Private Equity in India – Role, Challenges & Future

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"Don't ever get into a partnership". I remember hearing this from my grandfather, my parents and many others from their generation. I was born into a civil servants household but both my parents came from mercantile backgrounds. My dada was a jeweller and my nana was a landlord or as he would joke, that post partition he was a lord minus the land.

I don't seem to have followed this advice. I have led or co-led 26 investments in the last 19 years and each one of these investments was a partnership between the entrepreneur and my team. Take for example our latest investment into Eurokids – India's second largest pre-school company. We have backed the company's management team to buy out the company and take greater control of their destiny. Clearly I have done exactly the opposite of what I was supposed to do.

I have often wondered what stands between India & its potential. My mother and I often joke that other than producing children we Indians don't seem to be good at anything. Take any measure-patents, Nobel awards, Olympic medals or wealth; it is clear that one sixth of humanity is severely underperforming. Something is clearly missing.

We have the talent, the hard work, the intelligence, the culture and the numbers. Sports is one such area in which we have underperformed but now the tide seems to be turning. The process behind this turnaround can provide the answers to this great nation's turnaround as well.

Only some of you would have heard about an organisation behind the Olympic Gold Quest. Of the 6 medals that India won in London 2012, 4 were in some part due to OGQ. Supporting them has been amongst the best uses of our money. From their work I have learned that behind each success are many partnerships. It takes the combined effort of many individuals and their complete and single minded focus to achieve the pinnacle of human success in sport. The same applies to many fields.

Private equity's biggest contribution to India is not capital but the culture of partnership. Enterprise needs capital but it also needs partnerships. India has some capital and private equity has provided more of it, but India does not have the culture of partnership at all and in this case private equity is farming a virgin field.

People have come together in India for ages but rarely for common cause. Caste is the biggest driving force of Indian culture. Resources are allocated in India to one's own kin not the most deserving. This is not a recipe for greatness but for mediocrity.

Nations march towards greatness when they aspire for a meritocracy. This is the other big contribution of private equity to India. As an entrepreneur if you seek a bank loan, you are asked for your share of capital and guarantees. You need capital to get more capital. On the other hand with private equity capital is allocated on the basis of the power of ideas and merit.

Of the last 12 investments we have made so far in Gaja Capital, 11 have been made with first generation entrepreneurs. There is something common about the entrepreneurial teams in these 12 companies, but it's not their caste, community, language or religion. None amongst these 12 teams is related to our team members. They come from all parts of the country. They have diverse religious beliefs.

However each one of them has an outstanding background. They have excellent education backgrounds and most of them have studied at the best colleges in the world. They also have excellent professional backgrounds and some of them have worked with the best companies in the world. They are largely children of middle class parents who worked hard to send them to school.

India will begin its march towards greatness when resources are allocated on the basis of merit. In my private equity industry we are promoting a meritocracy. There couldn't be a stronger reason for India to promote the Private equity industry.

But we are doing exactly the opposite. We have exported our industry and talent. We are hostile to the industry and treat incumbents like hostages. No wonder over 90% of the industry is domiciled offshore. Indian private equity is amongst the worst performing in the world. On the basis of potential, India in the last few years, attracted more than its share of capital. However given our performance its share of global Private equity capital has fallen dramatically.

No doubt this is substantially due the deteriorating macro conditions in the Indian economy. Those who are entrusted with the development and regulation of the private equity industry cannot be blamed for the fiscal mess we have landed ourselves into. These macro conditions notwithstanding substantial steps can be taken to foster the development of the Indian private equity industry. These steps need to be taken in four critical areas. These relate to fund formation, taxation, dispute resolution and domestic availability of source capital.

We have to bring our industry onshore. Currently the bulk of the industry is offshore and for a simple reason. It feels safer offshore. We have to make it simple for the industry to form funds onshore, invite capital onshore, to be able to assure source capital of a stable taxation regime and to be able to transmit investment gains without double taxation and with benign withholding taxes if any. Remarkably most of this is possible for short term investors such as FIIs. It's high time we extended this to private equity investors.

Our policies on taxation in India have made us the laughing stock of the world. We are treating incumbents like hostages. If we are clear in our minds that we need capital and we need foreign capital then we must be clear that there will be trade-offs. The companies that grow with capital from the private equity industry pay every possible conceivable tax and are amongst the most conscientious tax payers given the standards of the industry. However the providers of capital have to be provided a tax regime which compares favourably to other countries that aspire for investments. And certainly we need to give up on this habit of changing goal posts midway.

Private equity is fixed term capital. It is based on a virtuous cycle of raising capital, making investments and then returning the proceeds of the harvest in a limited time frame. Indians have chosen to give themselves the slowest judiciary in the world. We have to insulate private equity from this luxury. Special courts must be set up and it must be possible for investors to elect for these courts while making investments.

And where does all this capital come from? The source capital for private equity comes from pension funds, charitable foundations, wealthy families, trusts, insurance companies, other similar institutions and from the investing public. India is the only major economy in the world that sources the bulk of the capital invested in the private equity industry from the outside world. Countries such as China have realised that this makes the industry dysfunctional and therefore developed domestic sources of capital. For private equity to function smartly in India, we need a healthy mix of domestic and global capital. Had this been the case Indian private equity industry could have played a bigger role in reversing the current economic slowdown. Currently most private equity in India is controlled by international investors whose views are more a function of how global media thinks of India and not how the situation is actually on the ground.

But perhaps the weakest link in the story is our lack of a domestic equity culture. The impact of this is profound and impacts more than just the private equity industry. Indians have been vigorously promoting their investment story to global investors while merrily investing their own savings elsewhere. Too little of the Indian savings pie flows into equity.

Our equity markets are caught in a vicious cycle. Lack of equity culture impedes asset-class performance which in turn turns away investors. This weak equity culture has a fundamental impact on the private equity industry. Thanks to it, there is a little domestic source capital on one hand and a weak IPO market on the other. Without a healthy IPO markets, the private equity industry cannot propagate the virtuous cycle of harvesting capital I had earlier described.

China is an excellent example of how these elements have come together to create a vigorous virtuous cycle. China has a healthy equity culture. This in turn promotes strong equity and IPO markets which in turn has attracted global capital to private equity in China. We have much to learn from their thinking, planning and execution. The biggest catalyst that our domestic regulators can provide to the Indian private equity industry is a healthy equity market.

Indian entrepreneurs have made their mark on the world. We have earned a reputation for being hard working and savvy business builders. Almost as a rule the typical Indian begins his journey in these foreign lands with little more than education and his or her parents' blessings. Meritocracy makes this possible.

Our constitution promises us a meritocracy. Private equity is a worthy partner for this cause. I am proud of the role my industry is playing in the transformation of our country. Meritocracy is a big leveller and private equity is its worthy disciple.

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