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# Investment Guide: Exits

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## Investment guide: Exits

Investors deploy capital across a portfolio of businesses, each of which they expect to yield positive returns. Upon realisation of these returns, investors need to liquidate their positions to redeploy their capital. Or if it is evident that the returns will not be realised, they require exit strategies to limit their losses. Regardless of the investment's performance, at the end of an investment lifecycle, investors must return capital to their investors. It is critical that businesses seeking investment understand potential investors' exit expectations before committing to any specific investment agreement.

### Stakeholders

Multiple stakeholders will be interested in a business' objectives, operations, and performance. These include customers, suppliers and investors, each of whom have varying goals and motivations. Investors are focused on the success of the overall business and how that impacts their returns.

Equity investors, or shareholders, are motivated by company value appreciation (via increased share prices) and dividend payments, which increase shareholder wealth. Debt financiers, on the other hand, are motivated by financial returns via interest payments and revenue participation.

In addition to these financial motivations, some investors seek the opportunity to support businesses that create positive social impact. These investors may prioritise the generation of positive social outcomes over purely commercial gains.

### Commercial and impact returns

**Commercial investors** are motivated to maximise financial returns for a given level of investment risk. They may exit their position when the expected financial returns have been realised, or when they determine that expectations cannot be met. Additionally, once the investment life cycle has ended, commercial investors must liquidate their positions to compensate their own investors (often referred to as limited partners).

Typically, investors forecast expected returns by discounting their own projected cashflows (cash invested and cash returned). The discounting process accounts for the time value of money – which states money today is worth more than the same amount of money in the future due to inflation – or expected market returns from similar opportunities that are available. Key terms associated with calculating expected returns include:

1. A **discount rate** is the rate used to calculate the present value of future cashflows; it reflects the risk associated with the timing and amount of cashflows, future market conditions and inflation
2. **Net present value (NPV)** applies the discount rate to projected cashflows, calculating a cash gain/loss relative to the initial investment
3. **Internal rate of return (IRR)** calculates the discount rate at which the NPV will be zero (i.e. the point at which an investment is break-even); higher IRRs usually indicate more attractive investments

**Impact-focused investors** invest in businesses that generate positive, measurable social and environmental impact and may trade off commercial financial returns for impact gains. Impact investors typically exit when

their investees reach financial gain targets and have attained the intended impact (or when it is determined that targets cannot be met).

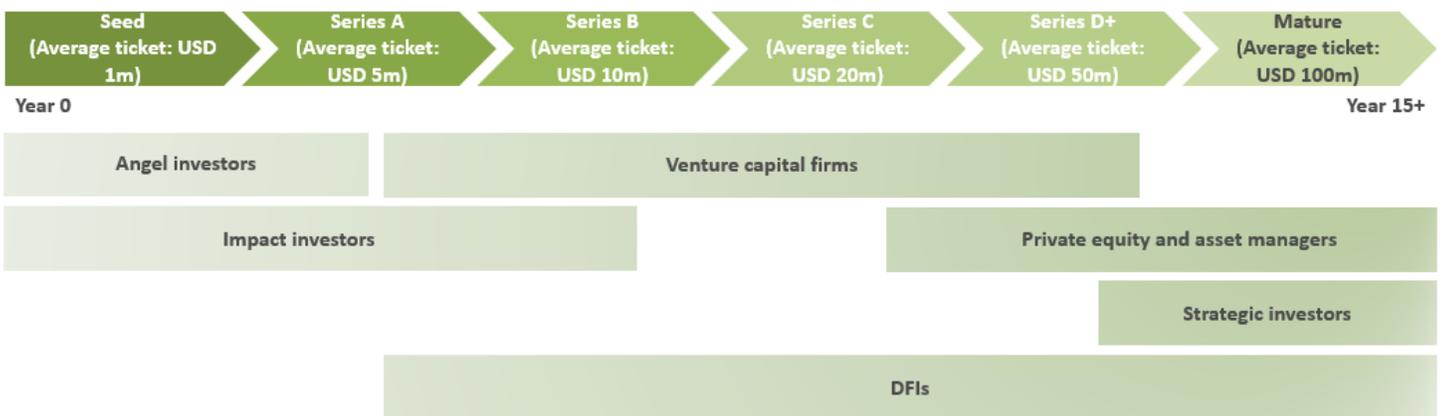
Impact investors and other ecosystem players provide frameworks for assessing a business' impact. These frameworks help investors understand when the intended impact is attained, so they can identify appropriate exit strategies that align with these expectations. Table 1 briefly outlines an example framework developed by Acumen.

**Table 1 Acumen impact measurement framework**

Impact focus	Considerations
Breadth	Number of people reached by the business
Depth	Change in the well-being of the customer/household
Poverty focus	Number of customers living below the poverty line

### Equity investor exit motivations

While debt investments have pre-determined return schedules – and thus little need for exit strategies – equity investors must weigh their own objectives against business realities to determine when to exit an investment. One key dimension along which equity investors differ is the growth stage of business they invest into, which creates a series of natural exit points for investors as companies “graduate” from one stage of their growth cycle to another. For example, early-stage investors may reach the end of their investment life cycle while a business is still in the growth phase, creating opportunities for later-stage investors to enter and deploy fresh capital. Figure 1 illustrates this process for the off-grid energy sector where, as the sector matures, later-stage investors, strategic investors and DFIs play a key role in facilitating exit strategies and providing liquidity to other – typically earlier stage – investors in the sector.



*Figure 1 Theoretical investor involvement by growth stage, off-grid energy sector*

### Early-stage investors

Early-stage investors provide capital to startups that have minimal cashflow and traction. These investors provide funding to businesses that require capital to set up operations, develop and market products, and boost sales. Such early-stage businesses are risky, and investors expect many to fail and few to yield high returns; a common

**Example:** Gaia Impact Fund is an impact investor that provides investment to renewable energy start-ups in Sub Saharan Africa and South East Asia

estimate is that 20% of the businesses will yield 80% of returns. Early-stage investors include high net worth individuals, impact investors and venture capital firms.

Early-stage investors may plan to exit about seven years after initial investment, but they often must wait 10-12 years before an exit is practical. They are motivated to exit their investments to redeploy capital to new businesses or repay their limited partners. They target financial and impact returns, but capitalising on liquidity opportunities (e.g. bringing in later-stage investors) often drives their exits.

### Later-stage investors

**Example:** Africa Infrastructure Investment develops and manages private equity infrastructure funds to invest in African infrastructure projects

Later-stage investors provide capital to financially viable businesses that are well-established in the market. These investors include private equity firms and asset managers (e.g. pension funds).

Since these investors provide capital to businesses with more established business models and cashflows, their

investments carry less risk than those of early-stage investors and the investors seek more consistent returns. For instance, private equity investors generally expect 2-3x returns on their investments.

### Development Finance Institutions

**Example:** International Finance Corporation provides capital to help businesses employ more people and supply essential services to alleviate poverty

A development finance institution (DFI), or “development bank,” is a national or regional financial institution that provides medium- to long-term capital required to achieve certain socio-economic goals in a region or sector. They may invest directly in businesses or indirectly through funds. A **DFI fund** is a pool of capital supplied by a DFI to invest in businesses or projects that match certain criteria with a pre-

determined investment life cycle.

Fund investments have defined exit timelines determined by their investment life cycles and are used by early and later-stage investors in addition to DFIs. Fund investments often reach the end of their life cycles 7 to 10 years after initial investment.

For direct investments, DFIs are mainly concerned with maximising returns upon exit and do not have pre-determined exit timelines, which could lead to investment lasting more than 10 years. For investments made indirectly (e.g. through specialist fund managers), the fund manager will make the ultimate exit decision.

### Strategic investors

**Example:** ENGIE Ventures makes strategic investments in cleantech and technology companies driving the energy transition

Strategic investors are typically experienced in running large corporations and may have direct experience in their investees’ sector of operation. They may invest in businesses to improve their own business models by leveraging the investees’ market, technology, and products, among others.

Their investments often catalyse growth in the sectors they operate in and promote industry consolidation.

Strategic investors are often driven by business synergies in addition to the investees’ own financial returns, and as such, may not plan to “exit” an investment if the investee adds value to the parent company.

## Equity investor exits

Equity investors have a variety of exit strategies that they can use to liquidate their positions and exit their investments. This section gives an overview of each strategy and recommendations to businesses on how to improve the viability of each strategy.

### 1) Strategic acquisitions

**Example:** ENGIE, a French multinational electric utility company, fully acquired Fenix International, Simpa Networks and Mobisol

A **strategic acquisition** is “the integration of entities or takeover of one entity by another entity operating in the same or different sector.” In emerging markets, this may be the most attainable exit strategy for existing investors in a company.

Incoming acquirers may seek to increase their market presence, gain insight into a sector they do not operate in, or acquire essential assets that would be expensive and time consuming to build internally. Additionally, they can acquire distressed rivals or purchase businesses in their sectors of operation for geographic expansion rather than expanding their operations organically. For this reason, existing investors may be able to negotiate a premium on company valuation, increasing their returns.

For the business, the incoming strategic investors typically have long-term investment horizons and may be prepared to provide support to the business. This may or may not include a broader integration of the company into the acquirer. In addition, acquirers may leverage their own asset base and technical expertise (e.g. product development) to benefit the acquired company.

Despite these mutual benefits, there are challenges to strategic acquisitions. Incoming investors may perceive premiums sought on large well-established businesses or smaller businesses with growth potential as being too high, leading to overvaluation.

Investors often look for businesses with differentiated products and services, operations in sectors and locations with a large untapped market, key assets, and unique technical expertise.

### 2) Secondary sales

**Example:** Jumia, an online marketplace in Africa, launched its IPO on the New York Stock Exchange in 2019

A **secondary sale** is the sale of shares by an existing shareholder to a secondary investor, often a later-stage investor. It is a more viable exit route for investors in emerging sectors (e.g. off-grid energy) as compared to IPOs and sector M&As, which typically occur in mature sectors and markets.

This exit strategy may enable investors to build a majority stake and control of a business, especially if shareholders are willing to sell their shares at discounted prices. They also allow the business’ current investors to liquidate their investment positions and pursue other ventures.

Later-stage investors view secondary sales as an opportunity to increase the value of their investments. This could be through investing in businesses with continued growth trajectories or previously underperforming businesses experiencing a turnaround.

**Example:** Blue Haven Initiative, an American impact investment company, bought out Acumen in M-KOPA

Secondary sales that are sought at a discount to the primary offering price can discourage existing shareholders from accepting offers. Conversely, new investors may be less willing to deploy their capital to buy out existing shareholders when the businesses itself requires significant

additional capital to continue scaling. The high capital requirements for early-stage businesses to scale and achieve profitability have led to early-stage investors remaining invested whilst new investors bring fresh capital to the business.

### 3) Initial public offerings (IPOs)

**Example:** Diageo, a British alcoholic beverages company, bought back 94m shares in 2019

An **initial public offering (IPO)** is the process of offering company shares to the public through issuance of new stock. This is a potential exit route for investors in mature sectors in developed markets rather than those in emerging markets and sectors (e.g. off-grid energy).

IPOs tend to have the highest ceiling for investor return because market sentiment can lead to higher than estimated valuations. Additionally, IPOs benefit the listing businesses. They give businesses access to a large pool of funds by opening the business to receive capital from the public.

IPOs are lengthy and uncommon for businesses in emerging markets. In addition, the IPO terms may prohibit current investors from exiting some or all their positions for a defined period called a **lock-up period**. A lack of buyers, high valuations, high transaction costs and lack of exchanges that accommodate small, emerging-market companies lead to few IPOs in developing economies.

To make IPOs more feasible, businesses should demonstrate the robustness of their business models and their growth potential. They should also consider geographic and product diversification to minimise risks, which will make them more attractive to the public.

### 4) Share buybacks

A **share buyback** is the sale of existing investor shares to company management/founders. Businesses with surplus cash and retained earnings may opt to repurchase their shares from existing investors by way of providing returns or enabling an exit.

This exit route provides improved shareholder value for existing investors who do not participate in the buyback. With the same levels of profit and lower number of outstanding shares, the business will have higher earnings per share.

Share buybacks can give management of a business greater control over its direction. Management can use this strategy to prevent other shareholders from gaining a controlling stake in the business.

This is not a common exit route as businesses often lack the cash for share buybacks and valuations may be perceived as too high for this exit route to provide value. Businesses conducting buybacks should ensure that they have adequate cash-on-hand to repurchase the shares without having a negative impact on future operations.

## Debt investor exit motivations

While equity investors observe a business' growth and performance and/or impact returns to decide when to exit an investment, debt investors' exits are contractually scheduled at the time of initial investment. Tracking performance is not critical to debt investors, but they may do it to ensure that the businesses can continue to service the debt.

Debt investors' exit decisions are based on the ability of the investee to make the scheduled repayments. This is determined by the expected cash flows in the business. The investor may choose to rollover their financing if the business has sustained cashflow.

### Commercial Banks

**Example:** Banco de Oro provides products and services to the retail and corporate markets including lending to SMEs in South East Asia

Commercial banks are the primary source of debt funding for businesses, and they provide debt capital to mature companies with a demonstrated ability to repay the loans. They are primarily motivated by commercial returns.

To gauge whether a business will be able to meet debt obligations, they assess the businesses' projected financial performance and look to secure their investment with collateral and impart covenants that restrict adverse management decision making.

Debt terms include an investment return schedule for investors, with commercial banks typically expecting principal and interest repayment within one to three years, however, longer term debt facilities may be available depending on the use of funds.

### Debt investor exits

Debt investments have pre-determined durations and repayment schedules. As such, the exit timelines are known at deployment of capital and businesses should plan to repay their debt on schedule. Businesses should consider their future cashflow needs and associated costs when assessing possible debt investor exit strategies.

#### 1) Follow-on financing

**Follow-on financing** is the creation of another debt instrument once the period of the initial debt has lapsed. A business may "roll over" its current debt, extending its duration, or it may pursue a loan from a different source.

Before taking on more debt, businesses should ensure that they can service the debt. They should assess their future cash flow trends to confirm that they will have the capacity to make the interest repayments.

#### 2) Debt refinancing

**Debt refinancing** is the replacement of debt with other debt that has more favorable terms. The new debt may take advantage of favorable market conditions (e.g. low interest rates) and repay the existing debt, providing the debt investor with an exit opportunity.

Businesses can free up cash flow if they refinance their loans at lower interest rates, giving them more money to invest in their operations. However, there could be significant closing and transaction fees associated with refinancing the existing debt that make it infeasible.

## Exits for underperforming businesses

**Table 2: Exit strategies for underperforming businesses**

Exit strategy	Definition	Recommendations for businesses
<b>Strategic acquisition</b>	Integration of entities or takeover of one entity by another entity operating in the same or different sector	Focus on developing key indicators (e.g. brand recognition, wide market penetration and a large customer base)
<b>Secondary sale</b>	Sale of shares by an existing shareholder to a secondary investor	Consistently report financial and operational metrics to demonstrate an improving track record
<b>Initial public offering</b>	Process of offering company shares to the public through issuance of new stock	Demonstrate the robustness of their business models and their growth potential, and diversify operations
<b>Share buyback</b>	Sale of existing investor shares to company management/founders	Ensure proper cash management to limit negative impact on future
<b>Follow-on financing</b>	Taking up another debt instrument once the period of initial debt has lapsed	Assess future cash flow trends to ensure that they will have repayment capacity
<b>Debt refinancing</b>	Replacement of debt with other debt that has more favorable terms	Consider the closing and transaction fees before refinancing debt

The exit strategies outlined in the table can be used for businesses that have strong performance or growth potential, but some businesses may not exhibit this. Businesses may become underperforming because of an economic recession, loss of competitive position, changing industry dynamics, regulatory issues, among many other causes. To limit their losses, investors can use the following strategies to exit their investments in such underperforming businesses.

**Down round:** A business sells new shares to new investors at a price per share that is less than the price per share it sold shares for in an earlier financing. Many shares will need to be sold to raise the capital required, which leads to a decrease in the ownership stake of the existing investors. While the business' book value will be written down by investors, this is not a true exit as the investors will maintain the same number of shares.

**Distressed sale:** Investors initiate the sale of the business' key assets or sale of the business as a going concern. Acquirers are often businesses in the same sector as the underperforming business looking to acquire key assets below market price.

**Liquidation:** This is a distressed firm's most drastic option, and it is usually pursued when the business and the investor cannot reach an agreement on an alternative exit strategy. Senior debt investors can also force businesses into liquidation if their payment terms are not met.

**Debt workout and write-offs:** A workout refers to a negotiated agreement between debtors and their creditors outside the bankruptcy process. In a workout, the debtor tries to convince creditors that they would be financially better off with the new terms of a workout agreement than with the terms of a formal bankruptcy. The main benefits of workouts are cost savings and flexibility.

## Conclusion

Exit strategies allow investors to leave their investments once they have earned the expected return, or to limit their losses when the investment is unsuccessful. This allows investors to redeploy capital to other investments or repay their limited partners. The choice of an exit strategy depends on the type of investor, type of capital invested and the business' performance.

Businesses should understand investors' motivations for exits and their preferred exit strategies. Each strategy has its benefits and limitations, and businesses should be aware of how to position themselves to provide their investors with viable exit strategies.

## References and further reading

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[https://www.lightingglobal.org/wp-content/uploads/2020/03/VIVID%20OCA\\_2020\\_Off\\_Grid\\_Solar\\_Market\\_Trends\\_Report\\_Full\\_High.pdf](https://www.lightingglobal.org/wp-content/uploads/2020/03/VIVID%20OCA_2020_Off_Grid_Solar_Market_Trends_Report_Full_High.pdf)

### Lighting the way: Roadmap to exits in off-grid energy

<https://acumen.org/wp-content/uploads/Acumen-Exits-Off-Grid-Energy-Report.pdf>

### Comparative study of equity investing in Development Finance Institutions Inter-American Development Bank

<https://publications.iadb.org/publications/english/document/Comparative-Study-of-Equity-Investing-in-Development-Finance-Institutions.pdf>

### The difference between NPV and IRR

<https://www.accountingtools.com/articles/the-difference-between-npv-and-irr.html?rq=internal%20rate%20of%20return>

### Business Essentials: Entrepreneurship and Raising capital

[Business Essentials](#)

### Exit strategies in private equity

[https://www.researchgate.net/profile/Didier\\_Folus/publication/299872017\\_Exit\\_Strategies\\_in\\_Private\\_Equity/links/574de51b08aec988526bc2c8/Exit-Strategies-in-Private-Equity.pdf](https://www.researchgate.net/profile/Didier_Folus/publication/299872017_Exit_Strategies_in_Private_Equity/links/574de51b08aec988526bc2c8/Exit-Strategies-in-Private-Equity.pdf)

### Investing in distressed debt

<https://caia.org/aiar/access/article-847>

### What you need to know about down round financing

<https://www.cooleygo.com/down-round-financings/>

## Useful contacts

### **Acumen**

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