PRIVATE EQUITY FLOWS: OPPORTUNITIES FOR CORPORATE INDIA

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ABSTRACT

Since its emergence in India, private equity has been regarded very much as a niche player in the broader Indian global financial sector. But, rapid development over the last few years, which includes the peak and trough of the dot.com bubble and its subsequent recovery, challenged this view. Growth between 2002 and 2005 in terms of assets under management has raised this asset class to above pre dot.com levels and onto the radar screen of a broader range of investors. It has also attracted the attention of policymakers and the regulators.

Private equity, as an asset class, is probably one of the less well-understood segments of today's financial markets though it is one of the most specialized asset classes. Private equity investments in companies involve considerable risk at an individual company level, and are broadly comparable with other asset classes at the portfolio level. For investors can offer substantial potential awards to investors. The attraction of private equity from investors’ point of view lies in the potential (risk-adjusted) performance of such investments relative to quoted equity. Such performance is the direct consequence of creating sustainable value through taking more direct and long-term influence in investee companies than public equity investments allow.

This paper is an attempt to address a number of key issues that the Indian industry faces today. It not only highlights problems of doing business in the India, but also submits fine practices which can be used in Indian as well as other markets.

Key Words

Private Equity, Small and Medium Enterprises, Buyout, Venture Capital, Foreign Institutional Investor

JEL Classification Codes: G1, G10, G23, G24, G32
INTRODUCTION

The private equity industry is a coin with two sides. One side is concerned with the process of collecting capital from sophisticated investors and pooling them in investment vehicles (usually called funds), and the other side is concerned with investment in the industry. Private equity is the provision of capital and management expertise to companies in order to create value and subsequently, with a clear view to an exit, generate capital gains after a medium to long holding period. In India, the terms "venture capital" and "private equity" or "risk capital" are often used interchangeably. For the purposes of this paper, private equity is used as the generic term to encompass all the sub-sets of financing stages which include, Venture capital, Expansion capital, and Management Buy-outs and Buy-ins.

Venture capital is focused on young, entrepreneurial companies and is an essential part of value creation in the whole private equity financing cycle. It provides finance for start-ups at their inception or shortly after their first technical or commercial developments. Much of this segment is technology-related in e.g. new information and communication technologies, life sciences and healthcare, electronics and new materials industries. Investments are often in individual minority shareholdings with a number of venture capital funds investing alongside each other in successive rounds of financing. The investors are closely involved in determining the investee company’s strategy, hiring key employees, organizing the search for further financial resources and negotiating partnerships with larger corporations.

In later stage, expansion (or growth) capital finance is provided to purchase holdings in existing, generally profitable companies by subscribing new capital (as equity or quasi-equity). Investee companies here have growth profiles that necessitate the consolidation of their financial structures to e.g. develop new products or services, set up a foreign subsidiary, make an acquisition or increase their capacity.

Buy-outs are typically majority investments made in companies together with existing management (management buy-out or MBO) or with a new management team (management buy-in or MBI). These normally use sophisticated financial techniques that involve bank financing. Opportunities for buy-outs are created from the sale of family-owned businesses, the sale of a non-core subsidiary by a large corporation, taking a listed company private and the sale by financial shareholders. Buy-out funds do not focus on any one industry, though most managers have sector specialists.

Private equity investors draw capital from a defined pool; and invest predominantly in unquoted companies on the basis of a medium to long-term strategy and holding period with a focus on financial gain through exit by sale or
flotation. They have dedicated professional teams; negotiated contractual relationships with qualified / professional investors; and involve active ownership driving value creation. Further, they have strong self-regulation with defined reporting and valuation requirements; and involving stand-alone management of each individual company.

OBJECTIVES AND RESEARCH METHODOLOGY

The study is analytical in nature; it focuses on trend and progress of PE in India, the scope for pick-ups in PE flows and also on sketching reasons behind vacillations in PE flows, with a view to envisage its future. The study is supported by secondary information (taken from research papers published in journals; Newsletters of AltAssets, a PE Advisory; internet websites) and also by primary information (collected through interview of selected 18 experts from PE/ VC firms, Brokers, Analysts, Merchant Bankers, Financial Consultants, Investment Advisors, and Portfolio Managers).

PRIVATE EQUITY PLAYERS

At the simplest, generalized level, Private Equity can be described as the allocation of capital from investors to entrepreneurs (or management teams) that yields a higher return than traditionally lower risk markets. The Private Equity industry has three primary constituents or players, i.e. Entrepreneur, Investor, and the Fund Manager.

Enterprise can be either entrepreneurial or an existing company looking for capital to expand. Though, Venture Capital is an important subset of private equity markets, and has been the primary face of private equity in Indian markets, there is enormous potential for MBOs and LBOs. Investors vary from the wealthy individual to the corporate pension fund. Most Indian investments are driven by foreign funds, with very little local investors. This is mainly due to the low participation of government institutional funds and the late privatization of the insurance markets. Fund Managers are representative advisors of funds. Most funds prefer to choose Indians who have gained several years of fund management experience in the western markets. This ensures continuity and standardization of investment principles and norms across the fund’s global operations. There is no dearth of talented and experienced advisors and fund managers in India.

PE players operating in India can be broadly classified into following categories:

Government Funds: Some Indian state government funds are actively investing in India. These include SIDBI Venture Capital Limited, Gujarat Venture Fund Limited, RVCF, APIDC, CanBank Venture Capital Fund Limited, IFCI Venture Capital Funds Limited, Rajasthan Asset Management Co. Private Ltd., KITVEN and Kerala Venture Capital Fund Private Limited. Investments from these institutions
have the advantage of lower ‘cost’ of capital and hence can be more attractive to entrepreneurs.


Large Company Funds: For the last 3 to 5 years, many large companies have also been making early stage and mid-stage VC investments. Such companies are mostly investing in their own industries and leveraging their expertise with a longer-term view of potential acquisitions. Large company funds operating in India include those set up by high-tech firms such as Intel, Blue Run Ventures (owned by Nokia), Motorola, SAP Ventures, Siemens, Acer Technology Ventures, and Cisco. In addition, several financial companies and a few Indian conglomerates including have small VC funds; e.g. Kotak, IDFC, Reliance Capital, JM Financial, Religare (owned by Ranbaxy), State Bank of India, Banc of America Equity Partners Asia, Unitech (a very large real estate developer and manager in India) and Piramal (a well known pharmaceutical company).

Major competing nations in PE investment in India are UK, USA, China, Latin America, Russia, OECD, Republic Nations, Israel, Japan, Germany, France, South Korea, and Singapore. The preferred sectors of PE investors in India in order have been Infrastructure, Energy, Real Estate, and Logistics; Retail and Consumer Goods; Media and Entertainment; Finance; Industrial goods; BPO and IT; Pharma and Healthcare; Telecom; and Textile. The study observed that the focus of private equity investment in India has been on Buyouts, Re-Structuring, Expansion, Early Stage Development, Private Investments in Public Equity, Infrastructure/ Real Estate, Global Competition, Mergers and Acquisitions, Buy-Ins, Turnaround/ Revitalize, Restructuring, Refinancing Debts, Replacement Equity, Bridge Financing, Increasing Market Share, Attracting new Opportunities & Customers/ Businesses, Private Investment in Public Equity, and Strategic Guidance.

**GROWTH OF PE IN INDIA**

The Indian private equity (PE) and venture capital (VC) market roughly started in 1996-1997 and it scaled new heights in 2000 primarily because of the success demonstrated by India in
assisting with Y2K related issues as well as the overall boom in the Information Technology (IT), Telecom and the Internet sectors, which allowed global business interactions to become much easier. In fact, the total value of such deals done in India in 2000 was $1.16 billion and the average deal size was approximately US $4.14 million.

Investing in India came crashing down when NASDAQ lost 60 percent of its value during the second quarter of 2000, and other public markets including those in India also declined substantially. Consequently, during 2001-2003, with a view to minimize risks, the PEs started investing less in new companies and more in matured companies. As a result, though average deal size more than doubled from $4.14 million in 2000 to $8.52 million in 2001, the number of early-stage deals fell sharply from 142 in 2000 to 36 in 2001, late-stage deals and Private Investments in Public Equity (PIPEs) declined from 138 in 2000 to 74 in 2001, and investments in internet related companies fell from $576 million in 2000 to $49 million in 2001. This decline broadly continued until 2003, but, due to attractive growth rate of Indian economy, the services sector and the high-end manufacturing sector, investors renewed their interest and started investing again in 2004. This led to substantial increase in number of deals and the total amount of PE investment in India.

Today, India is among the most attractive investment destinations globally, driven by a combination of strong economic fundamentals, an improving regulatory and policy environment, and favorable demographics. India is generally considered a “must have” destination for foreign institutional and private equity investors, who recognize the potential of Indian companies to generate high returns leveraging on the country’s economic growth. India’s GDP grew from US$ 3.73 trillion in 2009 to US$ 4.05 trillion in 2010 while the real GDP grew at 7.4 percent and 8.3 percent in 2009 and 2010 respectively. Even though the global economy as a whole experienced several corrections in its recovery from recession, India was able to continue its growth trajectory. Various sectors of the economy, like, IT, ITES, FMCG, real estate, retail, education etc. also have grown rapidly.

Recognizing the macroeconomic indicators and the investment environment in India, PE investors, have played a significant role in the development of several sectors in India over the past decade. Important among them are, technology, healthcare, telecom, retail, education etc. PE investment in India has grown from US$ 2.0 billion in 2005 to US$ 19.0 billion in 2007. (Graph 1).
If we look at quarterly break-up of private equity investment, it had been approximately stable except in some quarters. Table 2 given below exhibits quarter-wise PE investment in India.

**TABLE No. 2 – QUARTERLY BREAK-UP OF PRIVATE EQUITY INVESTMENT IN INDIA**

<table>
<thead>
<tr>
<th>YEAR/QUARTER</th>
<th>VOLUME (NO. OF INVESTMENTS)</th>
<th>VALUE (US$ BILLIONS)</th>
<th>YEAR/QUARTER</th>
<th>VOLUME (NO. OF INVESTMENTS)</th>
<th>VALUE (US$ BILLIONS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006 (Q1)</td>
<td>58</td>
<td>1.3</td>
<td>2008 (Q3)</td>
<td>76</td>
<td>2.2</td>
</tr>
<tr>
<td>2006 (Q2)</td>
<td>70</td>
<td>2.5</td>
<td>2008 (Q4)</td>
<td>50</td>
<td>1.3</td>
</tr>
<tr>
<td>2006 (Q3)</td>
<td>68</td>
<td>1.4</td>
<td>2009 (Q1)</td>
<td>63</td>
<td>1.2</td>
</tr>
<tr>
<td>2006 (Q4)</td>
<td>108</td>
<td>2.6</td>
<td>2009 (Q2)</td>
<td>43</td>
<td>0.8</td>
</tr>
<tr>
<td>2007 (Q1)</td>
<td>136</td>
<td>3.4</td>
<td>2009 (Q3)</td>
<td>43</td>
<td>0.7</td>
</tr>
<tr>
<td>2007 (Q2)</td>
<td>83</td>
<td>3.8</td>
<td>2009 (Q4)</td>
<td>74</td>
<td>1.0</td>
</tr>
<tr>
<td>2007 (Q3)</td>
<td>90</td>
<td>5.0</td>
<td>2010 (Q1)</td>
<td>94</td>
<td>2.4</td>
</tr>
<tr>
<td>2007 (Q4)</td>
<td>120</td>
<td>7.3</td>
<td>2010 (Q2)</td>
<td>66</td>
<td>1.4</td>
</tr>
<tr>
<td>2008 (Q1)</td>
<td>149</td>
<td>4.7</td>
<td>2010 (Q3)</td>
<td>58</td>
<td>1.7</td>
</tr>
<tr>
<td>2008 (Q2)</td>
<td>69</td>
<td>3.0</td>
<td>2010 (Q4)</td>
<td>70</td>
<td>1.6</td>
</tr>
</tbody>
</table>

*Source: Data Compiled from The Fourth Wheel: PE in the Indian Corporate Landscape, June 2011*

An important feature of the resurgence in the PE activities in India since 2004 has been diversified in nature. The investors, in terms of volume (number of deals) focused on almost all the sectors, e.g., IT and ITES (IT Enabled Services, commonly known as Business Process Outsourcing or BPO), Real Estate and infrastructure, Banking and financial, pharmaceuticals and healthcare, Media and Publishing, Power and Energy, textile and Apparels, Manufacturing, Automotive, Hospitality, FMCG, Food and Beverages, Engineering, Retail, Logistics, Education, Electrical and Electronics (Table 3). This was mainly because the growth in the Indian economy was no longer limited to the IT sector; it was also spreading more evenly to other sectors.
### TABLE No. 3 - SECTOR WISE PRIVATE EQUITY INVESTMENT IN INDIA (2005-2010)

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>VOLUME (NO. OF INVESTMENTS)</th>
<th>VALUE (US$ MILLIONS)</th>
<th>SECTOR</th>
<th>VOLUME (NO. OF INVESTMENTS)</th>
<th>VALUE (US$ MILLIONS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate &amp; Infra.</td>
<td>203</td>
<td>13,043</td>
<td>Electrical &amp; Electronics</td>
<td>19</td>
<td>634</td>
</tr>
<tr>
<td>Telecom</td>
<td>53</td>
<td>6,886</td>
<td>Cement</td>
<td>13</td>
<td>567</td>
</tr>
<tr>
<td>Banking &amp; Financial</td>
<td>186</td>
<td>5,850</td>
<td>Retail</td>
<td>31</td>
<td>471</td>
</tr>
<tr>
<td>Power &amp; Energy</td>
<td>78</td>
<td>3,772</td>
<td>Logistics</td>
<td>31</td>
<td>463</td>
</tr>
<tr>
<td>IT &amp; ITES</td>
<td>277</td>
<td>3,708</td>
<td>Oil &amp; Gas</td>
<td>16</td>
<td>437</td>
</tr>
<tr>
<td>Pharma &amp; Healthcare</td>
<td>141</td>
<td>2,124</td>
<td>Agri. &amp; Agro Products</td>
<td>24</td>
<td>366</td>
</tr>
<tr>
<td>Media &amp; Publishing</td>
<td>86</td>
<td>1,922</td>
<td>Aviation</td>
<td>19</td>
<td>291</td>
</tr>
<tr>
<td>Textile &amp; Apparels</td>
<td>59</td>
<td>1,423</td>
<td>Education</td>
<td>29</td>
<td>286</td>
</tr>
<tr>
<td>Others</td>
<td>75</td>
<td>1,065</td>
<td>Metals &amp; Ores</td>
<td>11</td>
<td>265</td>
</tr>
<tr>
<td>Automotive</td>
<td>45</td>
<td>1,030</td>
<td>Plastic &amp; Chemicals</td>
<td>19</td>
<td>259</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>49</td>
<td>988</td>
<td>Travel &amp; Trav. Services</td>
<td>12</td>
<td>196</td>
</tr>
<tr>
<td>Shipping &amp; Port</td>
<td>13</td>
<td>722</td>
<td>Mining</td>
<td>4</td>
<td>164</td>
</tr>
<tr>
<td>Engineering</td>
<td>32</td>
<td>710</td>
<td>Breweries &amp; Distilleries</td>
<td>2</td>
<td>27</td>
</tr>
<tr>
<td>Hospitality</td>
<td>35</td>
<td>661</td>
<td>Printing &amp; Stationary</td>
<td>3</td>
<td>18</td>
</tr>
<tr>
<td>FMCG, Food &amp; Beverages.</td>
<td>34</td>
<td>635</td>
<td>Gems &amp; Jewellery</td>
<td>1</td>
<td>17</td>
</tr>
</tbody>
</table>

*Source: Data compiled from The Fourth Wheel: PE in the Indian Corporate Landscape, June 2011*

Table 3 indicates that Real Estate and Infrastructure sector has got maximum PE investment during 2005-10 followed by Telecom, Banking and Financial, Power and Energy, IT and ITES sector. But, the fact is that PE investors have not restricted their investments to handful of sectors, they have diversified their investments over the years into other sectors also like Pharma and Healthcare, Textile, Shipping and port, Engineering, Hospitality etc. Table 4 indicates top deals (sector wise) over a period from 2005 to 2010.

### MENACE AND PROSPECTS

The past several years have seen a boom in private equity activity in the developing world. The reasons for this growth are several; prominent among them have been the recent rapid growth and the relaxation of curbs on foreign investments in many of these nations. A critical impetus is too much of this progress, in turn, has been the economic reforms adopted by these nations. The pace at which capitalism has rolled through developing economies is breathtaking.
### TABLE No. 4 – TOP 20 PRIVATE EQUITY INVESTMENT DEALS IN INDIA (2005-2010)

<table>
<thead>
<tr>
<th>YEAR</th>
<th>INVESTOR(S)</th>
<th>INVESTEES</th>
<th>SECTOR</th>
<th>VALUE (US$ MILLIONS)</th>
<th>PERCENT STAKE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>Temasek Holdings</td>
<td>Bharti Airtel</td>
<td>Telecom</td>
<td>1,097.00</td>
<td>4.99</td>
</tr>
<tr>
<td>2006</td>
<td>Kohlberg Kravis Roberts &amp; Co.</td>
<td>Flextronix Software Systems</td>
<td>IT &amp; ITES</td>
<td>1,035.00</td>
<td>85.00</td>
</tr>
<tr>
<td>2007</td>
<td>Temasek Holdings, Investment Corp., Dubai, Goldman Sachs, AIF, Macquarie, Citigroup &amp; IEP</td>
<td>Bharti Infratel</td>
<td>Telecom</td>
<td>1,000.00</td>
<td>10.00</td>
</tr>
<tr>
<td>2007</td>
<td>ICICI Venture Funds Management Company</td>
<td>Jaypee Infratech</td>
<td>Real Estate &amp; Infrastructure</td>
<td>800.00</td>
<td>NA</td>
</tr>
<tr>
<td>2007</td>
<td>George Soros, Credit Agricole, Park Capital, Capital International, Deutche Assets, Citigroup, T Rowe Price, UBS and Kotak Mahindra</td>
<td>GMR Infrastructure</td>
<td>Real Estate &amp; Infrastructure</td>
<td>767.00</td>
<td>NA</td>
</tr>
<tr>
<td>2007</td>
<td>Carlyle Group</td>
<td>HDFC</td>
<td>Banking &amp; Financial Services</td>
<td>650.00</td>
<td>5.60</td>
</tr>
<tr>
<td>2008</td>
<td>Providence Equity Partners</td>
<td>Aditya Birla Telecom</td>
<td>Telecom</td>
<td>640.00</td>
<td>20.00</td>
</tr>
<tr>
<td>2006</td>
<td>Providence Equity Partners</td>
<td>Idea Cellular Limited</td>
<td>Telecom</td>
<td>460.00</td>
<td>15.00</td>
</tr>
<tr>
<td>2006</td>
<td>Temasek Holdings</td>
<td>Tata Teleservices Ltd.</td>
<td>Telecom</td>
<td>380.00</td>
<td>9.90</td>
</tr>
<tr>
<td>2010</td>
<td>Blackstone Group</td>
<td>Moser Baer Projects Pvt. Ltd.</td>
<td>Power &amp; Energy</td>
<td>300.00</td>
<td>NA</td>
</tr>
<tr>
<td>2008</td>
<td>Orient Global Tamarind Fund Pte. Ltd.</td>
<td>Cairn India Ltd.</td>
<td>-Do-</td>
<td>279.00</td>
<td>2.60</td>
</tr>
<tr>
<td>2010</td>
<td>3i India Infrastructure Fund Ltd.</td>
<td>GVK Energy Ltd.</td>
<td>-Do-</td>
<td>255.00</td>
<td>21.10</td>
</tr>
<tr>
<td>2008</td>
<td>Farallon Capital</td>
<td>Indiabulls Power Services</td>
<td>-Do-</td>
<td>247.00</td>
<td>23.40</td>
</tr>
<tr>
<td>2007</td>
<td>3i India Infrastructure Fund Ltd.</td>
<td>Adani Power Ltd.</td>
<td>-Do-</td>
<td>227.00</td>
<td>NA</td>
</tr>
<tr>
<td>2007</td>
<td>Blackstone Group</td>
<td>Intelenet Global Services Pvt. Ltd.</td>
<td>IT &amp; ITES</td>
<td>200.00</td>
<td>80.00</td>
</tr>
<tr>
<td>2007</td>
<td>BNP Paribas</td>
<td>SREI Infrastructure Finance</td>
<td>Banking &amp; Financial Services</td>
<td>180.00</td>
<td>50.00</td>
</tr>
<tr>
<td>2007</td>
<td>Khazzanah Nasional Berhad</td>
<td>IDFC</td>
<td>-Do-</td>
<td>180.00</td>
<td>9.95</td>
</tr>
<tr>
<td>2006</td>
<td>Farallon Capital</td>
<td>Indiabulls Fin. Services</td>
<td>-Do-</td>
<td>165.00</td>
<td>NA</td>
</tr>
<tr>
<td>2007</td>
<td>Merrill Lynch</td>
<td>Multi Commodity Exchange</td>
<td>-Do-</td>
<td>160.00</td>
<td>5.00</td>
</tr>
<tr>
<td>2006</td>
<td>Olympus Capital</td>
<td>Quattro BPO Solutions</td>
<td>IT &amp; ITES</td>
<td>115.00</td>
<td>NA</td>
</tr>
</tbody>
</table>

Source: Date Compiled from The Fourth Wheel: Private Equity in the Indian Corporate Landscape, June 2011
India and China are both vast countries filled with opportunity and risk for private equity investors. Demographics also have shaped the future of India and China, as increasingly aging populations loom over the economies of North America, Europe and Japan. China's one-child policy will cause it to age more rapidly than India, leaving China to face the problem of too many retirees supported by a shrinking pool of workers. By mid-century, India's most populous age group will be 40 to 50, while in China it will be 55 to 65. Huge market for private equity investment is waiting to be tapped in India and China, the two rapidly growing economies of the world. Emerging markets private equity is firmly on the map. As developed markets become increasingly saturated, exciting new frontiers and fast-developing regions are opening up to those seeking to deploy private capital. India's chief advantage over countries such as China is that it offers investors abundant natural resources, better trained managers and more corporate transparency in the private sector. It also boasts the oldest stock market in Asia, the 130 year old Bombay Stock Exchange, and the largest number of listed stocks, over 7,000. Most important, India has strong economic fundamentals and the courts here are fairly reliable arbiters of investors' rights.

Ever since India adopted open door or open arm policy, the private equity investors from around the world are increasing their bets on Indian corporates or making new ones. Some of the prominent players in all include big name US firms like Blackstone Group, Carlyle Group and General Atlantic Partners, and Britain's Actis Partners. Local firms such as ICICI Venture Funds Management Ltd. and Kotak are also stepping up investments. In 2004 these firms poured an estimated $1.3 billion into private equity deals in equity in India. The PE investors in India are facing competition from Hedge Funds, Corporate Venturing, Buyouts, Asset Securitization, Venture Finance, Business Associates Funds, Merchant Banks, Factoring/Discounting, Clearing Banks, Public Sector Grants/Loans/Regional Assistance, Funds from Companies Own Directors.
India's private equity industry has experienced a steep growth in the recent past. Many investors have made VC and PE investments a mainstream component of their portfolios in India. The key elements for private equity growth are; the right regulatory, legal, tax and institutional environment; the presence of an entrepreneur society; the existence of inefficiencies in the private capital markets; and infrastructure support. In the last about one decade India has delivered on all these fronts. The government has recognized potential of further developing this positive environment. Chart 2 clearly indicates key forces in India’s private equity market.

In India today, there are three promising investment hypotheses:

- Target dynamic new sectors benefiting from the rise of the consumer class, including healthcare, real estate, banking and credit.
- Capitalize on low-cost labor resources in areas such as software applications development, business services, engineering and technical design.
- Look opportunistically at emerging industry niches, including pharmaceuticals, automotive components and metal forging, as these subsectors and these industries build global scale.

Some of the opportunities for taking advantage of PE investment in India are Negligible Capex Requirements, Industries Running to Optimum Capacities, Promoters Willing to Share Ownership, Booming Domestic Economy, Vibrant Stock Markets,

There are two main economic forces driving the estimated surge in the size of the Indian private equity market.

A growing consumer class is increasing demand in key industries, such as hospitality, retail and healthcare delivery.

Increasingly differentiated Indian skills, which include Technology skills (that underpinned India's initial rise in the global economy, now evolving toward higher-value design engineering skills), and Proficiency once (found in India's services markets, now being replicated in a number of growing Indian manufacturing sectors).

Private equity firms in India have never ever had it as good as in present times. Corporate performance in last few years has been outstanding on almost all parameters like sales, profits, exports and shareholders wealth creation. Strengthening domestic demand conditions coupled with a spurt in export demand have resulted in higher capacity requirements and expansion. Indeed, Indian economy is moving onto a stupendous growth trajectory. Moreover, India has become aggressive in the M&A space both in India and overseas. All this has led to a huge demand in the capital raised to fund investments. The good news is that liquidity or capital supply has been equally strong, if not more, resulting in robust demand-supply equilibrium.

There are significant downsides also that still give foreigners pause. For all of its recent financial and regulatory reforms, the country remains mired in bureaucratic red tape and bedeviled by poor infrastructure. Plus, there are limits to foreign ownership in industries such as defense, news media, retail, and some forms of banking. A much ballyhooed privatization process of state-run firms has been stalled by the current government, so big Indian and foreign private investors cannot exercise control over the juiciest public sector companies.

In brief, PE Investors in India are subject to some hurdles/ deterents which are related to:

Government Policies and Regulations: These may include Bureaucratic Control, Policy Restrictions and Hidden Barriers, No Free Access to Assets, No Free Flow of Forex, Outmoded Legal/Regulatory Framework, High Taxes/Teriffs, Complications in Registration Requirements, Investment Caps, Protectionist Tendencies, Delayed Legal/ Settlement System, Discriminatory Treatment,
Divergence between Policies of State and Central Government.

Company: Reluctance to Cede Control, Conservative Mentality of Businessmen, Labor Resistance, Corporate Governance Requirements, Long Distance between Company and Investors, Cultural Differences, Inefficient Management, Increased Accuracy, Depth of Holding and Financial Disclosure.


GROUNDS REALITIES AND BEST PRACTICES FOR INVESTING IN INDIA

In many respects, the sophistication and maturity of PE investments in India today are probably at the same level as in the early 1970s in the US. This section advocates some best practices and highlights some of the key differences between investing in early-stage and mid-stage companies in the US versus investing in similar companies in India.

MANIACAL FOCUS ON EARLY PROFITABILITY

Unlike most start-ups in US, which are usually product based expecting 2-3 stages of investment, entrepreneurs in India are by and large focused on making their companies profitable as soon as possible. This mindset might be because Indian entrepreneurs have, to some extent, traditionally founded services and trading companies. From an Indian entrepreneur’s perspective, the reasons for making their company profitable quickly may include; the scarcity of available venture capital, reluctance in giving up too much equity, and since most Indian start-ups have been in the service sector so far, they require a significantly smaller amount of venture capital. Of course, the disadvantages of such a maniacal focus on profitability include; the possibility that an Indian start-up may not able to grow very quickly or realize its full potential, and the possibility of an Indian start-up being upstaged by some other firm somewhere else in the world. Hence, the PEs must play a crucial role in educating Indian entrepreneurs to think differently, especially in the context of product based companies.

CONTINUED FUNDING IN SMALL AMOUNTS

Since the Purchasing Power Parity in India is 5, and since many, if not most, Indian start-ups still continue to be created in the services business, and since the entrepreneurs for even those product based start-ups wish to achieve profitability quickly, it is believed that
PEs should not look at funding Indian companies in distinct stages (i.e., Seed funding, Stage “A” funding, Stage “B” funding, Mezzanine funding etc), rather, they should provide small portions of continuous funding based on continued attainment of predefined metrics such as revenues, profits, development expenses, etc. Of course, this would imply that the VC has to be more involved operationally, and simply attending a board meeting every two-three months might not be sufficient, it would imply that the VC would essentially act as a “bank” that provides money in exchange for equity, as and when needed.

RIGHT TALENT FOR ADVANCED BUSINESS DEVELOPMENT

Indian entrepreneurs are found to be quite adept technically and definitely at par with similar entrepreneurs in developed countries, but, in general they lack expertise in marketing, sales, and business development, especially when compared to their counterparts in the US. This is perhaps because India had socialistic economic policies and protective business environment during 1947-1992. The problem is further exacerbated because the Indian economy has been growing at considerable rate and most start-ups have to compete for talent not only with other companies that are exporting similar or dissimilar products and services but also with many domestic companies. Hence, finding the appropriate people is one area where Indian start-ups need help. In fact, finding and retaining the “right talent” has become an issue not only in marketing, sales and business development but also in research, technical and advanced development areas.

INDIAN ENTREPRENEURS ARE HESITANT TO GIVE-UP CONTROL

Indian entrepreneurs are usually hesitant about giving up control. In fact, most of the entrepreneurs in India currently receive their initial funding from family and friends, and even if they do not do so, the Indian social system is such that relatives and friends still end up being a major influence. Also, since the Bombay Stock Exchange (BSE) has been growing quite rapidly (in spite of the recent drop) and a company with $208 million in annual revenue can be easily listed on it; that enables them to give up a substantial share to the PEs. Thus, PEs have to provide a very clear value proposition to the start-ups and cannot simply state that they bring value to the table just because they are well connected, etc.

LACK OF FINANCIAL TRANSPARENCY AND OTHER PROCESSES

Again, partly because the Indian economy was a socialistic and closed, and partly because Indian entrepreneurs are not as proficient as their counterparts in the US, the start-ups in India lack financial transparency and often have limited experience in implementing
effective financial processes. This usually makes the task of PEs much more difficult not only during the due-diligence phase, but also in helping the start-up to grow rapidly. It is believed that immediately after making its investment, the PE should have to roll up the sleeves and help the entrepreneurs in processes-zing the company. Directing the Indian entrepreneurs to implement processes during monthly or quarterly board meetings may prove to be futile because many entrepreneurs might not know how to execute on these instructions.

**UN-SUSTAINABLE INVESTMENT MODEL**

One of the most worrisome aspects is that most PE investors want to continue to invest in Indian start-ups in areas they are most familiar with, like IT, ITES, telecom and Internet products and services. If we study the cross-border and pure India based companies listed in Section 2.4, more than 90% are in the IT, ITES and BPO, telecom, and Consumer Internet. So, going forward, the PEs may want to investigate the following rapidly emerging sectors for potential investment: auto-components, travel and tourism, domestic healthcare and medical tourism, retail, textiles, biotechnology, pharmaceuticals, real estate and infrastructure, entertainment and media, gems and jewellery, and of course, the traditional sectors that include telecom, IT, and BPO services. It is interesting to note in this regard, that several PE firms (e.g., Chrys Capital, Westbridge – now a part of Sequoia Capital, India) are beginning to follow a well rounded and diversified strategy, but so far most of it is limited to late stage investments and PIPEs.

**LACK OF PES WITH CROSS-BORDER EXPERIENCE**

The other really worrisome aspect is that many PE investors believe that they can help the growth of Indian start-ups, and provide good returns to their own shareholders by making decisions, and visiting India periodically. Since Indian start-ups require a lot of handholding in the areas mentioned above, this approach is unlikely to be very effective. Although the approach, sending one of the senior partners in the PE firm to India to set up a subsidiary can help its portfolio companies, it is likely to fail in instances where the partner(s) do not live in India. This is because even Indians living in the US are usually not familiar with the typical business practices in India unless they have had 2-3 years of recent experience on the ground in India. Similarly, the approach of hiring a junior partner in India also has some disadvantages, like, (a) the junior partner may not be effective in identifying and hiring good talent inside and outside the country, (b) he may not have sufficient experience to advise this start-up effectively, and (c) such a junior partner may have a low standing within the PE firm.
BRAND RECOGNITION OF PES IN INDIA

Since venture capital investing in India is a relatively recent phenomenon, PEs who may be well known, may not yet be able to take their brand recognition in India for granted. It is believed that successful Indian entrepreneurs and PEs who have lived in abroad and have at least ten years of experience in running their own companies, or have been actively involved in helping others and can get down in the trenches with the Indian entrepreneurs are more likely to succeed and build a brand name for themselves and their groups. Of course, on the other hand, since most if not all of these groups are raising the money in the US, brand name PEs in the US will definitely be able to raise this money much more efficiently and effectively than those groups that are not known in the US. Again, the implication for the PE firm is that it will have to articulate a very clear value proposition.

CONCLUSION

Sound economic growth, stable socio-political conditions, strong focus on infrastructure development, alignment of key fiscal policies, continued political and business consensus on reforms and an entrepreneurial culture make India a fertile environment for private equity funds to operate in. There are trends of cross sector investments by private equity firms, but these are falling way short of the market demand. The initial players have rushed to focus on the IT sector and big-ticket deals like the privatization of government assets. But the bulk of the Indian economy (and the associated growth) is fuelled by the SME sector, which has been ignored by incumbent funds. The Indian (mid-sized) business psyche is not yet attuned to the idea of mergers and acquisitions and western private equity funds can help those spot opportunities, thus, offering value beyond plain vanilla capital.

The emergence of hedge funds doing PIPE (Private Investments in Public Equity) and pre-IPO deals is a clear sign that the Indian Private Equity market is approaching maturity. Within a few years this will be a catch up game with significant advantages appropriated by the early movers in the Indian PE market. Both fund managers and their investors rate PE as being important for India’s economic development. Their logic is that, though probably not the most important factor, PE is important for the flourishing of small businesses, which are usually the bedrock of any economy. One investor, however, noted that the debt market needs to be vitalized first and is probably more important than PE.

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