CHANGING PARADIGMS OF PRIVATE EQUITY IN INDIA AND ITS IMPLICATIONS

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ABSTRACT: Private equity (PE) has become an indispensable tool not only for financing but also helpful in streamlining the operations and proactively changing the contours of portfolio company thereby enriching value leading to successful exit. It had begun active in 2004 and reached the peak in 2007. Post crisis it was adversely affected. The signs of recovery started since 2012. The present article presents an overview of private equity activity from 2012 to 2014 in the light of the macroeconomic conditions prevailing in India. Each year presents distinct opportunities and challenges for private equity stakeholders. An attempt has been made to highlight the situations peculiar in each year and the implications for stakeholders has been emphasized. The article is constructed from the reports prepared by Bain & Company, globally leading consulting partner to the private equity industry and its stakeholders.
Key words: General partners, Limited partners, Sovereign wealth funds

Overview of Private Equity

Private equity is an alternative asset class where funds are created by General Partners (GPs) and manage them on behalf of investors known as Limited Partners (LPs). LPs may be institutional investors such as foundations, endowments, sovereign wealth funds and pension funds. GPs are private equity firms who manage the funds on behalf of LPs for management fees.

Private equity activity took a toll post global financial meltdown. The private equity activities spanning from fundraising, deal making, portfolio management and finally exits were adversely affected due to crisis. Private equity investment in any country is a function of macroeconomic conditions prevailing in a particular country and across the globe in a specific year. It was observed that the factors surrounding private equity atmosphere in all through the years compared were different and the private equity stakeholders' decision making is mostly influenced by the host of macroeconomic factors and internal factors of the portfolio company. GPs and LPs select appropriate strategy to tackle the specific challenges faced by industry across a particular geography.

In 2012, India's deal activity was $10.2 billion, a fall by $4.6 billion over previous year. The number of deals, however, increased by 20 over previous year to 551, highlighting a fall in average deal size from $28 million in 2011 to $18.4 million in 2012. 55 funds were ready with a mandate to invest in India, but the total fund value allocated to India was only $3.5 billion, down from $6.8 billion in 2011. The year 2012 was uncertain both politically and economically. Reported lapses in governance, coupled with a lack of clarity in regulation, raised considerable concern about India's attractiveness as an investment destination.

India received only $3.5 billion of the $320 billion funding raised globally in 2012, according to UK research firm Preqin. One of the main reasons for the declining investments in the Indian private equity industry is that LPs are showing more caution when allocating funds. They are becoming increasingly choosy about the fund managers they work with.

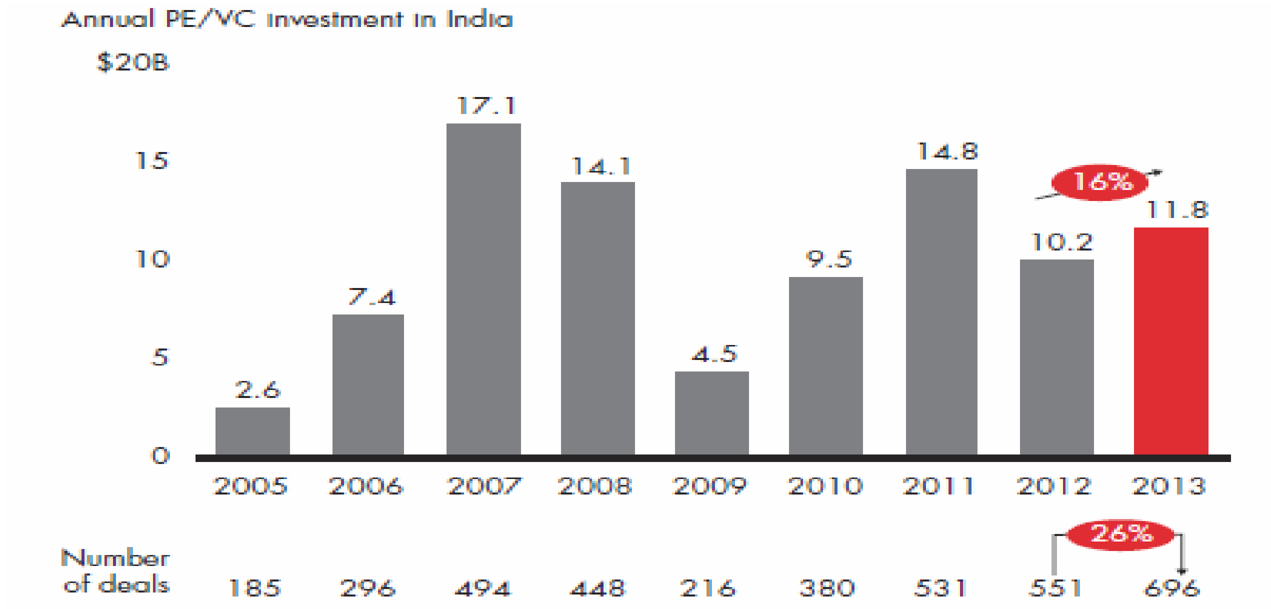
Throughout 2012, Indian economy witnessed slowdown. The reasons being: logjam in India's political landscape, high inflation, low index of industrial production growth, weakness of the rupee and regulatory uncertainty.

Despite these setbacks, there is no doubt that private equity has become a viable source of patient

capital in India. The number of deals in 2012 grew by 4% from 2011, indicating that more and more promoters and entrepreneurs are comfortable with the idea of private equity investment.
On the whole, 2012 was a challenging year. Nonetheless, the year saw many positive signs, from a welcome increase in exits to improved regulatory clarity.

In 2013, India experienced its own set of economic troubles, starting with a gaping fiscal deficit, persistently high inflation, currency depreciation and pessimism among businesses and consumers. Consequently, the Indian economy only managed a GDP growth of 4.7% during 2013. Despite the macroeconomic challenges, private equity continued to play a pivotal role in India's capital needs, accounting for 54% of foreign direct investment inflows against 45% in 2012. Overall private equity deal volume grew by 26%, with an increase in deal value of 16% ending 2013.

Fig.1: Private equity deal value and volume increased in 2013



Source: Bain & Company India Private Equity Report 2014

GPs in India continue to be concerned about macroeconomic conditions, exit environment challenges and valuation expectations in good quality deals. Most GPs and LPs believe that private equity asset allocation to India has declined in recent times, driven by the following key factors: lower-than-expected returns from investments, low liquidity and uncertainty around government policy and regulations. On the other hand, investors continue to believe in the long-term potential of India. They see the value of staying invested, but with increased caution and clarity.
Fund-raising for India has become more difficult as LPs have intensified their scrutiny of who they trust with their fund commitments. They are now looking much more closely at factors like team stability, GP track record and investment philosophy.
Moreover, LPs are rigorously testing the quality of investments, assessing value upside potential and ensuring liquidity at the time of exit.
In the future, fund-raising will continue to be difficult as uncertainties about India's macroeconomic

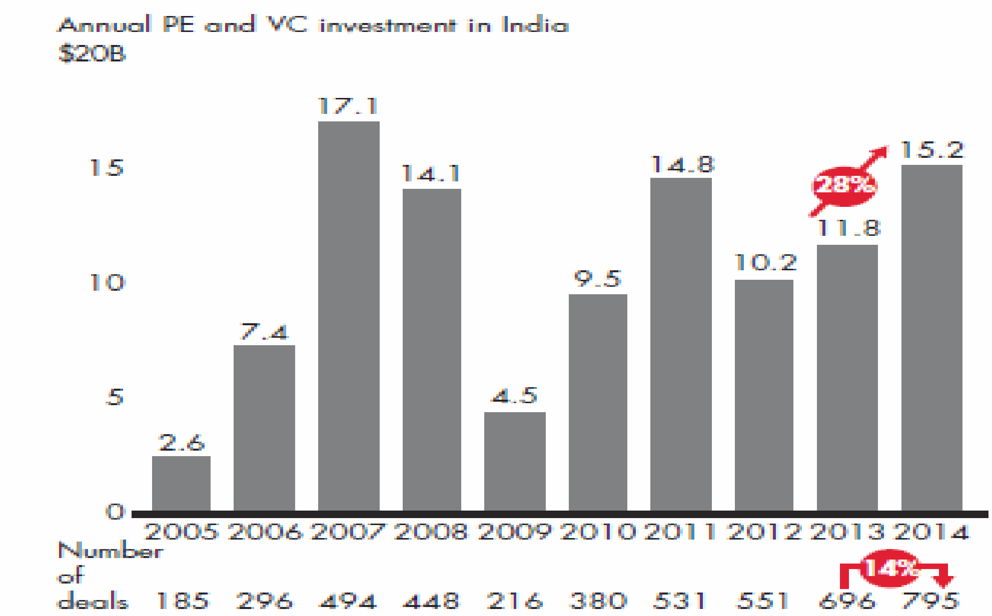
situation remains. In such a scenario, GPs need to work harder on the existing portfolios to demonstrate their value-creation ability and differentiate themselves on operational capability and realization with LPs. GPs are taking more time to get comfortable with the fundamental value-creation potential of possible investments and doing more comprehensive diligence including all aspects of the business. GPs agree that relationships are becoming more important and several funds are now seeing proprietary deals.

In an environment where access to debt is low, owing to high interest rates and tight liquidity, the number of companies looking to raise private equity money should be higher. Indian entrepreneurs and management teams are appreciating the role of private equity as being activist long-term capital that can positively contribute to value creation.

Private equity funds are sharpening their focus on the best quality deals based on their investment philosophy and are investing in relationships with promoters and management teams to conclude at reasonable valuations.

The year 2014 was marked with rising optimism, expectations and aspirations for India, especially due to the new government formation which took its reins in 2014. The Indian stock market gave phenomenal returns of more than 30% over the year, compared with less than 10% in 2013. Backed by the stronger macroeconomic landscape, private equity activity continued to play a pivotal role in the country's capital needs, accounting for 53% of foreign direct investment inflows. India's GDP grew by 6.6% from 2013 to 2014, compared with 4.9% from 2012 to 2013. Private equity investments in India saw a robust increase in 2014. Deal value increased by 28% to $15.2 billion. Overall deal volume registered was 795, an increase by 99 deals over previous year. There was an increase in early-and-growth stage deals accounting for 80% of total deals in 2014. There continues to be enough capital chasing good deals, especially because a significant amount of capital is also drawn into India via allocations from Asia-pacific and global funds.

Fig.2: Private equity deal value and volume increased in 2014



Source: Bain & Company India Private Equity Report 2015

However, GPs remain concerned about a mismatch in valuations expectations and the tough competitive environment for good quality deals. India needs to continue to improve the ease of doing business in the country, a large part of which involves a regulatory environment that is more conducive to business growth to attract investment. In 2015, PE firms plan to increase their focus on fund-raising, and they cite track record, team expertise and exit success as the most important factors in this regard.

Implications for General partners, Indian entrepreneurs, Limited partners and Public policymakers.

General partners: GPs should work on building strong relationships with entrepreneurs much earlier in the deal cycle. Striving to maintain congenial relationship will be helpful in securing deals at the right valuation. They should expose opportunities to invest with existing promoters or to re-up existing investments. GPs should take care to discuss their investment theses and value-creation blueprint with the entrepreneur throughout the deal-making process. They need to focus on developing value creation capabilities. Besides, they should also focus on corporate governance and integrity of the leadership in the investee company.

Indian entrepreneurs: Indian entrepreneurs have come to understand the value that private equity brings in as an activist capital. They should be open and transparent from the start and should look to leverage the expertise of private equity and venture capital partners; including learning and adopting the best practices in financing, expansion and customer access. They should agree on the operating model with the private equity fund to decide the latter's level of involvement right from the start, and align with the senior management accordingly. Moreover, entrepreneurs should work with their private equity partners to think about business opportunities and challenges together. It is equally important to understand that investors come in with a set exit time frame in mind, and it is best to align on the exit road map early in the relationship.

Limited partners: It is imperative for LPs to fully understand the investment opportunity in India and assess risks in certain sectors or specific companies before investing. This will be helpful in setting realistic expectations. Before committing capital to the fund, they should spend more time to understand the track record of the fund and its GPs, and develop a clear understanding of alignment of the fund's investment philosophy with their own risk-return appetite. An integral part of the diligence process is to create a clear exit road map on all new investments.

Public policymakers: India currently requires extensive capital across multiple sectors. Policymakers should realize the benefit of private equity funding and assess the risk diligently. They need to continue to frame more business-friendly policies and ensure that these come to pass. They should also recognize the value that private equity can bring to Indian entrepreneurs in terms of expertise and guidance. Reshaping the regulatory frameworks is essential to create an environment that's conducive to private investment. Private equity funding will only grow in India if the policy framework is supportive.

Conclusion

Funds, expect that coming years hold even more promise with even better prospects for investment in India. It is important that all the stakeholders work together to create a healthy landscape, as India seems poised to move ahead and unlock its true potential. Private equity and venture capital are critical to foster entrepreneurship in the country and help Indian companies professionalize and scale up rapidly, thereby unlocking the true potential of India.

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