Private Equity in India – Role, Challenges and Future

A.Murugappan
Managing Director & CEO
UTI Capital Pvt.Ltd.

Over the last decade, private equity has evolved as an important source of risk capital in India. The number of private equity firms has multiplied as have the assets under management. According to a recent report by Bain & Co., the total amount of private equity invested in India between 2004 to 2011, including in real estate companies and projects, is $71.6 billion. To put this into perspective, $ 54.4 billion was raised through public equity issues during FY05 to FY12 as per Prime Database.

From less than $ 1 billion invested in 2001, the amount invested has grown to over $ 14 billion in 2011. Over this period, the average deal size has also risen from about $ 8 million to about $ 28 million. Most sectors have seen private equity investments with the largest three sectors being Financial Services, Energy and Industrials.

The bulk of the investments have been growth capital accounting for about 60% of total money invested with about 10% in control transactions and the balance as venture capital or early stage investments. This contrasts sharply with transactions in most developed markets where buyouts form a significant majority of deals in value terms.

Ten years is typically a life cycle of a private equity fund and the funds raised in early 2000 will now be coming to the end of their cycle.

Role of PE funds- a partner in the business

Private equity contrasts with public equity in that it is more of activist in nature. PE funds typically seek board seats and other rights that help them to protect their investments. Generally, PE funds look for at least a ten percent stake in a company; this could go up to a majority stake in the case of buyout deals. Also, the investments are typically held for three to five years; this can of course be much longer in infrastructure and real estate funds. In that sense, PE funds are not mere financial investors but more of partners in the company along with the promoters or the management. However, promoters do not often see this as the case and this misalignment has often been the cause of major disagreements.

The level of involvement of a PE fund in its investee company varies depending on the kind of deal. At one end of the spectrum are buyout deals where the PE funds are actively involved in almost all important decisions the company makes including the recruitment of senior management. In fact, it is not uncommon for funds to delegate personnel to the investee company for considerable periods of time. On the other end of the spectrum are PIPE (Private Investment in Public Equity) deals where the fund has very limited rights and may not even get a board seat, akin to other shareholders. In between these two are growth capital transactions in unlisted companies where board seats are typically obtained along with minority protection rights. In such transactions, although funds typically have rights which ensure that they can intervene in the company's affairs to varying degrees, it is important that the promoter and the fund establish a cordial working relationship at an early stage for the company to conduct its affairs smoothly.

PE funds seek to add value to their portfolio companies in many ways. Improving corporate governance standards and enhancing the visibility of the company, corporate reorganization and talent acquisition, developing new business models, accessing other funding sources, improving operational efficiencies, networking to access new clients and markets, helping evaluate inorganic growth opportunities, preparing the company to go public are some of the ways PE funds can add value to their investee companies. In a recent study conducted by Bain & Co. it was observed that in the top 100 Indian companies, those that had received PE funding had an additional growth of 5% and 14% in respect of revenue and PBT respectively. As with all relationships, things rarely go as per plan and the relationship between the fund manager and the promoter is no exception. Promoters, especially ones accessing private equity for the first time, believe that the business is their own and do not wish to see any interference in the way they run it. Often, before the PE fund invests and especially in midsized companies, the distinction between the promoters' personal finances and those of the company is very thin. Even after the investment by a PE fund, promoters take time, in many cases, to make the distinction. What is accounted for as revenue and what is legitimate expenditure needs to undergo a transformation after a PE investment but this matter is often a source of irritation in the relationship. Other matters that sour the relationship are large items of capital expenditure and their pricing, recruitment of personnel and diversification of the business.

It is important that PE funds assess at an early stage, before the transaction, whether the promoter sees the PE fund as a pure financier or as a business partner. This is easier said than done as in a courtship where both parties are at their best behavior. The promoter wants the money and the PE fund wants to complete the deal

ahead of the competition. Often, this urge to complete the transaction may blind both sides as to what they are letting themselves in to. Clarity on expectations at this stage is vital to the success of the relationship.

Both parties need to work at gaining the confidence of each other. Their interests need to be totally aligned. The PE fund should be viewed as a trusted friend by the promoter and not as a policeman. Also, there needs to be a change in the mindset of the promoter who must see value accretion through increase in share price, as opposed to cash withdrawal, as his main source of wealth creation. He must realize that every additional rupee of profit enhances the value of the business manifold due to the price earnings multiple he gets. While this seems simple logic it is very difficult to achieve in practice. Further, there is a distinct premium for good corporate governance in the market and promoters should welcome the opportunity to use the PE funds to establish best practices in corporate governance.

The role of a PE fund is not just to provide capital but to partner with the promoters in order to enhance value for all shareholders. This realization by promoters is vital for a smooth and successful relationship with a PE fund.

Challenges faced by PE funds in India

While private equity has established itself as a source of equity capital in India, the returns to investors (limited partners) in PE funds has generally not been very attractive. In a recent study, KPMG drew some interesting conclusions. They drew up a basket of investments worth $ 5 billion made between 1999 and 2010 with a mixture of realized or exited investments and others that are yet to be realized. The total return from this basket was a gross IRR of 17.9% which was not spectacular when compared to the benchmark sensex returns of 14.4%. In fact, net of fees and profit share or carry, this return will be less than the sensex return over a similar period. The realized investments however threw up a healthy IRR of 29.1%. This may be because PE funds tend to sell their best investments first.

These returns are significantly lower than those expected by limited partners who see this asset class as a riskier one than listed equity on account of its illiquid nature (investments are typically tied up for a period of 5 to 7 years). Limited partners generally expect IRRs of over 25% or multiples closer to 3x when investing in PE funds. This is more so because they pay significantly higher fees (in the range of 1.5% - 2%) and share profits (up to 20%) in the form of carry.

Apart from the macro economic and political environment, key reasons for the depressed returns have been high entry valuations, lack of proper due diligence on business projections, poor corporate governance practices and inability to generate sufficient liquidity options.

Entry valuations have been rich mainly due to the high level of intermediation (it is estimated that over 60% of all private equity deals are intermediated in India) and competition (there are over 200 active funds in India with $ 17 billion of available capital or dry powder, as per the Bain & Co. report).

Related to this is the business projections made by promoters when raising money. These are often way off the mark and their achievability is often difficult to establish during the due diligence stage.

Exits have also been difficult to achieve in the Indian market. While the number of private equity investments in India was over 2,300 for the period of 2005 to 9M2011 as per the KPMG study, the number of exits has been only around 700. The most preferred option for an exit is through open market sales if the company is listed or through IPOs if it is not. Unfortunately, over the last few years, the capital markets have been unfavourable for large periods between 2008 and 2009 and again from early 2011 to now.

With more PE funds available and willing to buy out the stakes of other PE funds, secondary sale is beginning to be a viable exit mode but a small percentage of deals have thus far been transacted. This is however an increasing trend.

The strategic sale market is also developing and indeed in value terms it has been significant due to some large deals. According to Venture Intelligence, over the period of 2009 – 2011, PE funds achieved 60 exits through strategic sales out of a total of 255 exits.

On other fronts, the regulatory environment has been an issue especially in relation to taxation. Also, the issues relating to what constitutes a permanent establishment necessary to determine tax residency and the efficiency of double tax treaty benefits have yet to be resolved conclusively

Corporate governance in investee companies and disputes with promoters in relation to the running of the companies, the timing, kind and methods of exit have also been some of the challenges faced by PE funds.

The Future- full of opportunities

Despite all the challenges, just like the long term prospects of India, the future of the private equity industry in India continues to be bright. If India is expected to grow at a GDP growth rate of over 9% per annum, massive investments will be required. Private equity will be a key source of long term risk capital that will be required to fund India's investment needs. It is estimated that a large portion of foreign investment in India will be through the private equity route.

There is an increasing trend of venture capital firms setting up operations to invest in early stage ventures, especially in innovative sectors like biotech, nutraceuticals, clean-tech, ecommerce, product development and consumer businesses. This will provide great opportunities for new entrepreneurs who are currently starved for high risk capital.

Buyouts, which currently only account for about 10% of the money invested in India as per a Venture Intelligence report, has a promising future too. This is mainly because they can provide an exit to PE funds invested in companies that have not seen an exit for a long period as well as in

scenarios where conglomerates are looking to divest non-core holdings. A lot of small and medium scale businesses are operating below the optimal size especially in sectors such as hospitals, hospitality and software resulting in opportunities to consolidate these companies. More importantly, younger promoters of the current generation do not mind selling businesses where they believe that they cannot scale up as rapidly as in the past or where they wish to do other things with their lives by cashing out. Buyouts will be a great opportunity in the future.

The 12th five year plan projects an investment of $ 1 trillion in infrastructure with 50% coming from the private sector. This will mean an equity investment of about $ 150 billion over the next five years in infrastructure projects alone. Having burnt their fingers more than once, the capital markets are wary of funding projects where cash flows are not expected for a few years. This will necessarily mean that a large part of this funding will be through the private equity route.

A large number of urban infrastructure services are being privatized – water, sewage, waste collection and disposal, ambulance services are some of these. All these businesses require capital investments for up-gradation and private equity will be an important source for companies that bid for these services.

Real Estate is another area that will continue to require large capital. Investment in this sector more than doubled from $ 1.5 billion in 2010 to $ 3.4 billion in 2011, as per the Bain & Co. report. Private equity experience has been mixed here thus far but as corporate governance standards improve, further transparency sets into the market, REIT structures are developed and made possible by regulation, there is considerable scope for private equity to make further investments.

With cyclical downturns in the economy, distress asset investing is another key opportunity. Currently there are about 50 domestic funds with about $ 16 billion capital in this sphere. Regulations, enforcement procedures and the reluctance of banks to take a one-time hit when they sell these assets have hampered the growth of this class of assets. However, with the government making noises about coming down heavily on the corporate debt restructuring mechanism being misused to hide NPAs, there is likely to be an increasing demand for asset reconstruction companies and distressed asset funds.

Conclusion

Private equity as a source of risk capital is vital for India's growth. It is important that policy makers recognize this and make it as conducive as possible to attract this class of capital. It is important to recognize the long term nature of such investments with a bulk of the funds coming from pension funds, insurance companies and sovereign wealth funds. These institutions have a long term outlook and therefore need stability of policies when they invest. Stable policies in taxation, foreign exchange and FDI will give much needed confidence to these investors to continue allocating their capital to India. Private Equity also plays an important role in preparing companies for accepting public money by improving corporate governance, building scale and fine tuning business models so that they are less risky for the general public to invest in. SEBI's recent guidelines on streamlining these funds could be the first recognition that they are an important source of capital from the policy makers' perspective. The government's clarification on certain taxation aspects is also a step in the right direction. It is important that there is a continual dialogue between the highest levels of the government and the private equity industry on steps to encourage more private equity investment in the country.

Alignment of expectations and interests is vital to the success in a PE relationship. The transition from sole proprietor to a company with other shareholders requires a mental shift as much as a legal one. The idea of working for the common good of all shareholders and thereby increasing the pie for all is a transformation that has been painful in India but is happening. Now that a decade of private equity investment has taken place in India, PE funds and promoters are both better equipped to understand each other. At an early stage in the relationship, PE funds need to capture the confidence of the promoter so that they can act as his trusted partners. This can be achieved if the promoter perceives that the funds are keen and able to add value to the investee company. Once this happens, the partnership becomes fruitful where the promoter and the funds are both driving value in order to obtain better returns.

The lessons of the last decade should ensure that the next decade is significantly better in deploying more money and generating better returns.