0.605	0.5133	0.4362	0.3713	0.3166	0.2702	0.231	0.1978	0.1696	0.1456	0.1252	0.1077	0.0929	0.0802
18	0.836	0.7001	0.5873	0.4936	0.4155	0.3503	0.2958	0.2502	0.2119	0.1798	0.1528	0.13	0.1108	0.0945	0.0808	0.0691
19	0.8277	0.6864	0.5702	0.4746	0.3957	0.3305	0.2765	0.2317	0.1944	0.1635	0.1376	0.1161	0.098	0.0829	0.0702	0.0596
20	0.8195	0.6729	0.5536	0.4563	0.3768	0.3118	0.2584	0.2145	0.1784	0.1486	0.124	0.1036	0.0867	0.0727	0.0611	0.0513
21	0.8114	0.6597	0.5375	0.4388	0.3589	0.2941	0.2415	0.1986	0.1636	0.1351	0.1117	0.0925	0.0767	0.0638	0.0531	0.0442
22	0.8033	0.6468	0.5218	0.4219	0.3418	0.2775	0.2257	0.1839	0.1501	0.1228	0.1006	0.0826	0.0679	0.0559	0.0462	0.0381
23	0.7954	0.6341	0.5066	0.4057	0.3255	0.2617	0.2109	0.1703	0.1377	0.1116	0.0906	0.0737	0.0601	0.0491	0.0401	0.0329
24	0.7875	0.6217	0.4919	0.3901	0.31	0.2469	0.1971	0.1576	0.1264	0.1015	0.0817	0.0658	0.0532	0.043	0.0349	0.0283
25	0.7797	0.6095	0.4776	0.3751	0.2953	0.2329	0.1842	0.146	0.1159	0.0922	0.0736	0.0588	0.0471	0.0377	0.0303	0.0244
26	0.772	0.5975	0.4636	0.3606	0.2812	0.2198	0.1721	0.1352	0.1063	0.0839	0.0663	0.0525	0.0416	0.0331	0.0264	0.021
27	0.7644	0.5858	0.4501	0.3468	0.2678	0.2073	0.1609	0.1251	0.0976	0.0762	0.0597	0.0468	0.0368	0.029	0.0229	0.0181
28	0.7568	0.5743	0.437	0.3334	0.255	0.1956	0.1504	0.1159	0.0895	0.0693	0.0538	0.0418	0.0326	0.0255	0.0199	0.0156
29	0.7493	0.5631	0.4243	0.3206	0.2429	0.1845	0.1406	0.1073	0.0821	0.063	0.0484	0.0373	0.0288	0.0223	0.0173	0.0135
30	0.7419	0.552	0.4119	0.3083	0.2313	0.1741	0.1313	0.0993	0.0753	0.0573	0.0436	0.0333	0.0255	0.0196	0.0151	0.0116

PV Example Continued

$$FV \quad x \quad \frac{1}{(1+r)^n} \quad = \quad PV$$

$$\$100 \quad x \quad \frac{1}{(1+.10)^{10}} \quad = \quad \boxed{\$38.60}$$

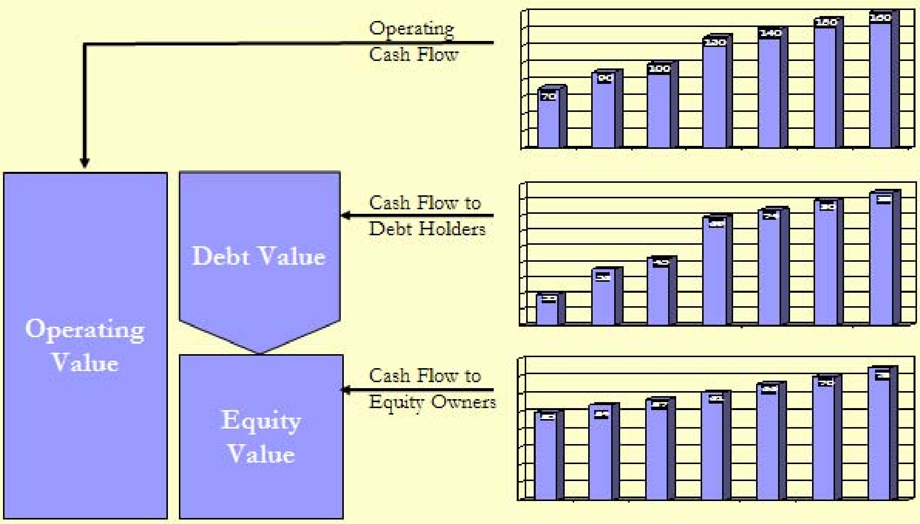
Discount Factor = 0.386

Per tables 10% for 10 years = 0.386

Cost of Capital

- Difficult to predict
- Small changes can have a dramatic effect on the estimated Value created
- Discount Factor/Required Rate of Return/Expected Rate of Return

Theory of DCF Company Valuation



Value of Corporation

- Value of anything = PV of expected future cash flows
- Corporation ➔ use Free Cash Flows

EBIT
+ Depreciation
- Taxes
- Δ NWC
- Capital Spending

Free Cash Flows

DCF Example

- To apply DCF we have to consider:
  - ☐ Time value of money concept.
  - ☐ The "free cash flows" of the business – cash from operating activities available to all investors, both debt and equity, after tax and after investment activities.
  - ☐ The rate of return demanded by investors.

DCF Formula

$$PV_0 = \sum_{t=1}^{n} \left[\frac{E_t(CF_t)}{(1+r_t)^t} + \frac{E_t(TV_T)}{(1+r_T)^T} \right]$$

PV_0 = the value of firm at time 0

$E_t(*)$ = the expectation, at time t, of *, conditional on information available at time t

CF_t = the cash flow available for distribution to the owners of firm's equity at time t

r_t = the Required Return for the equity of the firm, to discount the period t cash flow to time 0

Bringing the Cash Flows to Today:

Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
	$ 150	$ 300	$ 450	$ 600	$ 1,875
	x	x	x	x	x
	0.909	0.826	0.751	0.683	0.621
$136.35					
$247.80					
$337.95					
$409.80					
$1,164.38					
$2,296.28					

Total Value of Cash Flows

DCF Example (Continuation)

Year	Free Cash Flow $m	Discount Factor at 30%	Present Value $m
2006	10.0	1/1.3 = 0.77	7.70
2007	15.0	$1/(1.3)^2 = 0.59$	8.85
2008	16.0	$1/(1.3)^3 = 0.46$	7.36
2009	16.0	$1/(1.3)^4 = 0.35$	5.60
2010	17.0	$1/(1.3)^5 = 0.27$	4.59
Net Present Value			34.1
2010*	17 x 1/0.3 = 56.7	1/(1.3)5 = 0.27	
"Terminal" Value			15.3
TOTAL VALUE OF THE BUSINESS			49.4
DEBT			<10.0>
VALUE OF EQUITY			**39.4**

*Assume the business will continue as a going concern generating same cash

Earnings Based Methods

- Basic idea is to re-apply ratios of other companies to the company you want to value.
- Different Multiples Used P/E, P/B, P/S, etc.
- Earnings is normally EBIT but EBITDA also used.
- Need comparable accounting policies to be meaningful.
- Finding a "comparable" enterprise is always subjective.

Asset Based Methods

- Generally asset values do not take into account the value management has created or the value of using the assets (i.e. the intangibles).
- Provide a crude basic figure other valuations can be compared with.
- 3 main methods.
  - Book value - an accounting figure – useful for valuing banks.
  - Net Realizable Value or Break-up Value (what the assets can be sold for individually) – useful in bankruptcy, absolute minimum a vendor can accept.
  - Replacement Cost – useful for calculating "Market Entry" value, can be a starting point for an investor.
- Other methods (DCF, dividend yield and earnings) **DO** account for the value management creates.

Economic Value Added (EVA)

- Shareholder wealth created when:

(IRR - CC) x invested capital = NPV> 0

Industry Specific Valuation Methods

- Such methods normally take the form of indicators that have been proven to create value.

- Examples include:
  - Occupancy rates for hotels and airlines.
  - Subscribers or user numbers for telecoms, cable companies, utilities.

Gas Distribution – Valuation Example

■ Price paid per user by multinationals in Western Europe	$ 1,200
■ Adjustment for purchasing power↓ climate↑	$ <200>
■ Adjustment for Romania country risk	$ <300>
□ Valuation price per user	$ 700
□ Number of users connected	50,000
□ Value of gas distribution Company	$ 700 x 50,000
	$ 35 mil

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	$ 35 mil

Step 1 - Strategy

- Develop a well thought out, well presented strategy.
- Obtain research data and use as basis for projections.
- Prepare different scenarios.
- Balance vision with realism.

Step 2 – Preparation of the Information Memorandum

- The key presentation document written specifically for investors. It is NOT the same as a business plan.
  - Company history and strategy;
  - Market and industry dynamic;
  - Financial forecasts and financing requirement;
  - The investment opportunity and associated risks;
  - Company organization and operations.
- An Information Memorandum is written according to accepted industry practices.
- Only given to investors if they sign a "Confidentiality Agreement."

Step 3 – Targeting Investors

- Decide on the preferred type of investor:
  - "FINANCIAL"
    - Angel Investors
    - Venture Capital Funds
    - Private Equity Funds
    - Multilaterals (IFC, EBRD, ADB)
  - "STRATEGIC"
    - Companies in the same line of business who want to expand.
    - Companies in the similar line of business who want complementary business

BARING PRIVATE EQUITY ASIA

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Our Funds

Investment Strategy

Baring Asia specializes in growth capital and MBO financing for companies in the mid-market sector in Asia Pacific (typically companies with an enterprise value of under US$100 million). The team seeks businesses that have a durable competitive advantage, that are growing rapidly and in need of capital. Often, these opportunities arise as a result of inefficient bank loan and equity capital markets for privately owned as well as publicly traded small and medium size enterprises that require capital for expansion. Baring Asia is actively involved with its portfolio companies working closely with founders to help take their company to the next level both in terms of scale (through both organic growth and via M&A) as well as through its organizational development.

Primary investment markets include China, India, Singapore, Hong Kong, Taiwan, and Korea. Baring Asia has a track record of exits via multiple paths including public markets in Asia (including Hong Kong, Singapore, Korea, and India); public markets in the US (including ADR issues on both NASDAQ and the NYSE); as well as trade sales to corporate buyers.

Investment Criteria

- Proven management
- Market leader
- High barriers to entry
- Clear trade sale exit
- Control stake or shareholder rights
- IRR above 40%

Sectors

- Manufacturing
- Business Services
- IT Services
- Wireless Communications
- Consumer
- Financial Services

Step 4 – Presentations to Investors

- The entrepreneur should:
  - Be fluent in describing the strategy.
  - Be rehearsed; key facts, figures and other knowledge should be memorized.
  - Be very familiar with the financial forecasts and financing requirement.
  - State how the investor may ultimately exit the investment (IPO, purchase by the company over time, sale of the venture to a strategic investor).
  - Be prepared to answer all conceivable questions about the company.

Step 5 – Negotiations With Investors

- Key negotiation points:
  - Company valuation
  - What percent of the company for the investor's cash?
  - Rights of the shareholders (especially minority shareholder rights).
  - Management incentives to own more shares based on performance targets.
  - Amount of debt the company should have.

Ideally, a competitive situation.

- If interested – investor will issue a "Term Sheet"

Step 6 – Structuring the Transaction

- Consideration of:
  - ☐ The most suitable long term combination of equity and debt;
  - ☐ Current interest rates for debt;
  - ☐ The amount required;
  - ☐ Leasing available;
  - ☐ The supply of capital available and practical considerations like timing.
- Preliminary Transaction Structure.

Step 7 – Investor Due Diligence

- As an equity investor is taking no collateral and has no guarantees, he needs to do much more "detective work" before he invests his money.
- Typically an investor hires one of the "Big 5" and/or a large legal firm, to perform special verification procedures.
- These can include:
  - ☐ An audit of IAS financial statements.
  - ☐ Engineering Audit
  - ☐ Physical asset verification.
  - ☐ Review of all legal aspects.

Step 8 - Closing

- Money is paid, the share ownership changes, agreements are drafted by the lawyers to govern these changes and to govern future behavior.
- Typical agreements include:
  - Share Purchase Agreement.
  - Shareholders' Agreement

Negotiations can be long! It is important to maintain control of the process at this stage.

Legal, Regulatory and Control Issues

- Documentation
- Public company issues
- Financial assistance and other regulatory issues
- Monitoring

The Mind of an Investor

- The investor will share the risks of ownership so he wants:
  - TRUST
  - TRANSPARENCY

"The Economist" (February 2001) reported that Russian stocks are undervalued by US$ 58 bn. due to lack of transparency and other corporate governance procedures"

Key Criteria Investors Look For:

- Management.
  - With vision and determination
  - Who delegate responsibility and have genuine team dynamics.
  - Who are open and transparent
- High level of future growth.
- High return potential with a good exit plan (for example by becoming dominant player).
- Well prepared documentation and financials.

Investors look for "pro-business" governments

- Established a strong and sensible regulatory framework
  - Conducive to the conduct of business
  - Assurance of investor's rights
  - IAS and Internationally accepted laws
  - Corporate Governance
- Only when these are in place can you achieve SUSTAINABLE economic growth

Gov't Continued

- Economic and regulatory reform is never easy – investors want to see commitment and progress
- Must be far-sighted
- Do not OVER GOVERN
- Bankruptcy laws
- Developing the country's human capital
  - Constantly upgrading to prepare people to operate in a Global Economy
  - Training

Gov't Continued

- Taxation
- Bureaucracy
- "Stampele Hell"
- Business Licensing
- Get connected
  - eGovernment for more cost effective management
  - Leapfrog methods

Gov't Continued

- Impress Investors with a "Global" Mindset
- Model SUCCESS
- Success breads Success!

ANNEX H: GLOSSARY

A

"A" round — a financing event whereby venture capitalists become involved in a fast-growth company that was previously financed by founders and/or angels.

Alternative asset class — a class of investments that includes private equity, real estate, and oil and gas, but excludes publicly traded securities. Pension plans, college endowments, and other relatively large institutional investors typically allocate a certain percentage of their investments to alternative assets with an objective to diversify their portfolios.

Angel — a person that invests in companies in relatively early stages of development. Usually angels invest less than $1 million per startup. The typical angel-financed startup is in concept or product development phase.

Anti-dilution — a contract clause that protects an investor from a substantial reduction in percentage ownership in a company due to the issuance by the company of additional shares to other entities. The mechanism for making adjustments is called a Ratchet.

B

"B" round — a financing event whereby professional investors such as venture capitalists are sufficiently interested in a company to provide additional funds after the "A" round of financing. Subsequent rounds are called "C", "D", and so on.

Best efforts offering — a commitment by a syndicate of investment banks to use best efforts to ensure the sale to investors of a company's offering of securities. In a best efforts offering, the syndicate avoids any firm commitment for a specific number of shares or bonds.

Beta — a product that is being tested by potential customers prior to being formally launched into the marketplace.

Blow-out round — a financing event upon which new investors with substantial capital are able to demand and receive contractual terms that effectively cause the issuance of sufficient new shares by the startup company to significantly reduce ("dilute") the ownership percentage of previous investors.

Board of directors — a group of individuals, typically composed of managers, investors, and experts, which have a fiduciary responsibility for the well being and proper guidance of a corporation. The board is elected by the shareholders.

Boat anchor — a person, project or activity that hinders the growth of a company.

Book — see Private placement memorandum.

Bootstrapping — the actions of a startup to minimize expenses and build cash flow, thereby reducing or eliminating the need for outside investors.

Bridge financing — temporary funding that will eventually be replaced by permanent capital from equity investors or debt lenders. In venture capital, a bridge is usually a short term note (6 to 12 months) that converts to preferred stock. Typically, the bridge lender has the right to convert the note to preferred stock at a price that is a 20% discount from the price of the preferred stock in the next financing round.

Burn rate — the rate at which a startup with little or no revenue uses cash savings to cover expenses. Usually expressed on a monthly or weekly basis.

Business plan — a document that describes a new concept for a business opportunity. A business plan typically includes the following sections: executive summary, market need, solution, technology, competition, marketing, management, operations and financials.

Buyout — a sector of the private equity industry. Also, the purchase of a controlling interest of a company by an outside investor (in a leveraged buyout) or a management team (in a management buyout).

Buy-sell agreement — a contract that sets forth the conditions under which a shareholder must first offer his or her shares for sale to the other shareholders before being allowed to sell to entities outside the company.

C

Capital call — when a private equity fund manager (usually a general partner in a partnership) requests that an investor in the fund (a limited partner) provide additional capital. Usually a limited partner will agree to a maximum investment amount and the general partner will make a series of capital calls over time to the limited partner as opportunities arise to finance startups and buyouts.

Capitalization table — a table showing the owners of a company's shares and their ownership percentages. It also lists the forms of ownership, such as common stock, preferred stock, warrants and options.

Capital gains — a tax classification of investment earnings resulting from the purchase and sale of assets. Typically, an investor prefers that investment earnings be classified as long term capital gains (held for a year or longer), which are taxed at a lower rate than ordinary income.

Capital stock — a description of stock that applies when there is only one class of shares. This class is known as common stock.

Carried interest — a share in the profits of a private equity fund. Typically, a fund must return the capital given to it by limited partners before the general partner can share in the profits of the fund. The general partner will then receive a 20% carried interest, although some successful firms receive 25%-30%. Also known as "carry" or "promote."

Catch-up — a clause in the agreement between the general partner and the limited partners of a private equity fund. Once the limited partners have received a certain portion of their expected return, the general partner can then receive a majority of profits until the previously agreed upon profit split is reached.

Change of control bonus — a bonus of cash or stock given by private equity investors to members of a management group if they successfully negotiate a sale of the company for a price greater than a specified amount.

Clawback — a clause in the agreement between the general partner and the limited partners of a private equity fund. The clawback gives limited partners the right to reclaim a portion of disbursements to a general partner for profitable investments based on significant losses from later investments in a portfolio.

Closing — the conclusion of a financing round whereby all necessary legal documents are signed and capital has been transferred.

Collateral — hard assets of the borrower, such as real estate or equipment, for which a lender has a legal interest until a loan obligation is fully paid off.

Commitment — an obligation, typically the maximum amount that a limited partner agrees to invest in a fund.

Common stock — a type of security representing ownership rights in a company. Usually, company founders, management and employees own common stock while investors own preferred stock. In the event of a liquidation of the company, the claims of secured and unsecured creditors, bondholders and preferred stockholders take precedence over common stockholders.

Comparable — a publicly traded company with similar characteristics to a private company that is being valued. For example, a telecommunications equipment manufacturer whose market value is 2 times revenues can be used to estimate the value of a similar and relatively new company with a new product in the same industry. See Liquidity discount.

Control — the authority of an individual or entity that owns more than 50% of equity in a company or owns the largest block of shares compared to other shareholders.

Consolidation — see Rollup.

Conversion — the right of an investor or lender to force a company to replace the investor's preferred shares or the lender's debt with common shares at a preset conversion ratio

Convertible debt — a loan that allows the lender to exchange the debt for common shares in a company at a preset conversion ratio.

Convertible preferred stock — a type of stock that gives an owner the right to convert to common shares of stock. Usually, preferred stock has certain rights that common stock doesn't have, such as decision-making management control, a guaranteed return on investment, or senior priority in receiving proceeds from a sale or liquidation of the company. Typically, convertible preferred stock automatically converts to common stock if the company makes an initial public offering (IPO). Convertible preferred is the most common tool for private equity funds to invest in companies.

Convertible security — a security that gives its owner the right to exchange the security for common shares in a company at a preset conversion ratio. The security is typically preferred stock, warrants or debt.

Cost of sales — the expenses generated by the core operations of a company.

Covenant — a legal promise to do or not do a certain thing. For example, in a financing arrangement, company management may agree to a negative covenant, whereby it promises not to incur additional debt. The penalties for violation of a covenant may vary from repairing the mistake to losing control of the company.

Cram down round — see Blowout round.

Cumulative dividends — the owner of preferred stock with cumulative dividends has the right to receive accrued (previously unpaid) dividends in full before dividends are paid to any other classes of stock.

Current ratio — the ratio of current assets to current liabilities.

D

Deal flow — a measure of the number of potential investments that a fund reviews in any given period.

Debt service — the ratio of a loan payment amount to available cash flow earned during a specific period. Typically lenders insist that a company maintain a certain debt service ratio or else risk penalties such as having to pay off the loan immediately.

Default — a company's failure to comply with the terms and conditions of a financing arrangement.

Demand rights — a type of registration right. Demand rights give an investor the right to force a startup to register its shares with the SEC and prepare for a public sale of stock (IPO).

Dilution — the reduction in the ownership percentage of current investors, founders and employees caused by the issuance of new shares to new investors.

Dilution protection — see Anti-dilution and Ratchet.

Direct costs — see Cost of sales.

Disbursement — an investment by a fund in a company.

Discount rate — the interest rate used to determine the present value of a series of future cash flows.

Discounted cash flow (DCF) — a valuation methodology whereby the present value of all future cash flows expected from a company is calculated.

Distribution — the transfer of cash or securities to a limited partner resulting from the sale, liquidation or IPO of one or more portfolio companies in which a general partner chose to invest.

Dividends — regular payments made by a company to the owners of certain securities. Typically, dividends are paid quarterly, by approval of the board of directors, to owners of preferred stock.

Down round — a round of financing whereby the valuation of the company is lower than the value determined by investors in an earlier round.

Drag-along rights — the contractual right of an investor in a company to force all other investors to agree to a specific action, such as the sale of the company.

Drive-by VC — a venture capitalist that only appears during board meetings of a portfolio company and rarely offers advice to management.

Due diligence — the investigatory process performed by investors to assess the viability of a potential investment and the accuracy of the information provided by the target company.

E

Early stage — the state of a company after the seed (formation) stage but before middle stage (generating revenues). Typically, a company in early stage will have a core management team and a proven concept or product, but no positive cash flow.

Earnings before interest and taxes (EBIT) — a measurement of the operating profit of a company. One possible valuation methodology is based on a comparison of private and public companies' value as a multiple of EBIT.

Earnings before interest, taxes, depreciation and amortization (EBITDA) — a measurement of the cash flow of a company. One possible valuation methodology is based on a comparison of private and public companies' value as a multiple of EBITDA.

Elevator pitch — a concise presentation, lasting only a few minutes (an elevator ride), by an entrepreneur to a potential investor about an investment opportunity.

Employee Stock Ownership Program (ESOP) — a plan established by a company to reserve shares for long-term incentive compensation for employees.

Equity — the ownership structure of a company represented by common shares, preferred shares or unit interests. Equity=Assets-Liabilities.

Evergreen fund — a fund that reinvests its profits in order to ensure the availability of capital for future investments.

Exit strategy — the plan for generating profits for owners and investors of a company. Typically, the options are to merge, be acquired or make an initial public offering (IPO).

Expansion stage — the stage of a company characterized by a complete management team and a substantial increase in revenues.

F

Fairness opinion — a letter issued by an investment bank that charges a fee to assess the fairness of a negotiated price for a merger or acquisition.

Firm commitment — a commitment by a syndicate of investment banks to purchase all the shares available for sale in a public offering of a company. The shares will then be resold to investors by the syndicate.

Flipping — the act of selling shares immediately after an initial public offering. Investment banks that underwrite new stock issues attempt to allocate shares to new investors that indicate they will retain the shares for several months. Often management and venture investors are prohibited from selling IPO shares until a "lock-up period" (usually 6 to 12 months) has expired.

Founder — a person who participates in the creation of a company. Typically, founders manage the company until it has enough capital to hire professional managers.

Friends and family financing — capital provided by the friends and family of founders of an early-stage company. Founders should be careful not to create an ownership structure that may hinder the participation of professional investors once the company begins to achieve success.

Full ratchet — an anti-dilution protection mechanism whereby the price per share of the preferred stock of investor A is adjusted downward due to the issuance of new preferred shares to new investor B at a price lower than the price investor A originally received. Investor A's preferred stock is repriced to match the price of investor B's preferred stock. Usually as a result of the implementation of a ratchet, company management and employees who own a fixed amount of common shares suffer significant dilution. See Narrow-based weighted average ratchet and Broad-based weighted average ratchet.

Fully diluted basis — a methodology for calculating any per share ratios whereby the denominator is the total number of shares issued by the company on the assumption that all warrants and options are exercised and preferred stock.

Fund-of-funds — a fund created to invest in private equity funds. Typically, individual investors and relatively small institutional investors participate in a fund-of-funds to minimize their portfolio management efforts.

G

General partner (GP) — a class of partner in a partnership. The general partner retains liability for the actions of the partnership. In the private equity world, the GP is the fund manager while the limited partners (LPs) are the institutional and high net worth investors in the partnership. The GP earns a management fee and a percentage of profits (see Carried interest).

GP — see General partner.

Grossing up — an adjustment of an option pool for management and employees of a company which increases the number of shares available over time. This usually occurs after a financing round whereby one or more investors receive a relatively large percentage of the company. Without a grossing up, managers and employees would suffer the financial and emotional consequences of dilution, thereby potentially affecting the overall performance of the company.

Growth stage — the state of a company when it has received one or more rounds of financing and is generating revenue from its product or service. Also known as "middle stage."

H

Harvest — to generate cash or stock from the sale or IPO of companies in a private equity portfolio of investments

Hockey stick — the general shape and form of a chart showing revenue, customers, cash, or some other financial or operational measure that increases dramatically at some point in the future. Entrepreneurs often develop business plans with hockey stick charts to impress potential investors.

Hurdle rate — a minimum rate of return required before an investor will make an investment.

I

Incubator — a company or facility designed to host startup companies. Incubators help startups grow while controlling costs by offering networks of contacts and shared back office resources.

Initial public offering (IPO) — the first offering of stock by a company to the public. New public offerings must be registered with the Securities and Exchange Commission. An IPO is one of the methods that a startup that has achieved significant success can use to raise additional capital for further growth.

Inside round — a round of financing in which the investors are the same investors as the previous round. An inside round raises liability issues since the valuation of the company has no third party verification in the form of an outside investor. In addition, the terms of the inside round may be considered self-dealing if they are onerous to any set of shareholders or if the investors give themselves additional preferential rights.

Institutional investor — professional entities that invest capital on behalf of companies or individuals. Examples are: pension plans, insurance companies and university endowments.

Internal rate of return (IRR) — the interest rate at which a certain amount of capital today would have to be invested in order to grow to a specific value at a specific time in the future. Often used in capital budgeting, it's the interest rate that makes net present value of all cash flow equal zero

Investment thesis / Investment philosophy — the fundamental ideas which determine the types of investments that an investment fund will choose in order to achieve its financial goals.

IPO — see Initial public offering.

IRR — see Internal rate of return.

Issuer — the company that chooses to distribute a portion of its stock to the public.

J

Junior debt — a loan that has a lower priority than a senior loan in case of a liquidation of the asset or borrowing company. Also known as "subordinated debt."

L

Later stage — the state of a company that has proven its concept, achieved significant revenues compared to its competition, and is approaching cash flow break even or positive net income. Typically, a later stage company is about 6 to 12 months away from a liquidity event such as an IPO or buyout. The rate of return for venture capitalists that invest in later stage, less risky ventures is lower than in earlier stage ventures.

LBO — see Leveraged buyout.

Lead investor — the venture capital investor that makes the largest investment in a financing round and manages the documentation and closing of that round. The lead investor sets the price per share of the financing round, thereby determining the valuation of the company.

Letter of intent — a document confirming the intent of an investor to participate in a round of financing for a company. By signing this document, the subject company agrees to begin the legal and due diligence process prior to the closing of the transaction. Also known as a "Term Sheet".

Leverage — the use of debt to acquire assets, build operations and increase revenues. By using debt, a company is attempting to achieve results faster than if it only used its cash available from pre-leverage operations. The risk is that the increase in assets and revenues does not generate sufficient net income and cash flow to pay the interest costs of the debt.

Leveraged buyout (LBO) — the purchase of a company or a business unit of a company by an outside investor using mostly borrowed capital.

Limited liability company (LLC) — an ownership structure designed to limit the founders' losses to the amount of their investment. An LLC does not pay taxes, rather its owners pay taxes on their proportion of the LLC profits at their individual tax rates.

Limited partnership — a legal entity composed of a general partner and various limited partners. The general partner manages the investments and is liable for the actions of the partnership while the limited partners are generally protected from legal actions and any losses beyond their original investment. The general partner receives a management fee and a percentage of profits (see Carried interest), while the limited partners receive income, capital gains and tax benefits.

Limited partner (LP) — an investor in a limited partnership. The general partner is liable for the actions of the partnership while the limited partners are generally protected from legal actions and any losses beyond their original investment. The limited partner receives income, capital gains and tax benefits.

Liquidation — the selling off of all assets of a company prior to the complete cessation of operations. Corporations that choose to liquidate declare Chapter 7 bankruptcy. In a liquidation, the claims of secured and unsecured creditors, bondholders and preferred stockholders take precedence over common stockholders.

Liquidation preference — the contractual right of an investor to priority in receiving the proceeds from the liquidation of a company. For example, a venture capital investor with a "2x liquidation preference" has the right to receive two times its original investment upon liquidation.

Liquidity discount — a decrease in the value of a private company compared to the value of a similar but publicly traded company. Since an investor in a private company cannot readily sell his or her investment, the shares in the private company must be valued less than a comparable public company.

Liquidity event — a transaction whereby owners of a significant portion of the shares of a private company sell their shares in exchange for cash or shares in another, usually larger company. For example, an IPO is a liquidity event.

Lock-up agreement — investors, management and employees often agree not to sell their shares for a specific time period after an IPO, usually 6 to 12 months. By avoiding large sales of its stock, the company has time to build interest among potential buyers of its shares.

LP — see Limited partner.

M

Management buyout (MBO) — a leveraged buyout controlled by the members of the management team of a company or a division.

Management fee — a fee charged to the limited partners in a fund by the general partner. Management fees in a private equity fund typically range from 0.75% to 3% of capital under management, depending on the type and size of fund.

Management rights — the rights often required by a venture capitalist as part of the agreement to invest in a company. The venture capitalist has the right to consult with management on key operational issues, attend board meetings and review information about the company's financial situation.

Market capitalization — the value of a publicly traded company as determined by multiplying the number of shares outstanding by the current price per share.

MBO — see Management buyout.

Mezzanine — a layer of financing that has intermediate priority (seniority) in the capital structure of a company. For example, mezzanine debt has lower priority than senior debt but usually has a higher interest rate and often includes warrants. In venture capital, a mezzanine round is generally the round of financing that is designed to help a company have enough resources to reach an IPO.

Middle stage — the state of a company when it has received one or more rounds of financing and is generating revenue from its product or service. Also known as "growth stage."

Multiples — a valuation methodology that compares public and private companies in terms of a ratio of value to an operations figure such as revenue or net income. For example, if several publicly traded computer hardware companies are valued at approximately 2 times revenues, then it is reasonable to assume that a startup computer hardware company that is growing fast has the potential to achieve a valuation of 2 times its revenues (minus a liquidity discount and/or plus a control premia).

N

NDA — see Non-disclosure agreement.

Non-compete — an agreement often signed by employees and management whereby they agree not to work for competitor companies or form a new competitor company within a certain time period after termination of employment.

Non-cumulative dividends — dividends that are payable to owners of preferred stock at a specific point in time only if there is sufficient cash flow available after all company expenses have been paid. If cash flow is insufficient, the owners of the preferred stock will not receive the dividends owed for that time period and will have to wait until the board of directors declares another set of dividends.

Non-interference — an agreement often signed by employees and management whereby they agree not to interfere with the company's relationships with employees, clients, suppliers, and subcontractors within a certain time period after termination of employment.

Non-solicitation — an agreement often signed by employees and management whereby they agree not to solicit other employees of the company regarding job opportunities.

Non-disclosure agreement (NDA) — an agreement issued by entrepreneurs to protect the privacy of their ideas when disclosing those ideas to third parties.

O

Offering memorandum — a legal document that provides details of an investment to potential investors. Also called a Private Placement Memorandum and Information Memorandum.

Optics — the way a concept is presented. Sometimes entrepreneurs' presentations are strong on optics but weak in content.

Options — see Stock options.

Option pool — a group of options set aside for long term, phased compensation to management and employees.

Orphan — a startup company that does not have a venture capitalist as an investor.

Outstanding shares — the total amount of common shares of a company, not including treasury stock, convertible preferred stock, warrants, and options.

Oversubscription — when demand exceeds supply for shares of an IPO or a private placement.

P

Pay or play — a clause in a financing agreement whereby any investor that does not participate in a future round agrees to suffer significant dilution compared to other investors. The most onerous version of pay to play is automatic conversion to common shares, which in essence ends any preferential rights of an investor, such as the right to influence key management decisions.

Pari passu — a legal term referring to the equal treatment of two or more parties in an agreement. For example, a venture capitalists may agree to have registration rights that are pari passu with the other investors in a financing round.

Participating dividends — the right of holders of certain preferred stock to receive dividends and participate in additional distributions of cash, stock or other assets.

Participating preferred stock — a unit of ownership composed of preferred stock and common stock. The preferred stock entitles the owner to receive a predetermined sum of cash (usually the original investment plus accrued dividends) if the company is sold or has an IPO. The common stock represents additional continued ownership in the company. Participating preferred stock has been characterized as having your cake and eating it too.

PE ratio — see Price earnings ratio.

Piggyback rights — rights of an investor to have his or her shares included in a registration of a startup's shares in preparation for an IPO.

PIPEs — see Private investment in public equities.

Placement agent — a company that specializes in finding institutional investors that are willing and able to invest in a private equity fund. Sometimes a private equity fund will hire a placement agent so the fund partners can focus on making and managing investments in companies rather than on raising capital.

Portfolio company — a company that has received an investment from a private equity fund.

Post-money valuation — the valuation of a company including the capital provided by the current round of financing. For example, a venture capitalist may invest $5 million in a company valued at $2 million "pre-money" (before the investment was made). As a result, the startup will have a post-money valuation of $7 million.

PPM — see Private placement memorandum.

Preference — seniority, usually with respect to dividends and proceeds from a sale or dissolution of a company.

Preferred stock — a type of stock that has certain rights that common stock does not have. These special rights may include dividends, participation, liquidity preference, anti-dilution protection and veto provisions, among others. Private equity investors usually purchase preferred stock when they make investments in companies.

Pre-money valuation — the valuation of a company prior to the current round of financing. For example, a venture capitalist may invest $1 million in a company valued at $2 million pre-money. As a result, the startup will have a "post-money" valuation of $3 million.

Price earnings ratio (PE ratio) — the ratio of a public company's price per share and its net income after taxes on a per share basis.

Private equity — equity investments in nonpublic companies.

Private investment in public equities (PIPES) — investments by a private equity fund in a publicly traded company, usually at a discount.

Private placement — the sale of a security directly to a limited number of institutional and qualified individual investors. If structured correctly, a private placement avoids registration with the Securities and Exchange Commission.

Private placement memorandum (PPM) — a document explaining the details of an investment to potential investors. For example, a private equity fund will issue a PPM when it is raising capital from institutional investors. Also, a startup may issue a PPM when it needs growth capital. Also known as "Offering Memorandum" or "Information Memorandum."

Private securities — securities that are not registered with the Securities and Exchange Commission and do not trade on any exchanges. The price per share is negotiated between the buyer and the seller (the "issuer").

Promote — see Carried interest.

Prospectus — a formal document that gives sufficient detail about a business opportunity for a prospective investor to make a decision. A prospectus must disclose any material risks and be filed with the Securities and Exchange Commission.

Prudent man rule — a fundamental principle for professional money management which serves as a basis for the Prudent Investor Act. The principle is based on a statement by Judge Samuel Putnum in 1830: "Those with the responsibility to invest money for others should act with prudence, discretion, intelligence and regard for the safety of capital as well as income."

Q

Quartile — one fourth of the data points in a data set. Often, private equity investors are measured by the results of their investments during a particular period of time. Institutional investors often prefer to invest in private equity funds that demonstrate consistent results over time, placing in the upper quartile of the investment results for all funds.

R

Ratchet — a mechanism to prevent dilution. An anti-dilution clause is a contract clause that protects an investor from a reduction in percentage ownership in a company due to the future issuance by the company of additional shares to other entities.

Realization ratio — the ratio of cumulative distributions to paid-in capital. The realization ratio is used as a measure of the distributions from investment results of a private equity partnership compared to the capital under management.

Recapitalization — the reorganization of a company's capital structure.

Red herring — a preliminary prospectus filed with the Securities and Exchange Commission and containing the details of an IPO offering. The name refers to the disclosure warning printed in red letters on the cover of each preliminary prospectus advising potential investors of the risks involved.

Redeemable preferred — preferred stock that can be redeemed by the owner (usually a venture capital investor) in exchange for a specific sum of money.

Redemption rights — the right of an investor to force the startup company to buy back the shares issued as a result of the investment. In effect, the investor has the right to take back his/her investment and may even negotiate a right to receive an additional sum in excess of the original investment.

Registration — the process whereby shares of a company are registered with the Securities and Exchange Commission under the Securities Act of 1933 in preparation for a sale of the shares to the public.

Registration rights — the rights of an investor in a startup regarding the registration of a portion of the startup's shares for sale to the public. Piggyback rights give the shareholders the right to have their shares included in a registration. Demand rights give the shareholders the option to force management to register the company's shares for a public offering. Often times registration rights are hotly negotiated among venture capitalists in multiple rounds of financing.

Restricted shares — shares that cannot be traded in the public markets.

Return on investment (ROI) — the proceeds from an investment, during a specific time period, calculated as a percentage of the original investment. Also, net profit after taxes divided by average total assets.

Rights offering — an offering of stock to current shareholders that entitles them to purchase the new issue, usually at a discount.

Rights of co-sale with founders — a clause in venture capital investment agreements that allows the VC fund to sell shares at the same time that the founders of a startup chose to sell.

Right of first refusal — a contractual right to participate in a transaction. For example, a venture capitalist may participate in a first round of investment in a startup and request a right of first refusal in any following rounds of investment.

Road show — presentations made in several cities to potential investors and other interested parties. For example, a company will often make a road show to generate interest among institutional investors prior to its IPO.

ROI — see Return on investment.

Rollup — the purchase of relatively smaller companies in a sector by a rapidly growing company in the same sector. The strategy is to create economies of scale.

Round — a financing event usually involving several private equity investors.

S

Small Business Investment Company (SBIC) — a company licensed by the Small Business Administration to receive discounted government loans in order to raise capital to use in venture investing.

Scalability — a characteristic of a new business concept that entails the growth of sales and revenues with a much slower growth of organizational complexity and expenses. Venture capitalists look for scalability in the startups they select to finance.

Scale-up — the process of a company growing quickly while maintaining operational and financial controls in place.

SEC — see Securities and Exchange Commission.

Secondary market — a market for the sale of partnership interests in private equity funds. Sometimes limited partners chose to sell their interest in a partnership, typically to raise cash or because they cannot meet their obligation to invest more capital according to the takedown schedule. Certain investment companies specialize in buying these partnership interests at a discount.

Security — a document that represents an interest in a company. Shares of stock, notes and bonds are examples of securities.

Securities and Exchange Commission (SEC) — the regulatory body that enforces federal securities laws.

Seed capital — investment provided by angels, friends and family to the founders of a startup in seed stage.

Seed stage — the state of a company when it has just been incorporated and its founders are developing their product or service.

Senior debt — a loan that has a higher priority in case of a liquidation of the asset or company.

Seniority — higher priority.

Series A preferred stock — preferred stock issued by a fast growth company in exchange for capital from investors in the "A" round of financing. This preferred stock is usually convertible to common shares upon the IPO or sale of the company.

Spin out (or spin off) — a division of an established company that becomes an independent entity.

Stock — a share of ownership in a corporation.

Stock option — a right to purchase or sell a share of stock at a specific price within a specific period of time. Stock purchase options are commonly used as long term incentive compensation for employees and management of fast growth companies.

Strategic investor — a relatively large corporation that agrees to invest in a young company in order to have access to a proprietary technology, product or service. By having this access, the corporation can potentially achieve its strategic goals.

Subordinated debt — a loan that has a lower priority than a senior loan in case of a liquidation of the asset or company. Also known as "junior debt".

Sweat equity — ownership of shares in a company resulting from work rather than investment of capital.

Syndicate — a group of investors that agree to participate in a round of funding for a company. Alternatively, a syndicate can refer to a group of investment banks that agree to participate in the sale of stock to the public as part of an IPO.

Syndication — the process of arranging a syndicate.

T

Tag-along rights — the right of an investor to receive the same rights as owners of a majority of the shares of a company. For example, if a majority shareholder wants to sell his or her interest in a company, an investor with minority ownership and tag-along rights would be able to sell his or her interest as well.

Takedown — a schedule of the transfer of capital in phases in order to complete a commitment of funds. Typically, a takedown is used by a general partner of a private equity fund to plan the transfer of capital from the limited partners.

Takeover — the transfer of control of a company.

Ten bagger — an investment that returns 10 times the initial capital.

Term sheet — a document confirming the intent of an investor to participate in a round of financing for a company. By signing this document, the subject company agrees to begin the legal and due diligence process prior to the closing of the transaction. Also known as "Letter of Intent".

Turnaround — a process resulting in a substantial increase in a company's revenues, profits and reputation.

Two x — a statement referring to 2 times the original amount. For example, a preferred stock may have a "two x" liquidation preference, so in case of liquidation of the company, the preferred stock investor would receive twice his or her original investment.

D

Underwriter — an investment bank that chooses to be responsible for the process of selling new securities to the public. An underwriter usually chooses to work with a syndicate of investment banks in order to maximize the distribution of the securities.

V

Venture capital — a segment of the private equity industry which focuses on investing in new companies with high growth rates.

Venture capital method — a valuation method whereby an estimate of the future value of a company is discounted by a certain interest rate and adjusted for future anticipated dilution in order to determine the current value. Usually, discount rates for the venture capital method are considerably higher than public stock return rates, representing the fact that venture capitalists must achieve significant returns on investment in order to compensate for the risks they take in funding unproven companies.

Vintage — the year that a private equity fund stops accepting new investors and begins to make investments on behalf of those investors.

Voting rights — the rights of holders of preferred and common stock in a company to vote on certain acts affecting the company. These matters may include payment of dividends, issuance of a new class of stock, merger or liquidation.

W

Warrant — a security which gives the holder the right to purchase shares in a company at a pre-determined price. A warrant is a long term option, usually valid for several years or indefinitely. Typically, warrants are issued concurrently with preferred stocks or bonds in order to increase the appeal of the stocks or bonds to potential investors.

Washout round — a financing round whereby previous investors, the founders, and management suffer significant dilution. Usually as a result of a washout round, the new investor gains majority ownership and control of the company.

Weighted average ratchet — an anti-dilution protection mechanism whereby the conversion rate of preferred stock is adjusted in order to reduce an investor's loss due to an increase in the number of shares in a company. Without a ratchet, an investor would suffer from a dilution of his or her percentage ownership. Usually as a result of the implementation of a weighted average ratchet, company management and employees who own a fixed amount of common shares suffer significant dilution, but not as badly as in the case of a full ratchet.

Wipeout round — see Washout round.

Wipeout bridge — a short term financing that has onerous features whereby if the company does not secure additional long term financing within a certain time frame, the bridge investor gains ownership control of the company. See Bridge financing.

Write-down — a decrease in the reported value of an asset or a company.

Write-off — a decrease in the reported value of an asset or a company to zero.

Write-up — an increase in the reported value of an asset or a company.

Z

Zombie — a company that has received capital from investors but has only generated sufficient revenues and cash flow to maintain its operations without significant growth. Typically, a venture capitalist has to make a difficult decision as to whether to kill off a zombie or continue to invest funds in the hopes that the zombie will become a winner.