Private Equity in India-Role, Challengesand Future

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Introduction

At the turn of the century, many Indian industries weren't fully open to foreign investment, and family-run businesses were wary of ceding control. Private equity has now become a "very important" source of funding for Indian companies' growth. In the past few years, the investment climate has undergone a positive change. The private equity firms have also matured: they have seen a couple of investing cycles, and they now have experience with Indian companies and Indian management.

Private Equity funds have invested more than USD 200bn in India between 2001 and 2018, providing a stable source of equity capital, out of which more than USD 100bn has been invested in the past 5 years itself. 2018 has been an excellent year for private equity with total investment of c. USD 26bn across c.800 deals. Major sectors seeing traction in 2018 and 2019 are BFSI, Consumer/Retail, Healthcare and Energy. We are also seeing increased activity from sovereign wealth funds and AIFs.

Traditionally, private equity investments were only viewed as pure equity. Increasingly more sophisticated products such as earn out, convertible and performance linked products are being offered with equity. This provides options to both business owners and funds the freedom to make a right capital structure decision and achieve optimum shareholding and returns.

Role of Private Equity in India

The initial source of capital for many businesses, especially start-ups, used to be savings and seed capital from friends and family. Bank sources were virtually non-existent. Till the business achieved a certain scale, availability of capital (bank funding or access to capital market) was limited. However, private equity and venture funds are bridging this gap by stepping in with much needed capital.

Venture capital remains the most favored strategy among India-based fund managers. c. 60% of funds currently in market are venture capital vehicles, seeking more than USD 7bn in capital commitments with digital age companies a key investment area.

The bulk of transactions and funding (in volume basis) have happened for companies with revenue less than USD 100mn with majority for companies with revenue less than USD 5mn. This indicates that they have contributed to investing in the potential of the country and played a critical role in the development of early-stage ventures and small and medium-size enterprises.

Their contribution has also been crucial in the development of few critical industries like IT services, consumer internet and Renewable Energy. This inflow of capital in the previous few years has resulted in the recent surge in entrepreneurial activity.

PE has come a long way and from being viewed as a capital source of last resort, it is now seen as a beneficial source of capital. Private capital offers much more than just capital - PE fund owners are playing an active role as they join forces with promoters and management. They added tangible value by ensuring higher compliance with increased corporate governance practices, increased financial and operational management through implementation of efficient cost management techniques, and modern operational processes. They support portfolio companies by providing technical know-how and industry connect. Lastly, they offer patient capital in many cases, providing companies time to build up to function as world-class businesses without the regular and constant pressure of regulatory reporting and/or paying debt.

Challenges Faced by Private Equity

However, the industry is still evolving and faces challenges on multiple fronts. The major ones can be bucketed into two categories – tax/regulatory and valuation mismatch.

Firstly, the industry faces multiple challenges with the tax and regulatory frameworks such as introduction and uncertainty around General Anti-Avoidance Rules (GAAR) from 1 April 2017, foreign funds tax residency to be considered as Indian if its place of effective management (PoEM) is in India and "Angel tax". It is here that the government and regulatory bodies can play a very important role to provide an impetus for the country. It is estimated that for every percentage point of GDP growth, India needs ~USD 30bn of capital for which private equity will play a crucial role.

Regulations could further provide an impetus for the industry -

Currently, regulations restrict participation of domestic institutional investors such as provident and pension funds, banks and insurance companies in private equity investments. If made available, they could be a very large pool of investable capital. Insurance, provident and pension funds have available capital of c. USD 350bn in India, out of which only c. USD 10bn is available to be invested as private equity capital. Also, regulations could address issues related to withholding tax and safe harbor norms for overseas investors. This will make investment decisions and structuring of investments easier. Many global pension funds enjoy a tax-free status in most countries. Such benefits might increase the attractiveness of investing in India.

The ability to provide exit at attractive returns is a vital element of any healthy PE ecosystem. This will be the basis for allocation of capital in subsequent fund-raising rounds. However, there are two major regulatory constraints that impede the exit process. Firstly, a three-year lock post IPO as currently private equity investors are classified as “promoters” and secondly, tax authorities challenging exits post completion of the transaction adds W&I insurance costs and additional timelines for exiting investments. Lastly, simplified delisting norms for closely held companies would expand the investible universe available for investors.

Valuation mismatch, a trait typical of a rapidly growing emerging market, is a big challenge facing funds that hinder deal-making. Having said that, we see that the gap of valuation mismatch is reducing and there is a sense of pragmatism seeping in with respect to promoter’s expectation.

Future of Private Equity in India

Private Equity is still an evolving industry; however, it has started to align itself to global trends which indicates that the industry is maturing as can be seen from below behavior.

Firstly, investors have shown more interest in striking late-stage and buyout deals. This is evidenced by an increase in transactions where PE players have acquired majority stake in companies. This has been made possible as companies mature and management looks for exits. Also, as second and third generation entrepreneurs drift away from family business, this opens opportunities for acquisition of majority stake and influence control in these companies. The proportion of control and buyout transactions is higher in developed markets and the Indian market is moving in a similar direction. Funds are also focusing on buy-and-build strategy demonstrating confidence in their ability to take operational control and create value by bringing operational discipline and tuck-in acquisitions.

Secondly, the number of PE funds have increased significantly in the past few years. There is increased competition for good assets and focus on completing transactions. India focused dry powder available reportedly stands at an impressive level of c. USD 11bn indicating greater interest in the attractive Indian market. Also, family offices and direct investment teams of LPs have started investing directly adding to the competitive intensity of the industry.

Thirdly, due to rise in new generation of entrepreneurs and professional managers, we see that PE investment opportunities are increasing as they are more open to partnership and co-ownership structure with PE funds and alternate investments.

Lastly, IBC process and distress loan portfolio of Indian banks has attracted a new set of private equity funds focused on distressed assets to India. This investor group has a significant presence in developed markets where there is regulatory clarity. Their interest and presence in India further indicates evolution of the PE ecosystem.

Indian public markets have matured, which has made PE firms more comfortable with going the IPO route for exits. India has a robust capital market which makes it easy for PE firms to get attractive exits. Private equity funds such as Kedaraa, Warburg Pincus and Everstone Capital had good exits in 2018 via the IPO route. Public market exits were c. 30% of the exits in 2018 on a volume basis. The pipeline for public market exit is healthy as atleast 17 firms, backed by around 23 PE investors, have received approval from SEBI for IPO.

To conclude, private equity will continue to play an important role as a source of capital as the development of equity, bond, external commercial borrowing and bank lending market is not sufficient to meet the GDP growth requirements. Creating a sustained and conducive environment for private capital will ensure adequate support for economic growth for the future.