Private Equity in India

Summary of Interviews conducted in July/ August 2008

This class note was written by Rahul Agarwal, INSEAD MBA (Dec'08), under the supervision of Professor Claudia Zeisberger. It is intended to be used as a basis for class discussion and summarizes the feedback received from interviews with the Indian PE and VC community during the summer of 2008.

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The Evolution of Private Equity in India

(July/ August 2008)

Private equity in India has witnessed exponential growth in the last five years. This document synthesizes perspectives gained from interviews conducted in July and August 2008 by Rahul Agarwal, with major stakeholders - private equity and venture capital professionals, advisors, lawyers and entrepreneurs - in the Indian private equity ecosystem. The report aims to give the reader an arms-length introduction to an emerging private equity destination by relating the personal experiences of the interviewees and their views on the future of the market. Minimal data from public sources was used, and if, then purely for the purpose of lending context to the views expressed.

INSEAD would like to thank all of the interviewees who made time and shared their perspectives on the Indian private equity and venture capital industry, thus making this report possible. (Listed below in alphabetical order)

Mr. Ashish Agarwal (INSEAD alumnus), Investment Manager, Navis Capital Partners

Mr. Anil Ahuja, Managing Director, 3i (Growth Capital)

Mr. Aloke Bajpai (INSEAD alumnus), CEO, www.ixigo.com

Mr. Ritesh Banglani (INSEAD alumnus), Senior Investment Advisor, IDG Ventures India

Mr. Akshay Chudasama, Partner, Jyoti Sagar Associates

Mr. Gaurav Dalmia, Co-sponsor, Infinity Ventures and India Value Fund (among others)

Mr. Jayant Davar, Vice-Chairman and Managing Director, Sandhar Technologies Limited

Mr. Pravin Gandhi, Managing Partner, Seed Fund

Mr. Sandeep Gill, Managing Director, Deloitte Corporate Finance (India)

Mr. Gopal Jain, Partner, Gaja Capital Partners

Ms. Shweta Jalan, Director, ICICI Venture

Mr. Sanjiv Kaul, Managing Director, Chrys Capital

Mr. Raja Kumar, Founder, MD and CEO, UTI Ventures

Mr. Subhasis Majumder, Vice President, UTI Ventures

Mr. Naresh Malhotra, Operating Partner, Sequoia Capital India

Mr. Donald Peck, Partner, Actis Capital

Mr. Karthikeyan Ranganathan, Head of Energy and Infrastructure Investments, Baring Private Equity Partners India

Mr. Deepak Shahdadpuri (INSEAD alumnus), Founder and Managing Director, Beacon India Advisors Limited

Mr. Ranjit Shastri, Executive Director, Indian Venture Capital Association

Mr. Digbijoy Shukla, Supporting Evangelist ™, The Indus Entrepreneurs

Private Equity in India - A Growing Industry

The Indian VC/PE industry began in the late 1980s and early 1990s with regional funds such as Gujarat Venture Finance Limited and pioneers such as ICICI Venture and Actis Capital. The dot com boom led to a spurt in VC activity in the late 1990s, with a large number of funds setting up shop in India's Silicon Valley in Bangalore. According to Raja Kumar, at that time one could have described the Indian VC industry as an outpost of Silicon Valley because representatives of US VC firms in Bangalore constituted a major part of the industry. The dot com bust also witnessed the disappearance of many players, and the total value of VC/PE deals in India hit their lowest point post-boom at $470 million in 2003[1].

At Chrys Capital, one of the earliest entrants into India in 1999 and one that survived the initial shake-out, VC has metamorphosed into PE over the last few years. Beacon India's Deepak Shahdadpuri reminisced, "I came on a four-day trip here (in 2000) and met literally every fund. There were hardly 20 guys." Since 2004, the Indian VC/PE industry has surpassed all projections in going from a $2 billion to a $20 billion industry, with over 300 funds currently active in the country. Shweta Jalan noted, "We've gone from deal sizes of $1-$5 million to a stage where $500 million deals are not unheard of. Earlier, large cap companies would primarily look at debt or the capital markets, but now large companies explore private equity as a real option". To put the growth of the industry in perspective, in 2006 private equity overtook both foreign and domestic strategic investors to emerge as the largest investor class driving equity deals in India[2].

Global Economic Slowdown and Indian Private Equity

As of May 2008, the mark-to-market valuations of PE investments made in 2007 reveal pre-IPO returns at 128%, IPO returns at 22% and PIPE returns at 8%. (PIPE deals performed slightly worse than the number suggests because of upward distortions on account of megadeals like Bharti.) The public markets in many cases serve as a proxy for private equity in India, and with 38% of the total investments having been made in PIPEs; this performance has hit the industry hardest[3].

Some say that the current slowdown is no more than a bump in the road for the industry. The fact of the matter is, despite all the apprehensions surrounding the global economy, new funds continue to set up shop in India, as Deepak Shahdadpuri and Naresh Malhotra observed. Top-line growth in India, albeit slowed from dizzying heights, is almost considered a given. So far in 2008, India remains the 2nd largest Asian recipient of private equity capital after Japan. With inflationary concerns persisting, margin management will become a more significant value driver in coming months. Despite the stress in the capital markets and an expected consolidation of the industry, private equity companies continue to see value in India.

Indian Businessmen and Challenges for Private Equity

An important aspect of the private equity evolution in India has been the reception accorded to it by entrepreneurs, especially in fast-growing SMEs. According to Gaurav Dalmia, in the early 1990s people had to be educated that private equity is not a high-priced loan. Jayant Davar of Sandhar Technologies Limited summed up the entrepreneur's initial perspective, "India is historically a society of money-lenders. Money that doesn't come from a bank is therefore viewed with some suspicion".

Jayant Davar's is an interesting story. His company has enjoyed a "fantastic marriage" with Actis Capital, which owns just over 20% of Sandhar. He is effusive in his praise for Actis, but considers himself fortunate to have found such a constructive partner; he noted that there are "still [persistent] apprehensions about private equity, especially about American firms that have a reputation of walking in, stripping a company of its assets and its legacy, making what money they can and leaving." Private equity companies might therefore still have to convince the Indian entrepreneur that "Wall Street" was merely an entertaining film as opposed to its having had much basis in reality.

Jayant Davar made another interesting point: a number of Indian companies view the costs of doing business with PE companies as too high. It is unreasonable, he said, to expect a small but growing Indian company to appreciate the importance of increasing their auditing and management costs by a factor of 10 by moving to a big-4 auditor and from a Chartered Accountant

to a CFO. These costs, however, have become almost statutory for investee companies, and it will take some time for them to come to grips with the concept. Accordingly, private equity firms that can come up with more creative ways of installing corporate governance controls will be in a strong position to gain favour with the Indian entrepreneur.

Actis enabled Sandhar to execute a major strategic acquisition and have been pro-active partners who have made critical inputs in driving forward the vision of the founders. Actis has remained confident in management despite Sandhar having been slightly behind schedule in terms of its targets. Also, Jayant realized that his stake sale to Actis will lend credence to the valuation of the company when he eventually approaches the public markets.

It is these aspects of private equity that Gaurav Dalmia wanted Indian entrepreneurs to understand when he encouraged them to be ‘long-term greedy’ and appreciate the different mandates that come with capital. From operational or entrepreneurial experience; to management structuring and team-building; to network access; and in a broadly hands-on or hands-off fashion over investment horizons of varying duration; each private equity company offers a unique and distinct value proposition to Indian entrepreneurs with whom it partners. Shweta Jalan echoed the sentiment, urging Indian entrepreneurs to rise above market frenzy and realize that at certain points in their life cycles, businesses are better able to take advantage of the opportunities provided by private equity than of those provided by public markets.

One cultural aspect that presents a challenge for private equity is the Indian entrepreneur’s reluctance to sell, which as Gaurav Dalmia suggested, represents an almost “dysfunctional emotional attachment” to their businesses. He lauded Ranbaxy’s Malvinder Singh for “not being clouded by emotion or ego” in his recent decision to sell, and hoped that others will learn from his example.

Deal Structuring and Valuations

On deal-structuring aspects, Akshay Chudasama identified a few main issues between investee companies and PE firms. These include minority protection rights, information rights, US Foreign Corrupt Practices Act representations and warranties, IPO ratchets and valuations/price adjustments in lieu of indemnities.

A definite challenge for private equity in India is lack of information. According to Ashish Agarwal, “financial investors need data. To have data, entrepreneurs need to have had good processes for capturing data. Even in good family businesses where value is apparent, a lot of times there’s not enough data, which makes our task difficult.” Indian books of accounts have historically been geared towards lowering the incidence of tax, leaving much to be inferred. Some investors, however, are by now comfortable in their understanding of the peculiarities of the Indian way of doing business. They feel that installing the processes that Ashish Agarwal mentioned is part of their value-add. Yet others like Gaurav Dalmia insist that the price of non-transparency to the Indian entrepreneur remains high.

Burgeoning economic growth and competition in private equity has given the gift of choice to the Indian entrepreneur. The unprecedented explosion in the stock markets since 2004 has altered the balance of power between private equity players and entrepreneurs. There was a time in the early 2000s when the venture capitalist was viewed as evangelical; now, he is just another source of capital. However limited the initial understanding of private equity might have been, Gaurav Dalmia insisted that “VCs need to realize that the Indian entrepreneur is smarter than them. That’s why you get all these PIPE deals happening at the peak of the market. When every Tom, Dick and Harry is doing a PIPE issue, you have to step back and think, what is going on? But there’s too much adrenaline in the system at that point to think that.” Subhasis Majumder observed, “Effectively a bit of a bidding process came into the market, in which the highest valuation and the minimum term sheet would be the winner”. The self-correcting mechanism of the market has inevitably set in after the credit crunch, and industry players generally expect the playing field to be a lot more level in coming years.

At the end of the day, valuations remain the chief bone of contention between entrepreneurs and private equity players. Not surprisingly, the popular view in the industry is that target companies must recalibrate their expectations and make a trade-off between current valuations and future growth. In the words of Deepak Shahdadpuri, “most private equity valuations are still at a

premium to market. So we're grappling with the issue: why bother with private equity at present. We need to decide if we should re-allocate a part of our capital to public markets."

Insights into China

It is difficult to discuss India these days without the inevitable comparisons to China. Our interviewees systemically responded that from an investor's standpoint, it really isn't India *or* China but India *and* China. Nonetheless, and perhaps predictably, there were some opinions as to why India might be a superior destination for international private equity.

One of the views about India as a PE destination is that it is tech-dominated, whereas in China deals flow across multiple industries[4]. That might have been true a few years ago, but recent statistics tell a different story. In India during the first half of 2007, financial services actually saw the greatest fraction of total PE investment, whereas tech accounted for only about a sixth. With continuous easing of foreign direct investment norms, even firms that began their India operations with an IT focus are increasingly sector-agnostic, as Naresh Malhotra pointed out. Sector-specific funds have also begun to look at a variety of industries including real estate, retail, and infrastructure among others.

Another reason why India might be more promising is that wealth creation and economic growth in India are primarily driven by the private sector, whereas in China SOEs (*state-owned enterprises)* dominate. According to Sandeep Gill, this exacerbates in particular the problem of transparency, which is an issue for investors in both markets. It might be fair to say that private-sector driven growth is more robust. Anil Ahuja also commended Indian regulation for having been progressively conducive to investment without any significant policy reversals.

Indian Firms and Principals

One aspect of the Indian private equity industry that stands out is the apparent dominance of foreign firms, and certainly of foreign LPs. There are of course prominent 'Indian' players. According to Shweta Jalan, almost every major business house in the country has a PE arm. She pointed to business houses like Tata, the Aditya Birla Group and Reliance, saying that "the ones that get spoken about here are generally the foreign companies", partly because their deals are bigger. Naresh Malhotra pointed to PremjiInvest, the personal investment venture of Wipro's Azim Premji, which has a corpus in excess of $1 billion. Yet, as Ranjit Shastri, Executive Director of the IVCA put it, "India has effectively exported the industry".

The most obvious reason for this would be regulation. India's tax regime is more conducive to funds incorporated outside India, and as Sandeep Gill observed, "some of the so-called 'foreign' players could just as easily be Indian enterprises setting up funds in Mauritius." Subhasis Majumder further observed that Indian banks' risk weighting on illiquid investments has increased from 100% to 150%, creating capital adequacy implications and constraining banks' participation in private equity.

Anil Ahuja opined that there is "no significant Indian LP": endowment funds don't really exist, and pension funds are not allowed to invest in private equity. He further pointed out that whereas a lot of family offices in the US are financial players, in India they are mostly industrial players. Indian high net worth investors (HNWIs) are still relatively unfamiliar with the asset class and choose to invest in their own businesses, or in real estate. According to Raja Kumar, "Indian HNWIs are short-term in their outlook. They prefer to invest in their own businesses, effectively meaning that they prefer to manage risk directly." He also contended that lack of talent in India - few Indian fund managers with significant VC/PE experience - has been forcing the industry to look abroad.

As the industry matures out of its nascence, local participation will definitely increase. Sandeep Gill indicated an increasing likelihood that more and more HNWIs will become Limited Partners, and that international players will set up domestic, rupee-denominated funds inside India. For the moment, however, private equity capital will continue to be largely imported.

Regulation and Exits

Karthikeyan Ranganathan said that, "Regulation, like infrastructure, always tends to be reactive in India. We make cars before roads and that's just how it is here. Things will keep falling into place." Deepak Shahdadpuri reminded us that the Indian PE industry has advanced to where it is *despite* the regulatory environment. Anil Ahuja insisted that the industry needed to put itself in perspective and be reasonable in what it asks for, pointing out that India is a trillion dollar economy with a 35% savings rate, and that "[PE is] just a $15 billion industry". Most, however, were less philosophical about Indian regulation: as one example, Sandeep Gill pointed out, "Every year we conduct a survey [in the private equity industry] on which the first thing everyone wants to see change is regulation".

Gopal Jain is most concerned by the "19th century judicial infrastructure trying to cope with 21st century problems and demands", which impedes in particular the M&A process. Gaja Capital has numerous investments in India's promising education sector. He asserts that "just as we realized that a Soviet-inspired model wouldn't work for industry, we must realize that the Western model, where education is the prerogative of the welfare state, will not work for education".

According to Donald Peck, the biggest issue is that there are too many ever-changing micro issues in India. Labour laws and FDI caps came in for frequent criticism. Retail has outperformed every other sector in mark-to-market valuations of PE investments made in 2007, and FDI norms in retail were singled out for criticism. No foreign equity is permitted in multi-brand retailing, and single-brand foreign retailers in India are allowed to take up to 51 per cent in a venture with a local firm. Foreign venture capital investment is not permitted in India's realty sector.

Clarity was a frequently-cited issue with regard to Indian regulation, whether pertaining to tax laws or deal structuring. There are numerous restrictions on debt structuring and external commercial borrowings (ECBs). The Indian regulatory environment for preferred structures is particularly challenging due to a number of grey areas, according to Akshay Chudasama. In India, entities like the Reserve Bank of India (RBI) and Foreign Investment Promotion Board (FIPB) are empowered to make updates to legislation by issuing circulars called 'press notes'. Mr Chudasama is most indignant about the use of this mechanism to govern policy, and calls for comprehensive and rationalized FDI and FII policies.

On the ease of exiting investments Anil Ahuja stated, "We have a proven track record of 15 years of putting our money in and taking it out. The hoops we have to jump through in India are very simple compared to most other countries in the world." Many feel that the regulatory environment also impacts exits: pricing guidelines for sale of shares between residents and non-residents, SEBI restrictions on IPO ratchets, and other well-intentioned laws designed to protect the retail investors cloud the exit environment in India.

On the issue of other structural elements in the Indian business environment that make exits particularly difficult, responses were divided fairly down the middle. Some respondents held that Indian public markets still lack depth; with Indian entrepreneurs reluctant to sell their companies, the public markets often remain the only viable exit option and therefore need to be more accessible. Others pointed to the fact that market capitalization in India is almost 100% of GDP and to Warburg's now-famous $560 million exit from Bharti which the public markets absorbed in a matter of minutes. Finally, Deepak Shahdadpuri said, "as an industry we just don't have enough of a history to display a bouquet of exits."

Buyouts

KKR's $900 million buyout of Flextronics International in 2005-06 was India's largest PE deal ever[5]. The opportunities should be huge, not least because "Indian companies are distinctly under geared by any Western standards", as Donald Peck pointed out. Yet, Indian buyouts are conspicuous in their rarity.

Some have pointed to the fact that India is a tremendous growth capital market and there is little need to look at buyouts. However, the absence of buyout activity has also been attributed largely to regulation; Sandeep Gill mentioned the absence of a squeeze-out law and a complicated take-private mechanism as hindrances to buyout activity.

Shweta Jalan was involved with ICICI Venture's buyout of Tata Infomedia, India's first buyout deal. She contended that the Indian buyout market is particularly exciting because growth in India compounds the gains from financial leverage. ICICI Venture's performance really speaks for itself: the main proponent of buyouts in India, the lowest return ICICI Ventures has ever made on a buyout deal was 4 times their investment, achieved over an 18-month period. Factoring in the multiple expansion effect, ICICI Venture has in some cases made up to 20 times their investment on buyout deals.

Shweta Jalan noted that the regulatory framework is completely adverse to buyouts because banks are not allowed to fund buyouts, unless a division were to be spun off by purchasing assets instead of stock. She mentioned tapping Indian non-banking financial companies (NBFCs) and overseas debt as possible ways to work around regulatory constraints.

Early-stage Investments

Ritesh Banglani described the second wave of the Indian VC industry after the burnout of the early 2000s as "an experiment driven by the successful private equity experiment in India". Early-stage funding, however, barely captured 5% of the total private equity pie.

Shweta Jalan reminded us that early-stage funding in India is bogged down by its historical performance, whereas late-stage funding is spurred on by its. Pravin Gandhi noted that assuming early-stage risk in India is not required in order to make money, and the space simply needs more successful entrepreneurs with a passion for early-stage VC. Tax incentives and clarity in tax pass-throughs are also needed to encourage early stage investment. The effect of what Deepak Shahdadpuri called the "curse of success" - private equity companies growing so fast that small ticket sizes are no longer either attractive or feasible plays - is another reason why late-stage deals receive a disproportionately large share of total private equity investment. Government initiatives like the Enterprise Capital Fund in the UK, which augments private funding at reasonably low required rates of return, he said, are necessary to encourage more early-stage investment in India.

Across the board, our interviewees identified a demand-supply gap in the angel/seed funding stage. Globally, the participation of HNWIs has been critical to providing capital at this stage, and in India, the relative lack of HNWI participation is therefore most felt at this stage. Another view was that investment horizons in India must begin to increase and permanent capital must also have more of a role to play in the space. Both courage and patience, Gaurav Dalmia said, are needed in greater measure in the Indian VC industry.

Concerns were also expressed for Indian entrepreneurship. According to Gaurav Dalmia, "the belief in alchemy, of creating something out of nothing, that an entrepreneur needs, the belief that created Dhirubhai Ambani [of Reliance] and Sunil Mittal [of Bharti] is not as prevalent in India as it should be." There are important cultural constraints for entrepreneurs in India, as well. Aloke Bajpai lamented that entrepreneurship in India is viewed as a second-best option to a professional career, and indeed that entrepreneurship is not viewed as a profession in itself. Further, fear of failure is commonly associated with Indian society. Since family holds sway over the individual, entrepreneurial fire therefore often gets snuffed out at home.

'Key man dependency is often a red flag from a VC standpoint, and in India, entrepreneurs are frequently loath to cede any measure of control leaving too many businesses as one-man shows. It is not uncommon to see family members comprising the bulk of the Board of Directors without adding any real value to the business itself. Our interviewees stressed the importance of team-building for Indian entrepreneurs; unfortunately, Indian entrepreneurs lack a proper support system for team-building, mentoring and deal facilitation, according to Ritesh Banglani. Aloke Bajpai agreed, and said that "the key is to ensure that budding Indian entrepreneurs don't have to fall back into the job market within six months of venturing out. Organizations like TiE, Stern Fisher and Silicon Valley Bank and start-up events like proto.in are definite steps in the right direction, but a lot more handholding is needed for the Indian entrepreneur. Key incubators like the Indian Institutes of Technology and Management must continue to fuel the nascent fire and also foster better links with the VC industry." Gopal Jain contended that emerging India cannot sustain as the world's 2nd or 3rd largest economy without becoming the 2nd or 3rd largest innovator. A number of people pointed to the absence of pure technology start-ups: as Donald Peck put it, "IT services don't really count (as technology)".

Focus, according to Aloke Bajpai, is critical. For instance, too many IT product start-ups look at services to provide revenues in early days, and end up getting permanently derailed. He also advised entrepreneurs to refrain from seeking too much capital too soon, a mistake identified by many as common. Finally, too many Indian entrepreneurs still view VCs as capital-providers instead of smart capital; Digbijoy Shukla noted that an entrepreneur's and a VC's relationship is "a marriage" which begs careful thought and selection by entrepreneurs.

Academia

Many interviewees noted that apart from continuing to fuel the support system, academia can help the industry secure a more conducive regulatory climate. Regulation on deal structuring and taxation were identified as areas where key contributions could be made.

Another common response, possibly directed more at Indian academia, was that academic institutions could help create better incubators and foster links with the industry. Bajpai identified connections with academia as "the big difference" between India and the US. Ranjit Shastri agreed, observing that one sees the ecosystem thriving around centres of learning in Boston and Silicon Valley.

A third response was that academia can help educate entrepreneurs and family businesses about the merits of private equity finance and the trade-offs to evaluate when considering different types of financing.

Gaurav Dalmia offered yet another area where research was needed: It is difficult to find a narrow-band consensus, by asset class, for country risk premium for Indian investments. He felt that clarity in this area would help channel more growth capital into India.

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