

KARNATAKA VENTURE CAPITAL FUND FOR SME SECTOR

OPERATIONAL GUIDELINES

SPONSORS

Karnataka Venture Capital Fund (KARVEN Fund) would be a Trust sponsored by the Government of Karnataka through Karnataka State Industrial Investment and Development Corporation Limited (KSIIDC).

KARVEN Fund

Objective

The objective of KARVEN Fund is to make available Venture Capital Fund to small and medium sized companies in Karnataka in the Engineering, Agro processing, Automobile components, Aerospace Engineering, Clean Energy, Production of Patented Products and such other manufacturing sectors.

The Fund intends to

- (i) Leverage its management expertise, operational experience and extensive industry network, to help these start-up and expansion-stage companies to become successful enterprises.
- (ii) Support Promising innovative Engineering, Agro processing, Automobile components, Aerospace Engineering, Clean Energy, Production of Patented Products and such other manufacturing sectors.
- (iii) Deliver good Financial Returns to Investors / Subscribers
- (iv) Increase Employment opportunities, Export revenue to the Country and Entrepreneur skills for creating more and more SMEs

Constitution

KARVEN Fund will be constituted as a Trust in accordance with the provisions of the Indian Trusts Act 1882. The Venture Capital Fund would also be registered with the Securities and Exchange Board of India.

Board of Trustee

The Trustee shall be the KARNATAKA TRUSTEE COMPANY PVT. LTD. ("KATCO") a Company incorporated under the provisions of the Companies Act, 1956 and having its Registered Office situated at #403, 4th Floor, HVS Court, 21, Cunningham Road, Bangalore - 560052. The authorised share capital of the company is Rs.2.00 Lakhs.

Investment Manager

Karnataka Asset Management Company Private Limited (KAMCO) a company incorporated under the Companies Act, 1956 and having its registered office at #403, 4th Floor, HVS Court, 21, Cunningham Road, Bangalore - 560052 will be the Investment Manager. The Investment Manager is responsible for the investments of the Fund.

Rights of Beneficiaries

The unit holders have a proportionate right in the beneficial ownership of the assets of the fund. The unit holders have a right to ask the Trustee about any information that may have an adverse bearing on the investments and the Trustee shall be bound to disclose such information.

SUMMARY OF PRINCIPAL TERMS

- Structure** KARVEN Fund (the Fund) would be structured as a Trust investing through the Trustee Company and invest in VCUs as evaluated and recommended by the Investment Manager.
- Corpus** Minimum of Rs.5 Crores
- Contributor** We shall be approaching other institutions such as KSHDC, KSFC, KSSIDC, SIDBI etc to mobilize the balance Rs. 4 Crore as the minimum corpus required for operation of a Venture Capital Fund as per SEBI regulation is Rs.5 Crore.
- Contribution** By way of subscription to units each of Rs.25 Lakhs denomination. The units are not proposed to be listed on any recognized stock exchange(s) till the expiry of three years from the date of issuance of units in consonance with clause 13 of the SEBI Venture Capital Fund Regulations 1996, wherein it is stated as under

No Venture Fund shall be entitled to get its securities or units as the case may be, listed on any recognized stock exchange till the expiry of three years from the date of issuance of securities or units as the case may be, by the Venture Capital Fund.

Commencement of Operation of the Fund

The fund becomes operational when minimum of Rs.5 Crore is committed for subscription.

Investment Policy

The investment of Fund will be made in Equity / Equity related instruments / convertible preference shares / convertible debentures or any other instruments as may be permitted under the SEBI guidelines in Venture Capital Undertakings (VCU) primarily in the private sector in new as well as existing Companies so as to achieve the objectives of the Fund.

The entire Fund shall be invested in Small & Medium Enterprises in the Engineering, Agro processing, Automobile components, Aerospace Engineering, Clean Energy, Production of Patented Products and such other manufacturing sectors.

The investment in each VCU shall range from a minimum of Rs. ~~25~~^{10.0} Lakhs to a maximum of Rs.100 Lakhs.

Investments will normally have an exit horizon of 3-5 years except in so far as is required under the SEBI Regulations as may be in force from time to time.

The investments and all activities of the Fund as a Venture Capital Fund will be in accordance with Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996 and Government of India/RBI guidelines as applicable, if any.

Manager

The Manager of the Fund will be Karnataka Asset Management Company Private Limited.

Investment**Committee**

An Investment Committee appointed by the Manager shall comprise not more than five or more voting members depending in the size of the corpus, who are persons of eminence in the field of industry, finance, management, science and technology. Efforts will be made to give one representation to each of the Subscribers subject to a minimum investment of Rs.1 Crore.

Investment Committee shall meet at least once in a quarter (3 months) but the time gap between two meetings shall not be more than four months to review the achievement of investment objectives, investment performance, strategy and potential conflict of interest.

Term

The Fund will be a 10 year close-ended Fund. The Fund will normally terminate on the tenth anniversary of the date of the Trust deed unless a consent to extend the Trust is given by the Trustee and all the Contributors in which event, the period of the Trust/ Fund will stand extended to terminate on such later date as may be decided by the unanimous written approval of the Trustee and all the Contributors provided that such period shall not exceed 2 years.

Closing

The Fund will be open for subscription by the Contributors up to the end of 31st March, 2011 or till the committed Contribution totaling Rs.5 crores is realized, whichever is earlier.

Winding Up

While the Fund will normally terminate according to the Clause regarding 'Term' mentioned herein above, the Fund, which is set up as a Trust shall be wound up according to Clause 23(1) of Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996. which is repeated hereunder for ready reference of the Contributors:

'23(1) A Scheme of a Venture Capital Fund set up as a trust shall be wound up

- (a) when the period of the scheme, if any, mentioned in the placement memorandum is over,
- (b) if it is in the opinion of the trustees or the trustee company as the case may be, that the scheme shall be wound up in the interests of the investors in the units,
- (c) if seventy-five percent of the investors in the scheme pass a resolution at a meeting of unit holders that the scheme be wound up or ,
- (d) if the Board so directs in the interests of investors.'

(2) A venture Capital fund set up as a company shall be wound up in accordance with the provision of the Companies Act, 1956 (1 of 1956).

23(2) A Venture Capital Fund setup as a Company shall be wound up in accordance with the provisions of the statute under which it is constituted.

23(3) The Trustees or Trustee Company of the Venture Capital Fund set up as a Trust or the Board of Directors in the case of the VC Fund is set up as company (including body corporate) shall intimate the Board and Investors of the circumstances leading to the winding up of the Fund or Scheme under Sub Regulation (1).

Management Fee

(a) A Management fee of 2.00% p.a. (plus applicable taxes) of the Contributions committed to the Fund till the entire corpus is invested. Thereafter, the management fee would be based on the outstanding corpus at the end of the previous year subject to a minimum management fee of Rs.5 Lakhs per annum to be paid on quarterly basis. The management fee is payable for the quarter during which the Fund becomes operational i.e., receipt of first tranche from the contributors/subscribers.

The Manager will also be entitled to 'Success Fee' which would be computed as Follows:

- (i) The Manager will record all cash distribution it makes to the subscribers.
- (ii) The Managers will notify the Trustee of the date (the "Return Date") when the aggregate of these cash distributions exceeds the minimum return after redeeming the entire Contribution (defined below).
- (iii) As long as this Agreement is not terminated, the Trustee will pay the Manager 20% of the surplus, if any after meeting the minimum return.

"MINIMUM RETURN" means an amount equal to

- (i) The Contributions, plus
- (ii) The amount which would accrue upon the Contribution at 15% return on IRR basis from the date the contributors pay their contributions to the Return Date.

Trusteeship Fee

The KATCO will be entitled to a fixed fee of Rs.1.00 Lakh per annum. It has to meet all its operational costs

Distribution Realisation proceeds will be distributed to investors as soon as practicable in the form of income and return of corpus. It is anticipated that the majority of exits will come from Initial Public Offerings or Acquisitions of the VCU's. The Manager will convert quoted positions into cash to be distributed to unit holders, but the nature of the stock markets often precludes easy liquidation of even quoted holdings.

Establishment Expenses

All preliminary expenses relating to setting up of KARVEN Fund such as Trust Registration expenses, legal expenses, SEBI registration fee etc., shall be met by KAMCO initially and the fund shall reimburse the same after it becomes operational.

Fees and expenses of professional advisors appointed by the Manager in relation to the operation of the Fund (including lawyers and accountants), the costs of printing and circulating reports and any costs, expenses or fees which are associated with specific investments made, held or realized by the Fund (and not borne by the VCUs) will be paid by the Manager.

The Manager will try to recover the deal related costs (accounting, investigations, legal expenses, due diligence charges and external consultants' report expenses etc.,) from the VCUs.

Reports The Fund will provide audited financial statements annually to all investors. Each investor will also be sent a half yearly un-audited financial statement of the Fund.

Indemnification The Fund will indemnify and hold harmless the Board of Trustees and the Manager and personnel against claims, liabilities, costs and expenses, including legal fees, incurred by them by reason of their activities on behalf of the Fund and its portfolio companies.

Tax Considerations The Fund would qualify for Income Tax exemption as all Income of a SEBI registered "Venture Capital Fund" under Section 10 (23FB) of the Income Tax Act, 1961, (namely capital gains, dividend, interest, and any other income) would be fully exempt from tax in the hands of the Fund if the investment is made as per the sectors mentioned in the Act. However, when the Fund distributes income to individual Subscribers, the same is taxable in the hands of the Subscribers.

Risk Factors

An investment in a Venture Capital Fund involves significant risk and should be considered only by sophisticated investors able to assume risks of loss and illiquidity inherent with an investment in the Fund. Please see 'Risk Factors'.

Auditor to the Fund The Trustee company KARNATAKA TRUSTEE COMPANY PVT. LTD. ("KATCO") will appoint the Auditors to the Fund.

THE INVESTMENT APPROACH

The overall objective of the Fund shall be -

- i. to meet the long term risk capital of SME units in Engineering, Agro processing, Automobile components, Aerospace Engineering, Clean Energy, Production of Patented Products and such other manufacturing sectors and to enable them to achieve rapid growth rates and maintain their competitive edge in domestic and international markets and
- ii. to provide mentoring support for SMEs.

The Fund's primary investment objective is to achieve medium to long term capital appreciation by making investments in equity, equity related instruments including convertible instruments in unlisted companies/ growth oriented Small & Medium Enterprises in Engineering, Agro processing, Automobile components, Aerospace Engineering, Clean Energy, Production of Patented Products and such other manufacturing sectors as per SEBI guidelines. Investments will typically be in companies undertaking early stage or first/ second stage financing with a track record or proven technology or business model and/or growth and earnings.

Investments of the Fund shall consist primarily of equity, equity related instruments, convertible instruments etc. in companies falling within the Focus investment Sector. Currently, the sectors expected to be of interest to the Fund include Engineering, Agro processing, Automobile components, Aerospace Engineering, Clean Energy, Production of Patented Products and such other manufacturing sectors.

Investment Range Investment by the Fund is expected to be in the range of Rs.25 Lakhs to Rs.100 Lakhs.

Investment Horizon Investments will be made with an envisaged holding period of 3-5 years although there could be no assurance for exit opportunities during such time frame.

Investment Instruments The Fund will predominantly invest in the form of equity or equity related instruments, convertible instruments etc.

Investment Criteria The Manager would screen for potential investments based on the following characteristics:

1. Management Strong and Dynamic Management with established track record and having relevant experience. Especially important is technical expertise with the product / services line and marketing knowledge

2. Market The market will have to be quantifiably large with excellent opportunities for growth. Ideally, Companies that are niche players in specific market having scalable untapped opportunities. This leads the companies to go global even though they may be much smaller today.

3. Future Potential Seek differentiated Products / High-end products with barriers to new entrants or large suite suppliers. The investee Company should have the potential for substantial future earnings & increased market share

4. Competitiveness The investee company should have demonstrated or possess the ability to develop significant competitive advantages

5. Area of Operation The Fund will be a regional fund with high priority investments to Companies based in the State of Karnataka.

The investment proposals shall be put up to the Investment Committee for its consideration and approval.

The Fund shall invest in accordance with its Investment Objectives and Policies as outlined in the Trust deed. The broad Investment Policy shall be as under:

1. Not more than Rs.100 lakhs of the Fund's Capital commitments shall be invested in any one investee company.
- ~~2. The minimum investment per project shall be Rs.25 Lakhs (Rupees Twenty Five Lakhs only). The minimum investment criteria may be relaxed by the Board of Investment Manager on the unanimous recommendation of the investment committee in respect of investment in specific proposals.~~
3. The projects to be supported by the Fund should promise a minimum Internal Rate of Return ("IRR") of 25% per annum on the investment, over a period of 3-7 years from income by way of dividend, capital gains, interest and royalties etc. However, this may be relaxed, if necessary, on a case to case basis, by the Board of Investment Manager, on the unanimous recommendations of the Investment Committee in respect of investment in specific proposals upto a minimum of 20% on IRR basis.
4. The Trust Fund may make second and subsequent round of investment in the same project subject to the limits set out hereinabove.
5. The Fund shall invest primarily in unlisted companies in the Focus Investment Sectors as indicated above.
6. The exit route for each investment shall be indicated in each investment proposal to be considered by the investment committee for its recommendations to invest in the identified company.
7. A balanced and diversified portfolio shall be developed with an appropriate mix of investments in start-ups, expansions and new technology companies.
8. The Fund shall not engage in speculative trading activities in commodities or commodity contracts.
9. The Fund will not invest in companies engaged in the operation of casinos, other gambling facilities or other activities forbidden by the Government of India and SEBI.

Investment Process

The Fund will endeavor to develop an extensive network of contacts amongst the Engineering, Agro processing, Automobile components, Aerospace Engineering, Clean Energy, Production of Patented Products and such other manufacturing sectors. Such a network will often bring proprietary transactions to the Fund's attention and the constituents provide valuable assistance to the Fund in performing the due diligence review.

Investment proposals will be first subjected to an initial review and if found suitable will be pursued for further investigation and due diligence. If the due diligence process indicates a favorable outlook, an outline of investment terms will be negotiated. Subsequently, proposal will be presented in the form of a detailed information memorandum to the Investment Committee for its consideration and approval.

The Fund to the extent possible will try to be the lead investor and will ensure a representation on the Board of Directors of the VCU.

Nurturing

The Fund will try to assist the VCUs in terms of making available strategic inputs pertaining to human resource development, marketing, financial and other corporate issues. However, the Fund will strive not to get involved in day to day operations of the VCU.

Exit

The exit will be through a planned initial public offering although there can be no assurance that such opportunities will be available at the proposed time. Other options such as sale to promoters, other financial and strategic investors or to a special purpose vehicle will also be explored to ensure maximum return on the Fund's investment.

Benefits for the Government by setting up KARVEN Fund:-

1. Based on the past performance of KARVEN Fund a return of around 10-12% on IRR basis can be expected.
2. Depending the size of the Corpus at least 10-15 SMEs can be assisted.
3. Will give employment opportunity to around 1000 and the annual turnover of these companies would be around Rs.500 Crore over a period of time.
4. Will further boost the economic activity around the area.

Board Of Directors of KAMCO

1. Ms. Vanditha Sharma, IAS, MD, KSIIDC (Chairperson)
2. Shri V. P. Baligar, IAS, Principal Secretary, C&I Department
3. Shri Ashok Kumar Manoli, IAS, Principal Secretary, IT, BT and S&T Dept.,
4. Shri Kaushik Mukerji, IAS, MD, KSFC
5. Dr. Raj Kumar Khatri, IAS, Director F & C and Commissioner for Industrial Development.
6. Shri B V Naidu, Managing Director, Green Olive (India) Technologies Private Limited.
7. Shri G L Jeré, Executive Director, KSIIDC
8. Dr. S S Chandra Shekar, Executive Director, KSFC
9. Shri Ramesh Dharmaji, GM, SIDBI, Bangalore
10. Shri A R Jayakumar, CEO.

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4. Dr. Raj Kumar Khatri, IAS, Director I & C and Commissioner for ID,
5. Shri G L Jere, Executive Director, KSIIDC
6. Dr. S S Chandra Shekar, Executive Director, KSFC
7. Shri Ramesh Dharmaji, GM, SIDBI, Bangalore
8. Shri A R Jayakumar, CEO.

RISK FACTORS

RISK

Potential investors should be aware that an investment in the KARVEN Fund involves certain considerations and significant risks. There can be no assurance that the investment objective of the KARVEN Fund will be achieved, or that an Investor will receive a return of its Capital. Investment in the Fund should be considered only by sophisticated investors able to meet the drawdown obligations and assume the risk of loss and degree of illiquidity that an investment in Venture Capital Fund requires.

Risk Associated with Unspecified Transactions

As on the date of this Memorandum, none of the Fund's investment has been identified. Investors will be relying on the ability of the Manager with respect to the investments to be made using the proceeds of this offering. Since such investments may occur over a substantial period, and if the investments of the Fund are not successful, they are unlikely to produce a realized return for the investors for a period of several years.

Lack of Control over the Fund Policies.

The management, deal sourcing, investment terms and disposition of the Fund and its policies with respect to certain other activities, including its distributions and operating policies will be determined by the Board of Trustees in consultation with the Manager. These policies may be changed from time to time at the discretion of the Board of Trustees without the consent of the Contributors, although the Board has no presented intention of making any such changes. Any such changes could be detrimental to the value of the Fund.

Dependence on key personnel

The ability to successfully manage the Fund will largely depend on the skill and expertise of key individuals. There can be no assurance that these individuals will continue to be employed by the Fund. The loss of any key individual can have a materially adverse effect on the Fund.

High Risk Investment

Investment will be made in companies that can have substantial variation in operating results from period to period. Portfolio companies can experience failures or substantial declines in value at any stage and may face intense competition. Since the investments will only be in companies in the Engineering, Agro processing, Automobile components, Clean Energy, Production of Patented Products and such other manufacturing sectors, the volatility of the value of the portfolio will be high. Some companies can have the need for additional capital to support expansion or to achieve or maintain a competitive position but there can be no assurance that such capital will be available.

Illiquid Private Investments

The investments in privately held companies will be illiquid and difficult to value. In almost all the cases, investments in these companies will be long term in nature and may require many years from the date of initial investment before disposition. Sales of securities of private portfolio companies may not be possible and if possible, may be made at substantial discounts from cost.

Significant Competition

The VCUs operate in extremely competitive environments. New products and services are continuously being developed rendering older technologies, products and services obsolete. There can be no assurance that VCUs will successfully penetrate their markets, or establish or maintain a competitive edge.

Limited Number of Investments

The Fund will participate in a limited number of investments and as a consequence, the aggregate return of the Fund may be substantially affected by the unfavorable performance of even a single investment.

Risks associated with Small and Medium Enterprises Sector

Accounting, Disclosure and Regulatory Standards

Accounting, financial and other reporting standards in India are not very rigorous in certain areas including accounting for depreciation, deferred taxation and foreign exchange transactions. Accordingly, the Investment Manager, the Fund and Investors/Investment Committee may not have adequate information while evaluating investment and divestment decisions.

Information

Privately held companies maintain less comprehensive financial information than listed companies. Therefore, the Fund may make investment decisions and monitor such investment after reviewing information which are less comprehensive than that available to an investor in listed public company.

Non-Controlling investments:-

The Fund will generally hold less than 50% of the outstanding equity securities of any investee project and therefore may have a limited ability to protect its investment in such investee project, although as a condition of investment in a investee project the investment manager expects that appropriate shareholder and supervisory rights will generally be negotiated to protect the Funds interests.

Potential for Insufficient Investment Opportunities:-

The Investment Manager may not be able to identify and obtain a sufficient number of investment opportunities to invest the full amount of capital that may be committed to the Fund.

Third Party Litigation:-

The Fund's investment activities subject it to the normal risks of becoming involved in litigation by third parties. This risk is somewhat greater where the Fund exercises some amount of control over an Investee Project's direction. The Investment Manager and others are indemnified in connection with such litigation.

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