

Private Equity in India

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Definition of Private Equity:

Equity capital that is not quoted on a public exchange is Private equity.

It consists of investors and funds that make investments directly into private companies. Capital for private equity is raised from retail and institutional investors, and can be used to fund new technologies, expand working capital within an owned company, make acquisitions, or to strengthen a balance sheet.

The majority of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time. Private equity investments often demand long holding periods to allow for a turnaround of a distressed company or a liquidity event such as an IPO or sale to a public company.

Private equity investments can be classified into:

Seed Stage: Financing provided to research, assess & develop an initial concept before a business has reached a start-up phase.

Start-up Stage: Financing for product development & initial marketing.

Expansion Stage: Financing for growth & expansion of a company.

Replacement Capital: Purchase of shares from another investor or to reduce gearing via the refinancing of debt.

Securities and Exchange Board of India Regulations

(ALTERNATIVE INVESTMENT FUNDS)

- Registration of Alternative Investment Fund
- Eligibility Criteria
- Furnishing of Information
- Procedure for grant of Certificate
- Procedure where registration is refused
- Investment in Alternative Investment Fund

History:

- Started in 1946 with the establishment of American Research & Development Corporation (ARD)
- Founders: Ralph Flanders & George Doriot
- Purpose of ARD

Why is PE required in India?

- Indian companies depend heavily on Western-style business practices and entrepreneurialism though maturing quickly, but not without some false starts.
- Different law and property rights in foreign countries.
- Emerging investor's community.
- PE an important component in Venture capital- from idea generation to buy out.
- Leverage has increased in PE transaction but is still lower than expected levels.
- FDI attracts huge investment through Equity, Compulsorily Convertible Preference Shares, Compulsorily Convertible Debentures, ADR /GDR, etc.
- Offset economic conditions due to 2010's sovereign debt crises, which persist to the present times.
- Limited Partner (LP) appetite for the PE achieving new heights.
- Significant for Business Model changes, Corporate Governance and Professional talent management.
- Alternate source of long term funding for new and innovative business models.
- Apart from capital, it also leads to transformative inputs for the growth of the company.
- Diversified investment helps in covering all the sectors of the economy.

Advantage of India over other countries

- Developing economy with major sector uncovered such as software, tech outsourcing and pharma outsourcing.
- Better trained managers and corporate transparency in private sector.
- Oldest stock market in Asia- The 130 year old Bombay Stock Exchange, with over 7000 listed stocks.
- Courts are fairly arbiter to investor's rights, more developed jurisprudence and relative sanctity of contracts.

Performance of Private Equity in India:

Potential source of finance for the cash strapped small and medium enterprises, infrastructure sector, education and environment sensitive sectors

- **Key driving factors**
 - Strong Macroeconomic fundamentals (high growth rates, high gross domestic investments and booming stock market)
 - Booming secondary market
 - Wider exit possibilities
- **Sectorial Analysis**
 - Banking and Financial Services
 - Construction and real estate
 - Information technology
 - Media and entertainment

- **Successful private equity deals in India**

- Bharti Airtel –Warbug Pincus deal
- The leveraged buyout of Infomedia by ICICI Venture in 2003 from Tata Group
- The ‘Shriram Transport Finance Corporation’, a vehicle finance company opted for private equity capital from ChrysCapital and TPG Newbridge in 2005

Private Equity – Implications for India / Challenges:

- Foreign investors under the FII and FVCI routes require registration with SEBI to invest in India
 - The buy-out model is yet to be successful in India
 - Foreign debt is subject to the Guidelines on External Commercial borrowings issues by the RBI which sets out limitations on the eligibility of the borrower and the lender and also prescribes the maximum all in cost-ceilings, the end use restrictions and the minimum average maturity of debt
 - Double Taxation Avoidance Agreement with Mauritius and other countries are presently being reviewed and they may be renegotiated to make them more stringent
- **Trade- off between Private equity and other Non- bank Sources of finance**
 - Does easy access to private equity funds delay firms’ decision to go for public offers?
 - Does it compete away investments/suck liquidity from the domestic debt market?
 - Does private equity compete with traditional non-bank sources of finance like public issues and private placement or supplement them?
 - **Trade-off between PE Regulation and Non- Regulation**
 - Private equity deals are most sensitive to situations of high growth and high interest rates
 - Private equity firms may not be able to secure financing on attractive terms and may also have to carry more demanding debt service burden than anticipated
 - Increased regulations
 - Diversification of many private equity firms into hedge funds
 - Need for relaxing both entry and exit barriers for the industry

The Private Equity Image Problem

Private equity is, by definition, a private industry that operates outside the traditional, public investment system. The huge impact that the private equity industry has on the financial market, and more recent high-profile buyouts have caused concern outside the industry and led calls for greater transparency in private equity.

Key factors that contribute to private equity's bad reputation:

- **Size:** The relatively new development of private equity, specifically the buyouts of large companies, has caused much public concern because the private equity industry is less than transparent
- **Media:** The media struggled to define an industry that few really understood. Now, private equity firms are making an effort to work with the media and explain the private equity process.
- **Public Interest:** Private equity is exclusively motivated by capital and does not contribute locally. The substantial inflow of foreign capital to private equity funds does not help this image.
- **Employment:** A private equity firm may cease control of an underperforming company to help it realize its full profit potential.

How to improve the private equity industry's image

- Improving Transparency
- Opening to the Media
- Focusing on Benefits

What Makes private equity successful in India:

- Gradual pace of opening of the economy
- Efficient regulatory supervision
- Strong domestic demand
- Comparatively limited dependence on foreign trade
- Growth prospects remain robust
- India's industrial and service sector growth remains resilient
- India remains a relatively high-return and low risk source of diversifying returns for private equity investments

Nature of Private Equity Firms:

Virtually, all private equity firms are organized as limited partnerships where private equity firms serve as general partners and large institutional investors and high net worth individuals providing bulk of the capital serve as limited partners. Such partnerships usually last for 10 years and partnership agreements signed clearly define the expected payments to general partners.

Business Cycle of Private Equity:

A private equity business cycle consists of **four** stages. These are as follows:-

The **First Stage** is to establish investment funds that collect capital from investors or limited partners. Limited partners include pension and provident funds, hedge funds, sovereign wealth

funds, multilateral development banks like the Asian Development Bank and bilateral development financial institutions.

In the **Second Stage**, The capital thus raised is used to buy equity stakes in high-potential companies. A private equity investment takes place through one of the four investment vehicles viz., direct investments, funds, fund-of-funds and more exotic products like collateralized fund obligations (CFOs), publicly quoted entities or mixed portfolios.

Private equity funds seek to acquire control of companies, implement value adding changes and then realize the resulting capital gain by disposing of their investment within a relatively short time frame which is generally 3-5 years. Hence the **Third Stage** of a private equity business cycle is to exit the investment. They require timely and profitable exits to redeem capital and returns to their investors and themselves and also to establish and maintain their reputation, which in turn enable them to raise capital again for future funds from existing and new limited partners.

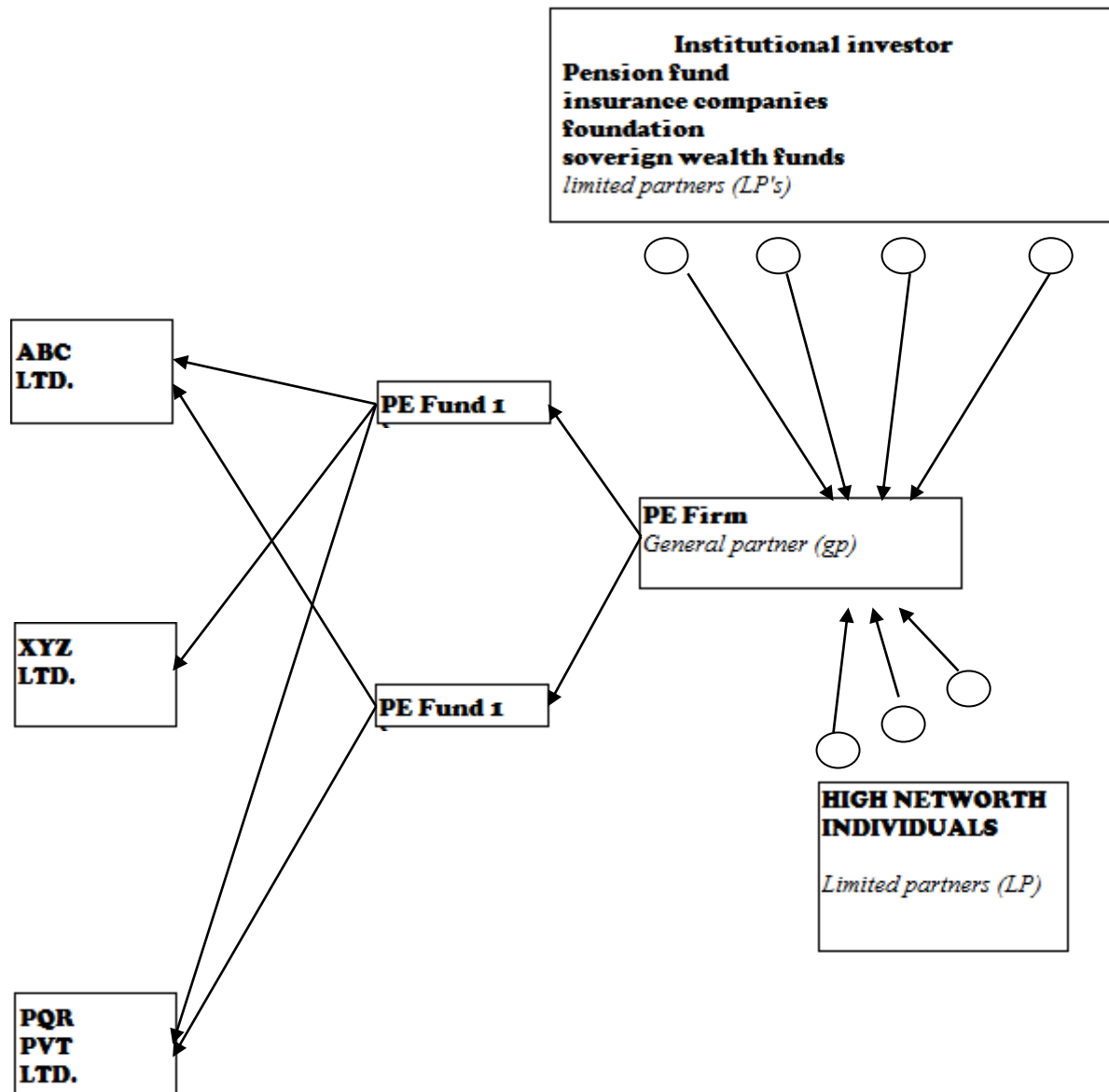
Finally in the **last stage**, the capital recovered from the exit is redistributed to original investors on a pro-rata basis depending on the size of their initial investment. These reimbursements along with the capital gains, allow the institutional investors to honour their insurance contracts, pensions and savings deposits. This completes one private equity business cycle.

Players in the Private Equity Market:

There are **three** major participants in a private equity market namely

- i. **Issuers or firms** where private equities invest in- Issuers are generally firms that do not have recourse to an alternative source of financing such as a bank loan, private placement or the public equity market.
- ii. **Intermediaries** which operate in private equity fund themselves- These are usually organized as limited partnerships where investors who contribute to the fund's capital are limited partners, while the professional managers running the fund serve as the general partners.
- iii. **Investors** who contribute capital to private equity firms- These may include public and corporate pension funds, endowments, foundations, bank holding companies, investment banks, insurance companies and wealthy families and individuals.

Structure of Pvt. Equity in India



A Pvt. Equity fund is basically run and set up by a partnership firm or a professional. Many institutional investors like insurance companies, pension funds, sovereign wealth funds and foundation etc. joins the firm as a limited partner to contribute surplus funds.

In the case of Venture Capital (“VC”) and Private Equity (“PE”) investors, the focus had been skewed more towards high growth sectors such as Information Technology (“IT”) until early 2001. However, with the technology slowdown following the dot-com burst, the VCs have diversified their interest into other high potential sectors such as **pharmaceutical (especially biotech), manufacturing, infrastructure, banking, media and entertainment, retailing, Public Sector Undertaking (PSU) disinvestments and business process outsourcing(BPO/ (IT-enabled services).**

IDENTIFYING THE RIGHT OPPORTUNITIES:

Irrespective of the size of the deal or the sector in which the investment is made, identifying the right companies for investment is a very critical matter. Investors could be looking at opportunities either for long-term capital appreciation or for investments that make sense from a strategic business perspective. Investors typically look at several aspects of a potential investee company, like business focus and strategy for the company, its financials, the management team, its ranking in the industry in India, *etc.* In the technology sectors in particular, one also needs to look more closely at the sustainability of the products or services being offered by the company and the efficiency of its business model, owing to constant threat of obsolescence.

Top private equity training programs

- **Private Equity Training dot com:** This website is geared toward people who simply want to learn more about the industry but do not want to enroll in an intensive training program.
- **Certified Private Equity Professional:** The Certified Private Equity Professional (CPEP) program is designed exclusively for those who work in the industry, would like to begin working for a buyout firm, or would like to better understand and serve their PE firm clients.
- **The Private Equity Institute:** This program combines the classroom with online courses so it could be either convenient or inconvenient if you don't live where the courses are offered.
- **Private Equity Seminars and Conferences:** These are typically 1-2 day conference in major cities that have speakers from PE firms but they do not often provide the kind of PE training that professionals are looking for.

Private equity fund marketing

- **Focus on Building Authority:** The power of true authority within an industry trickles down and puts other influential factors into motion which help you develop valuable relationships
- **Move the Free Line:** Give away your best ideas within press inquiries, books, interviews, articles, white papers and videos
- **Diverse Investor Case Studies:** Have at least two case studies of investors choosing to place capital with your firm for each of the major distribution channels you are focusing on raising capital from.
- **The 4 P's of Marketing Materials:** Focus on Pedigree, Process (USP), Portfolio Risk, and Presentation Quality

Private equity advertising and marketing

- Websites
- Public Relations Professionals
- Book Publishing
- Conferences
- External Consultants
- Television Interviews
- Database

Private equity secondary market overview

- The secondary market for private equity is a market for the buying and selling of capital commitments to private equity funds by limited partners.
- The private equity secondaries market is a way for private equity investors to exchange pre-existing investor commitments, similar to public exchange markets.
- private equity funds seek to maximize profits of portfolio companies by restructuring and reducing the areas that cut into profits
- private equity for limited partners because they attach themselves to the fund for such a long time period, during which various problems could occur within the investment or beyond, which causes the investor to want to cash out early.

Types of Transactions on the Private Equity Secondary Market

- **Sale of Limited Partnership Interests:** There are several variations on the basic sale of a limited partnership interest: a structured joint venture is a typically more complicated exchange where the buyer and seller negotiate terms that suit both parties. A stapled transaction is a negotiated agreement when a general partner is raising another fund which ties the limited partner's current fund investment to the new fund.
- **Sale of Direct Interests:** This is different from the sale of limited partnership interests as it trades a direct investment in operating companies rather than in an investment fund. It is the sale of a captive portfolio of direct investments that must be either actively managed by the buyer or the buyer is supposed to arrange for a manager

Overview of private placement memorandum

A private equity firm offers a private placement memorandum to potential investors. The document explains an investment opportunity to potential limited partners.

The private placement memorandum is a document for private equity firms hoping to attract investors, and limited partners rely on the PPM to make their decision based on the information presented in it.

General sections of the private placement memorandum are:

- Executive Summary
- Firm and Fund Investment Strategies
- Investment Professionals and Committee
- Investment Performance Record
- General Partners and Limited Partners Terms and Agreements
- Legal and Tax Concerns
- Fund-related Investment Risks
- Accounting and Reporting

How private equity and hedge funds connect

Private equity and hedge funds have developed a strong relationship benefiting both partners. Private equity groups own many hedge funds and make long-term investments in hedge funds. The risk is too great for hedge funds in private equity, because hedge funds are known for making short investments. Another risk is the illiquidity in private equity, which may be a problem for hedge funds if investors want to cash out their investment. Hedge funds are not afraid of risk so the relationship between private equity and hedge funds will probably only grow stronger in the future.

Impact of private-equity on the economy

Private-equity funding provides long term funding

Seventy nine percent of the PE-backed companies utilise the financing to invest in capital expenditure or Research and Development (R&D). This creates valuable assets that can lead to enhanced profitability in the long term.

Private-equity backed companies provide foreign exchange returns

Private Equity-backed companies utilize capital to expand their operations internationally and improve their sales in export markets. Also, fund managers use their international networks to help portfolio companies reach out to newer markets.

Private Equity-backed companies create well-paying jobs

Wages at Private Equity-backed companies grew at a significantly higher rate compared to their peers which are not PE-backed. The differential can be explained by rise in salaries of employees due to enhanced productivity and/or increase in the number of employees.

Private Equity catalyzes innovation in the economy

Research and Development (R&D) activity – that helps launch innovative products and services – is key to spurring economic demand. Lack of capital to invest in R&D has long been a factor that has held back corporate India. Private Equity capital is helping address this issue. Private Equity-backed companies invest more in R&D activities compared to their non PE-backed counterparts.

Private Equity reinforces India's entrepreneurial spirit

Private Equity is a necessity – and not just sufficient – for most companies to grow.

Profiles of some of the private-equity companies in India

ICICI Venture Funds

ICICI Venture is the largest and one of the most successful private equity and venture capital management companies in India with aggregate funds under management in excess of US\$ 2 billion. ICICI Venture is a subsidiary of ICICI Bank, India's second-largest bank.

UTI Venture Funds

UTI Ventures is a leading Indian Private Equity firm. It is backed by marquee investors from India and overseas and is associated with UTI AMC, India's largest asset management company. Their unique team blends decades of rich experience in Indian public and private equity markets. This, coupled with their track record and a vast network, gives them an edge and helps us achieve success.

IDFC Private Equity

IDFC PE is the largest and most active private equity firm focused on Infrastructure in India. Under two funds, the India Development Fund and the IDFC Private Equity Fund II, the firm manages a corpus of US\$ 632 million. IDFC PE is a subsidiary of IDFC, India's leading Financial Institution focussed on Infrastructure. The firm is backed by over 100 years of investing experience and domain knowledge in infrastructure.

Zephyr Peacock India Fund

Zephyr Peacock India Fund is an India-focused Private Equity fund which provides growth financing for fast growing companies. The fund's objective is to help small and medium sized companies in India become highly profitable players with global scale. The fund seeks investments in knowledge-based businesses where there are large export or domestic markets, significant barriers to entry, and the opportunity to add value. Zephyr Peacock seeks to make investments in businesses that will benefit from the rapid growth of the Indian economy and provide competitive advantages beyond low cost labor.

Top 25 business schools for private equity

1. Harvard Business School- Private Equity and Venture Capital
2. Dartmouth offers
3. University of Pennsylvania
4. University of Chicago Booth School of Business
5. The University of North Carolina Kenan Flagler
6. New York University

7. Columbia University Business School
8. Duke University
9. Northwestern University Kellogg Business School
10. Yale School of Management
11. Stanford Graduate School of Business
12. University of Virginia Darden School of Business
13. Cornell University
14. Georgetown University
15. University of California, Los Angeles
16. University of Michigan
17. University of California, Berkeley
18. Massachusetts Institute of Technology
19. University of Texas, Austin
20. University of Southern California
21. Indiana University
22. Arizona State University
23. Emory University
24. University of Rochester
25. Carnegie Mellon University

Key challenges for private equity investors in 2013

- Private equity investors expect to dedicate most of their time in 2013 to actively developing portfolio companies –extending existing funds and fundraising are not focus activities for 2013
- 57% of the participants anticipate a more competitive environment in fundraising, whereas 37% expect no changes
- Divestments of family-owned businesses, carve-outs from large corporations and secondary buy-outs or distressed/insolvent companies are ranked equally as attractive sources for new targets. Listed companies (going private) rank far behind
- Improvement in the quality of targets is anticipated by 35% of the participants – 45% expect no changes
- The availability of debt financing, particularly for recaps and LBOs, is still expected to become more difficult in 2013
- Strategic investors are expected to play the most important role in PE exits, but other exit channels follow closely

Recent trends:

Pvt. Equity investments in India during 2000-2010

- There was a huge decline in private equity investment in 2002, 2004 and 2009.
- PE firms invested almost US \$ 10,110mn over 441 deals in 2010-2011.
- In 2009-2010 PE investment was of US \$7970mn over 362 deals.
- During first 3 months of 2012 PE investment was of \$2.45bn across 131 deals

Sector	Allocation (%)	No. Of deals	Investments(\$mn)
Real state	29	18	711.0
BFSI	15.6	19	384.2
Healthcare	15	12	367.2
Retail	10.2	15	249.6
Manufacturing	9.6	14	235.5
Logistics	5.5	4	135.7
Infrastructure	4.9	8	120.3
Media and Entertainment	3.2	7	78.5
Others	7	34	172.0
Total	100	131	2454

Number of deals and investment during the first three months of 2012

How Private Equity Consultant help Business Succeed

- Private equity firms act like business consultants to their portfolio companies. It's a misconception that private equity owners want to control their portfolio investments and directly manage the firm
- Buyout team tries to put in place the best investment
- Streamlined, efficient business
- Private equity consultants operate as long term owners and have a vested interest in the success of the company
- Take action to remove the inflexible management

The Sorry State of Private Equity Fund raising

- Capital raised is still low
- Double-dip recession are driving investors away
- Investors are turning to more traditional investments
- A dragging economy and unstable markets combine for poor conditions for raising funds for long term investments
- Private equity have a tough sell against stocks and hedge funds
- Pension funds, endowments, and mutual funds reduced new commitments to private equity firms by more than 50%

Benefits of Private Equity Finance:

- Most private equities conceptualise 'provision of capital' as their most important contribution to growth of business
- Speeds up product commercialization, adoption of human resource development policies
- Strengthens companies commercialization strategies
- Private equity also provides 'venture capital' hence acts like 'company builders'
- Improved performance

- Better long-term stock performance
- Social benefits
- Catalyses innovation in the economy
- Incentivising capital formation

Sources:

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