PRIVATE EQUITY IN INDIA: A MIXED BAG STORY

An Interview with Mr. Vishal Dixit, Director, Zephyr Peacock India Management, Bangalore

Till around a couple of years back, India was the favourite child of most private equity funds across the world. A large number of private equity funds had earmarked substantial funds for investment in India. In terms of investments and bullish sentiments, the Indian PE story was second only to China. However, the private equity story hasn't quite panned out as expected.

Success stories for private equity funds in India are Flipkart, Pipavav Shipping, Bharti Airtel, ABG, Punj Lyod, Pantaloons, and Snapdeal among others. Private equity funds that invested in sound growth companies around 2000-2002 earned handsome returns on their investments. However, this sector in India in recent times is facing many challenges. including inability of PE funds to raise capital from LLPs, declining interest from foreign investors in the India growth story, promoter- private equity discord, experienced private equity professionals venturing out on their own, inability to exit investee companies, low returns on investment and a glut of me-too private equity funds flooding the capital markets.

The image of India Inc and the government of India is tarnished and the India growth story no longer sells abroad too easily. At the same time, economic situation looks grim, growth and investment have stalled. A lot of private equity funds that invested during the boom period of 2006-08 are now due for exit. Considering this environment, the 4 key points for the interview emerge as below:

- The reasons for varied performance of funds. While some private equity funds have delivered below par performances and have had to shut shop, certain private equity funds continue to deliver value to their investors with each fund raising and investment cycle.
- Issues peculiar to India such as uncertain tax regulations, private equity investors, and promoters failing to reach consensus on management issues, and low standards of corporate governance in investee companies.
- Comparison with China, Philippines, Indonesia, and Vietnam that have given favourable returns in the same global economic environment.
- There is considerable amount of uncertainty for private equity funds in the future from the regulatory, economic and policy perspective. Hence delivering on the performance will be especially challenging.

Characteristics that differentiate the good funds from the under-performers

Tejas: Some private equity funds managed superlative performances even during the crisis period. However, a large number of funds have shut shop in the recent years after failed follow-on fund raising attempt. What specific characteristics distinguished the good ones from the under performers in the past decade?

Vishal Dixit (VD): There are a couple of things that the good funds did right in the past 6-7 years.

I think the major difference was that the good funds were disciplined in whatever they did. During the period of 2006-07 there was a lot of optimism in the air. People were willing to buy businesses at very high values. But these funds were more disciplined in what they paid for businesses and the quality of businesses they invested in.

Secondly, they had a good sense of quality of the management teams and scalability of the business models and so on. So mainly they were good at the qualitative assessment of businesses.

Tejas: A lot of funds were chasing in a particular sector because that sector was hot then and was supposed to have a lot of promise. Do you think funds have also suffered because of the herd mentality?

VD: That is actually very difficult to say whether funds have suffered because of herd mentality because there are good and bad companies in every sector and it can go either ways. The whole idea is whether you are disciplined with respect to the environment, valuations for companies, how you evaluate those businesses, how you pay for them and the qualitative evaluation of the management team.

Tejas: What are the new practices or innovations that the over achievers successfully implemented /tried in India but aren't seen in practice in other countries? In other words, have private equity funds evolved/need to evolve any successful India specific strategies/innovations that could enable them to deliver superlative returns and differentiate themselves from the crowd?

VD: I think the whole private equity sector in terms of structure etc. is very flexible. In geography like India, it takes a couple of years more to exit from a company because the businesses you invest in may be younger or there more be more volatility in the market. But that apart, otherwise, from the point of view of structure such as the 2/20 model and so on, it is fairly compatible in India as such.

Tejas: And are the Indian markets also similar in terms of other characteristics of private equity investing such as investment decision making, criteria, value added to the businesses?

VD: You mean as compared to other countries? That is a different thing as compared to the structure features such as 2/20 etc. In terms of approach to investing in India, it is important to understand that investors here deal with much more ambiguity which makes the market more challenging and exciting. How business analysis is done, or how MBA's are taught to look at things is that you really look at the data, analyze it and try to understand how the business will perform is important part of the investment process. In India, there is more ambiguity, in the quality of information, its accuracy, what is your prediction of the state of the world and so on. Hence, in India, it becomes especially important to apply good commercial judgment in a qualitative sense. From that perspective, investing in emerging markets such as India is very different from investing in the more developed Western markets. For e.g. it is very easy to predict the revenues of a company like Walmart with a +-5% margin for error. It is so much more difficult for a similar business in India because the market is so dynamic.

Tejas: Has this ambiguity and uncertainty which is so peculiar to the Indian market affected performance of funds especially the funds which are based abroad and have India offices?

VD: Funds which are based abroad have their own set of advantages. They have an advantage in terms of fact that they can give a lot of access to the global markets and global relationships. They also have people who have seen the sectors evolve in the past and that from that point of view it is very helpful. At the same time, on ground investing experience is required. Funds which have done well in India are funds which have a good mix of global and local not just in terms of offices or investment professionals but having investment professionals who have significant exposure to both global and local market. That is an ideal mix.

Issues peculiar to India

Tejas: Private equity generally add value to the investee companies through strategic and management changes, improvement in corporate governance and reporting practices, hiring senior executives, bringing global synergies etc. Have Indian private equity funds succeeded in adding this value to their investee companies?

VD: In India, the potential to add value is much higher. The businesses are much younger and the promoters may have less exposure in some cases. Hence the ability to add value is much higher. Whether it happens or not really depends on the relationship with the promoters and how closely the promoter is willing to work with them. That is important aspect of a good investment strategy - identifying promoters who are willing to work together and who are open to receiving business inputs and ideas and who don't believe they have all the answers. So in India, yes, the potential to add value is higher, whether it happens or not really depends on the relationship with the promoter, the promoter's personality, and most importantly, the ability of the fund to add value.

Tejas: We don't see a lot of buyouts happening in India, whereas buyouts are perhaps the more popular form of private equity investing abroad. Do you see buyouts picking up as a trend in India?

VD: It really depends. If you look at the Indian promoters, they have inherited the businesses from their families or have built it from scratch over a number of years and hence they are unwilling to let go off control. Hence they prefer an IPO rather than selling off the control in the business. That may change over a period of time, as the markets really mature, the promoters may find better uses for their time and money. At the same time IPOs which are an easy strategy, smaller IPOs may become more difficult and control stake sell may become an easier strategy.

India story – a mixed bag for private equity funds

Tejas: What is the current perception among foreign LPs about the capabilities of the Indian private equity players? What is the current tone of the relationship between the mostly foreign based limited partners and the Indian general partners?

VD: We keep the funds constantly informed about how the investments are performing, what has gone wrong with the investment, what was the aim in mind while making those investments, what is being done to rectify the situation. We keep them in loop regularly and if it is a genuine case where the investment opportunity made good business sense, the limited partners generally do understand. It also depends a lot on the relationship you build and maintain with them.

Tejas: What are the current trends in fund raising for India focused private equity funds? Have most major limited partners reevaluated their allocations to India in the light of the lack lustre performance of the Indian economy? Do you see the flow of capital reversing and major private equity investment returning aggressively to India in the short term future?

VD: I think most private equity investors/limited partners have taken the 'wait and watch' approach with regards to India at the moment. I think the belief is that the short term outlook may not be good however the long term India story is still largely intact.

Limited partners largely look at two factors while making their fund allocations. Whether the fund has a good performance history and secondly whether the limited investors have a good relationship with the fund's general partners. In the case of younger funds or funds which are raising funds for the first time, the performance history is not available and hence these funds need to have a sound and convincing investment strategy in place. When the above two factors are in place, you will generally be able to raise funds from investors abroad.

Navigating the uncertain future

Tejas: The last couple of weeks have seen a lot of reforms such as deferment of GAAR, the cut in diesel and cooking gas subsidy and FDI in retail and aviation. However, many private equity funds, including the large reputed ones took a haircut on their investments and exited them in the first half of the year itself. Do you think the reforms are a case of 'too little, too late' or can they turn the tide for PE sector in India?

VD: I think the government has taken a lot of good steps in recent times. Now we need to watch how much of it actually translates into reality and changes things on the ground. With regards to GAAR, I am not sure of its implications and the magnitude of the same for private equity sector in India and hence do not want to comment on it.

Tejas: What pressing reforms, policies or regulatory changes are required to enable private equity funds to significantly improve on their performance in the past 2-3 years and revive the investment in the sector?

VD: I think reforms are required in two areas: mainly the legal rights that private equity investors in India have as shareholders of companies and secondly, ambiguity in the structure of private equity funds in India.

Conclusion

Private Equity Industry in India has a lost a bit of its shine in the past few years. PE funds are struggling to exit portfolio companies or secure investments at good valuations.PE funds are finding it difficult to raise funds from foreign investors given the current global economic scenario and the lackluster performance of the Indian economy. Perhaps the private equity industry in India which is currently overcrowded with several hundreds of funds needs consolidation

However, there is no doubt about the fact that for India to grow at 9% private equity investments are indispensable especially in sectors such as infrastructure, education , healthcare, IT/ITeS. Private equity has a big role to play in helping companies grow, increasing employment, raise productivity, improve corporate governance in small and mid-sized firms; foster growth and encourage innovation and entrepreneurship.

However, for PE to realize its full potential, important regulatory hurdles like uncertainties in India's tax regime and limited investment opportunities for foreign investors in several regulated sectors such as multi brand retail need to be addressed. Going forward the Indian private equity investor still has faith in the long term growth potential of the Indian economy and is cautiously optimistic.

Profile of Interviewee – Mr. Vishal Dixit

Vishal Dixit is a Director for Zephyr Peacock India Management and is based in Bangalore. Prior to joining Zephyr, he has worked with Actis Capital in London and Macquarie Capital in New York, focusing on private equity transactions in infrastructure and industrial sectors. Mr. Dixit started his professional career with the United Nations in New Delhi as the Group Coordinator for the education sector and was subsequently seconded to the Planning Commission of India to manage a joint UNDP-Govt. of India project on development financing. He went on to serve the Secretariat for the Indian Prime Minister's Committee on Infrastructure, where he supported multibillion dollar initiatives and transactions in the airports, highways, ports and power sectors. Mr. Dixit holds an MBA from Stanford University, an MA in Mathematical Economics from the University of Bombay and a B.Com from the Sydenham College in Mumbai

References

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