India Private Equity Report 2010

BAIN & COMPANY

IVCA

Content: Lou Richman, Elaine Cummings
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1. Indian business and private equity: A promising start

Among developments having a far-reaching influence on the global economy, two have particular relevance to readers of this document. The first has been India's emergence as one of the world's most dynamic economies over the past two decades. The second is the expanding size and geographic reach of private equity (PE) and venture capital (VC) as one of the world's most powerful sources of value creation. Inevitably, India's capital-hungry businesses and opportunity-seeking private equity investors, both domestic and international, have discovered each other in recent years, and the impact has been profound.

Between 2004 and 2009, as PE and VC firms began to acquire critical mass, PE investors invested nearly $50 billion in more than 1,400 Indian businesses—including nearly one-third of what are now India's 500 biggest enterprises. By providing a critical new source of patient capital, management expertise and deep networks of connections, they helped catalyse the growth and international expansion of companies in which they invest. For their part, successful Indian companies have rewarded PE investors with superior financial returns.

As we will see in the sections that follow, the past year marked an important turning point for private equity in India. The global credit crisis and economic turbulence led PE and VC investors to retrench. India's economy briefly cooled, and the public equity markets tumbled. Growth has since rebounded on all fronts, but the recovery of PE activity and resumption of cyclical growth for Indian industry make now a good time to take stock of the health and future direction of the still-young relationship of private equity and India.

For all of the early indications of its promise, private equity is still viewed sceptically by wide swaths of the Indian business community. Government regulations continue to impose limitations on PE and VC investors' freedom to manoeuvre effectively. As a result, most PE investments have been limited to passive minority holdings rather than the active hands-on role these investors play in more mature markets. This report will explore the issues that stand in the way of private equity's relationship with India reaching its full potential.

Conditions in place for the year ahead bode well for private equity in India to embark on that journey. Based on extensive interviews with industry experts and our own analysis, VC and PE fund flows could rebound to some $17 billion through the end of 2010. Indeed, the Confederation of Indian Industry estimates that if India meets the challenges of creating a more hospitable environment for PE investment, private equity has the potential to fund up to $100 billion over the next three years.

Bain & Company is uniquely well positioned to undertake this evaluation. Since beginning operations in India, Bain has been an active and well-informed participant in India private equity, observing and helping to shape the new industry and serving as adviser to some of its biggest deals. Bain's growing presence in India has been a natural outgrowth of the firm's prominence in private equity in Asia and globally. It is the world's leading consultant to all players related to the industry. Addressing areas such as firm strategy and operations, deal generation, due diligence and post-close portfolio company value creation, Bain has led the global PE industry for more than 25 years, working with the world's most sophisticated investors. Combining world-class capabilities with dynamic industry expertise, its unique business model delivers customised insights to more PE investors than any other firm in the world. We estimate that Bain has advised on half of all buyout transactions valued at more than $500 million over the past decade.

In creating this report, we benefitted from the indispensable collaboration of the Indian Venture Capital and Private Equity Association (IVCA). As India's leading PE and VC trade association, IVCA has created a forum for educating Indian business leaders and policy makers about the industry and serves as a clearinghouse for industry information and viewpoints. IVCA generously made its members available to us to participate in the surveys and in-depth interviews that provide the data and perspectives that inform our findings. At Bain, the project was led by Sri Rajan, the partner who leads the firm's Indian Private Equity practice, and Prashant Sarin, a manager with Bain's New Delhi office.

We hope you enjoy Bain's private equity report—the first in what will be an annual look at private equity and venture capital's continued development and maturation. We look forward to having you join us and other PE stakeholders in India and around the world in a continued dialogue about this important industry and the businesses it helps build.

2. About this report

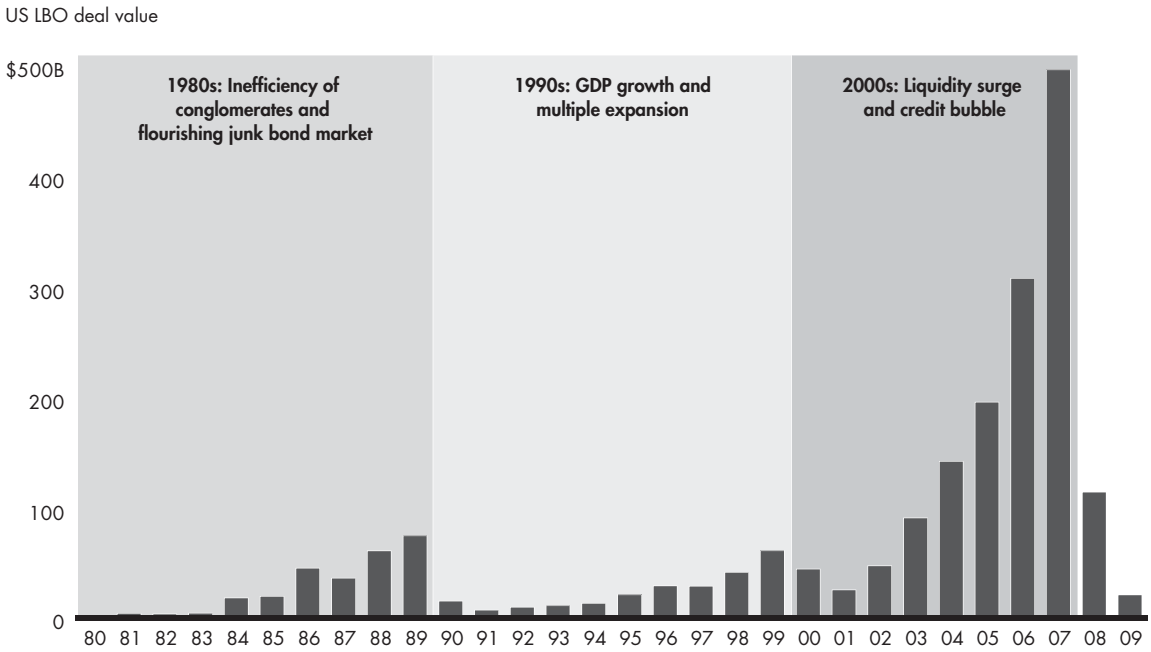
The vitality of India's economy over the past two decades has attracted investors from around the world looking to participate in—and profit from—its remarkable growth. Prominent among the new arrivals are two categories of investors—venture capitalists (VC) and private equity (PE) firms—that are especially well suited to further the ambitions of an economy that, like India's, is in start-up and rapid development mode. VC and PE investments have quickly sunk roots in India, growing at a 72 per cent annual rate to more than $14 billion in 2008, compounded from just $1.6 billion in total deal value in 2004.

Yet, despite their rapid growth and heightened visibility, venture capital and private equity are still only beginning to be understood by Indian corporate leaders, entrepreneurs and public officials as an asset class for the distinctive value they can bring to India's development. Conventional sources of capital, such as mutual funds, hedge funds, commercial lenders and other individual and institutional investors in corporate equities and debentures, provide market liquidity and trade actively on companies' stock and bond price movements. They are generally not directly involved in shaping the strategy or setting the operational priorities of companies in which they invest.

VC and PE firms, in contrast, are sources of patient capital that take a hands-on role grooming their portfolio companies across all phases of their life cycles. They tie their own success to their portfolio companies' financial performance. They help management of start-up enterprises formulate and execute their initial marketing and product-development strategies. The working capital they provide helps management line up institutional financing and supports capital investment in new plants and equipment. They help reinvigorate their portfolio companies by restructuring operations, commercialising new products, acquiring or disposing of assets, or providing buyout capital that facilitates the transition to a new management and ownership team.

Decades of refinement of these capabilities for helping companies grow, evolve and prosper have made private equity one of the world's most creative and successful investment vehicles. Since it first emerged as a major asset class in the 1980s in the US, private equity has experienced three major booms (see Figure 2.1). Each expansion was a direct result of private equity's resourcefulness, adaptability and capacity for innovation in the face of fast-changing market realities. In the 1980s, the PE industry capitalised on the sale of many poorly run public companies and corporate divestitures available at low cost and largely financed with junk bonds. During the 1990s, PE industry returns were driven mainly by gross domestic product (GDP) growth and expanding price-to-earnings multiples during the long economic expansion.

Figure 2.1: Private equity is a cyclical business



Notes: Represents control LBO transactions by US-based firms; includes closed deals only and represents the year deals were closed
Source: Bain US LBO deal database

Over the past decade, private equity rode a credit bubble inflated by low interest rates to record deal values. A global liquidity surge from investors hungry for returns fuelled private equity's "golden era". Leveraged lending grew larger and more complex than ever before, and investor demand for structured finance vehicles such as collateralised loan obligations (CLOs) powered the market for leveraged loans to new heights. Favourable debt-market and fundraising conditions provided the capital to finance multibillion-dollar deals. Fuelled by strong GDP growth and rising equity markets in both developed and emerging markets, price-to-earnings multiples expanded steadily, creating a strong market for initial public offerings (IPOs) and highly profitable exits.

An upswing in PE activity across Asia has been a distinctive feature of the industry's growth since 2000, with total deal value increasing from just $10 billion to a peak of $91 billion in 2007 before tumbling back to $23.7 billion last year in the aftermath of the global credit market meltdown. Even as private equity contracted globally between 2007 and 2009, the share of investment in the Asia-Pacific region more than tripled, from 7 per cent to around 25 per cent.

As private equity enters the new decade, global deal activity has revived, with Asia and India leading the way. The very qualities that first attracted the interest of PE investors—strong, sustained economic growth and dynamic young companies in need of the

financing and expertise PE investors can provide—stand to make the region a leading destination of PE interest going forward. Indeed, PE funds have raised more than $300 billion earmarked for investment across the region over the past seven years, of which nearly $200 billion has yet to be invested.

Certainly some of that capital will find attractive opportunities in India, but Bain analysis reveals that two factors in particular will influence how big the potential impact will be. The first is the attractiveness of the business environment as determined not solely by macroeconomic fundamentals, such as the current size and projected growth rate of national GDP, but also by conditions on the ground, such as the ease of investing in and exiting from portfolio companies. The second is how actively government policy encourages venture capital and private equity. In countries where financial sophistication is high and the regulatory environment is favourable, private equity flourishes. Conditions in India are only moderately attractive today. India has become more accommodating towards PE in recent years, but still has not achieved its full potential.

The goal of this report is to shine a spotlight on conditions influencing the current state and future prospects of venture capital and private equity in India. Prepared by Bain & Company, in collaboration with the Indian Venture Capital and Private Equity Association (IVCA), it is intended to help all the stakeholders better prepare for the growth India is likely to present.

In particular, our objective is to help PE firms and promoters better understand each other's expectations and to highlight the opportunities, challenges and changes that will mark their evolving relationship in the period ahead.

Additionally, we hope the report will be used to strengthen the partnership between policy makers and the PE and VC industries by drawing attention to some of the regulatory issues that funds operating in India face. We hope to focus attention on how this sector can do more to advance India's economic growth within appropriate regulatory constraints.

After describing the current state of private equity and venture capital in India, we provide a comprehensive outlook for the industry in the coming year and beyond. Our forecast is based on extensive data, interviews and analysis. We have surveyed dozens of PE investors. To deepen our insights and add context to the survey findings, we also interviewed dozens of industry leaders, including general partners as well as promoters—both those who have accepted PE funding and those who have not.

We hope the report will provide all industry participants with valuable insights into the role private equity and venture capital can fulfil as corporate India seeks new

sources of funding to boost its strong growth momentum further. In particular, this report is an effort to reach out to promoters who have not engaged with PE and VC firms in the past to point out the role these investors can play in supporting the growth of family-owned companies, both as a source of capital and for their management expertise.

3. Private equity in India: Its context, impact and key challenges

India's long economic expansion barely paused during the recent deep global downturn that still has a firm grip on the economies of many nations. At just 6.7 per cent in FY2008–2009, India's GDP growth rate declined from the torrid pace of better than 9 per cent at mid-decade. But it was well in line with the solid growth trend that has been in place since India embarked on its market-oriented economic liberalisation in the early 1990s.

It is clear that India's commitment to deregulation, privatisation, tax reform, sound monetary policies and openness to international trade and investment are reaping big dividends that continue to compound. India's forex assets (excluding gold)—$258 billion in 2009—have increased by 141 per cent since 2004, and are up nearly 100-fold since 1998. Today, India is well integrated into the global economy, with trade flows and capital flows as a percentage of GDP having risen to 53 per cent and 64 per cent, respectively, from just 20 per cent and 12 per cent over the past two decades.

By nearly every important indicator, prospects for a continuation of these positive trends appear strong. Personal income per capita is forecast to increase at a better than 10 per cent rate compounded through 2012, and foreign currency reserves are expected to increase at an annual 16 per cent rate compounded to more than $390 billion. India's robust macroeconomic performance and outlook are reflections of the dynamism of India's entrepreneurship and strong corporate growth. More than 400 Indian companies now book annual revenues exceeding $1 billion—up from just 250 in 2002. And many thousands of innovative Indian business leaders have taken their companies from start-up to healthy concerns in cutting-edge sectors like information technology, telecom and healthcare, to industrial and consumer goods manufacturing, to retailing and transportation services. Looking beyond India's borders, conglomerates such as Tata, Aditya Birla and Bharti are making large acquisitions to diversify their portfolios and build new platforms for growth. Their success has made India a magnet for domestic and global investors and powered the equity markets' upward climb. Since 2002, the Sensex has increased from 3,000 to above 17,000, with fund inflows from foreign institutional investors a big factor in that rise.

But the public equity markets have not been able to carry the full weight of the nation's capital formation needs. The debt market, too, clearly lags behind India's Asian counterparts. India will need to tap every potential source of new capital to continue to achieve its growth aspirations, and private equity has emerged as one of the most promising over the past several years.

Over the past six years, the emergence of India both as a destination of interest to global PE investors and home to a vibrant domestic PE industry coincided with the most buoyant period in the history of private equity globally. The economic and business climate from early 2003 through the end of 2007 was extremely favourable in nearly all of the fundamentals that matter to PE investors.

As capital flowed in to private equity over the course of the decade, PE funds broadened their geographic and industry reach. Broad economic forces, including robust GDP growth and rapid expansion in both manufacturing and service industries, have been major draws for PE interest. Though growing off a small base, PE deal value in India witnessed the greatest rate of expansion in Asia between 2004 and 2008, increasing at an annual 72 per cent compounded to $14.1 billion in 2008 (see Figure 3.1).

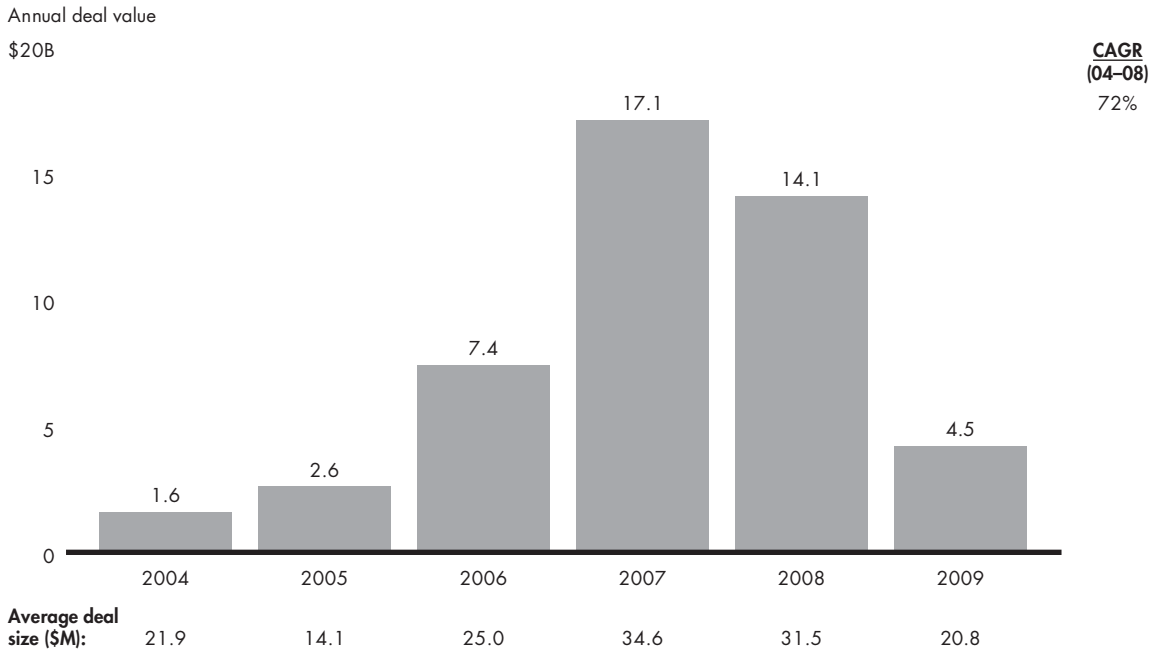
The numbers tell the story of private equity's growing place in India's economy. From 2004 to 2008, PE and VC firms have invested nearly $43 billion in India. That money has helped fund approximately 1,400 companies—some 900 of these just in 2007 and 2008 alone, making India Asia's largest PE market for both years. Even in the harsh climate of 2009, 231 Indian companies accepted VC or PE funding (see Figure 3.2).

As much as India's fast-developing economy has been a lure to venture capital and private equity, VC and PE funds have contributed to India's growth. Many young Indian firms still have only limited access to capital through the public equity markets, and PE and VC investors have stepped in to fill the void. Growth capital has become a preferred source for mobilising funds in India, and many Indian companies have aggressive growth and investment plans. With large reserves entrusted to them by limited partners (LPs) on hand but not yet drawn down for investment ("dry powder"), VC and PE funds can play an important role as financial backers of entrepreneurial Indian companies.

Private equity and venture capital offer distinct benefits to the Indian companies in which they invest. In early-stage investments, for example, they foster entrepreneurship, providing capital and expertise to first-generation company founders. As companies grow, PE and VC firms provide deep industry knowledge and operational expertise derived from their previous work in the industry and the experiences of other companies in their portfolios. By tapping their extensive networks of experts and international relationships, they help their portfolio companies expand internationally or facilitate cross-border mergers and joint ventures. And as a source of patient capital to finance growth, they have helped accelerate the dramatic growth of some of India's new corporate leaders.

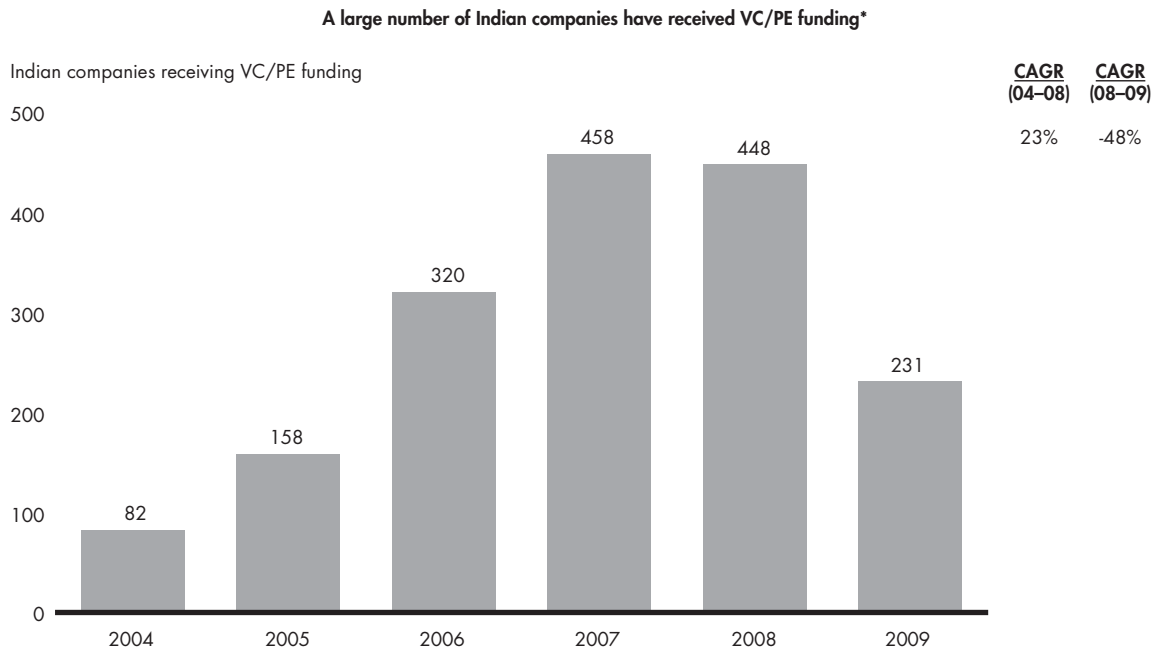
PE and VC firms have brought those qualities to the table over the life of several high-profile investment relationships in recent years. For example, successive investments of $290 million by Warburg Pincus in 1999, $210 million by CVC International in 2004

Figure 3.1: Private equity in India grew at 72% compounded between 2004 and 2008, topping Asia's growth rate for that period



Note: Includes aggregate value of all deals (including real estate); average deal size calculated using deals with disclosed values from Bain PE deal database
Sources: Bain PE deal database; Bain analysis

Figure 3.2: Some 1,400 Indian companies have accessed VC/PE funding in the past six years



*Companies receiving PE funding more than once in a particular year have been counted only once
Source: Bain PE deal database

and $2 billion by Temasek Holdings in 2007 hastened the development of Bharti Airtel into India's premier wireless telecom company. With FY2010 revenues of $8.6 billion, Bharti had a recent market capitalisation of $24.5 billion—up nearly fivefold in the past six years.

Likewise, it was an investment of $22 million by IDFC Private Equity in 2004 that helped propel the GMR Group into one of India's leading infrastructure development companies. In 2003, GMR was a relatively small company with a handful of road and power projects in its portfolio. Subsequently, IDFC Private Equity made its first investment in GMR, acquiring a reported 15 per cent stake. It was during this time that GMR decided to aggregate the power projects and created GMR Energy in 2004. The deal was the first in the Indian infrastructure sector based on an aggregation play instead of simply a project finance business.

Partnering with IDFC Private Equity resulted in several benefits for GMR, including improved corporate governance; a sounding board for strategic decisions; assistance creating a joint venture with Fraport, the operator of Frankfurt airport; and subsequently, the pricing of GMR's initial public offering. IDFC Private Equity ultimately earned seven times its initial investment in GMR and has since invested two additional tranches in the group, including the construction of Delhi International Airport.

PE funding has also had a powerful multiplier effect on SKS Microfinance. Investments by Sequoia Capital and other PE firms, in 2006 and 2007, catapulted SKS, a young lender to capital-starved small entrepreneurs, onto a rapid growth trajectory. SKS increased its number of branches from just 11 that served 25,000 loan clients by early 2004 to 276 that served 600,000 three years later.

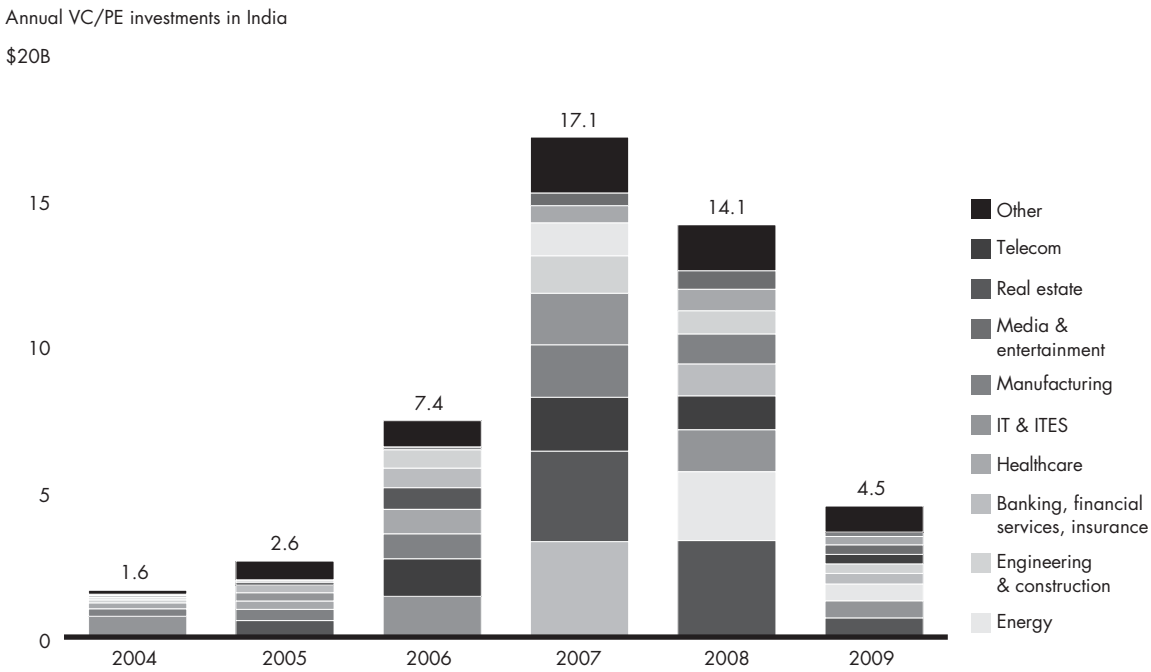
The wide variety of PE and VC firms now operating in India tend to be categorised by their national origin and breadth of geographic focus rather than their distinct investment style. Thus, along with domestic Indian PE and VC firms, there are global, regional and India-focused international PE funds. India has also attracted the interest of sovereign wealth funds, representing the investment arms of asset-rich foreign governments. In more mature PE and VC markets like the US, EU and Japan, these funds would be viewed less by their national pedigree than by whether they target their investments towards large, midsize or small companies. It is not yet possible to do this in the Indian context because PE firms typically end up competing against one another in most deals. The intense pursuit of many deep-pocketed investors for every available opportunity has been a major force for driving up valuations.

Still, PE and VC firms in India are taking on several distinctive characteristics shared across other emerging-market economies. For one, both Indian and internationally based PE firms draw principally on foreign capital to fund their investments. Respondents

to our survey reported that nearly 80 per cent of the funds routed to India for investment were sourced internationally. They anticipate that proportion will increase slightly over the coming two years. Second, in contrast to the US and Europe where sector specialisation is becoming a hallmark of PE firms' identities, PE and VC funds in India invest opportunistically across a broad spectrum of industries (see Figure 3.3). Third, most PE and VC investments are small, typically averaging less than $25 million, a characteristic Indian private equity shares with private equity in China. Unlike in the more mature markets where buyouts prevail, PE investors in India are acquiring minority stakes, usually in the form of Private Investment in Public Equities (PIPEs) or as late-stage growth capital in private companies. Finally, while PE and VC investors are able to negotiate board representation, they take on a far less active role than in majority or buyout situations, and their participation is commonly limited by promoters to a broad corporate governance role.

Private equity has also played a major role in helping to power the growth of several of India's best-known companies, which points to private equity's significant future potential. More than 30 per cent of PE investments in India have been made in companies that have since grown into the nation's 500 largest firms. For example, a $640 million infusion of growth capital from the PE firm Providence Equity Partners helped fuel the

Figure 3.3: VC and PE funding has spread across a broad spectrum of industries



Sources: Bain PE database; literature search

rapid expansion of Idea Cellular into a leader in wireless telecommunications. One of the largest PE investments in India to date, the Providence capital has helped finance the company's expansion into 13 service circles and extend its reach to more than 75 per cent of the nation's potential telephony market.

Having come this far, what does the future hold for private equity in India? Over the near term, conditions in the global economy will be a major factor, as economies continue to absorb aftershocks of the turbulence that rocked credit markets in late 2008. The global credit crisis and deep recession in the US and Europe have had a profound effect on the PE and VC industry that has been felt in India. As we will explore in detail later in this report, the number of Indian companies accepting VC or PE capital, the total value of deal-making activity and average deal size all fell dramatically in 2009. But the falloff in deal making in India and other fast-growing emerging markets paralleled even steeper declines in the developed markets. India's recovery has arrived sooner and has been stronger than elsewhere in the world.

New PE deal activity has been picking up since the middle of last year and is gaining momentum in 2010. Another sign that a robust cyclical recovery is well under way: The number of PE firms—both domestic and foreign based—continues to grow. This increasing population of hungry deal makers is also wielding plenty of dry powder—capital committed by limited partners to invest in PE deals, but not yet allocated. Bain analysis estimates that current investment reserves are deep enough to finance between two and four years of PE deal making.

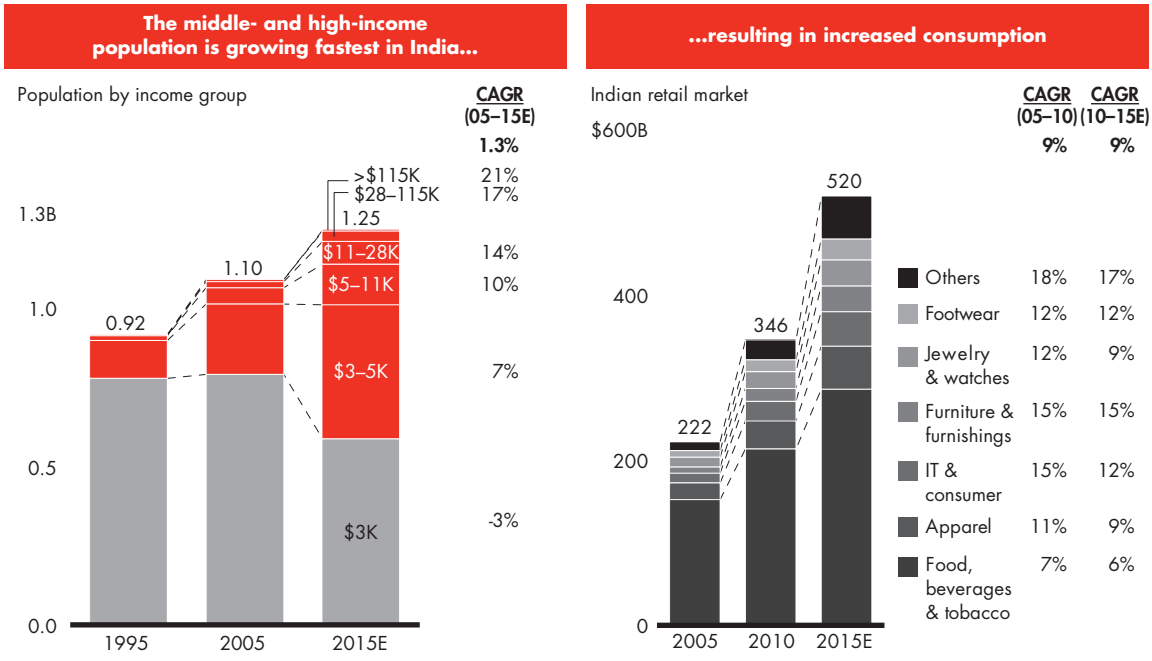
Beyond the business-cycle turn, however, Bain's data analysis and interviews with leading industry participants reveal important structural shifts at work shaping Indian private equity at this critical juncture in the industry's development. Signs that Indian private equity may be reaching an important milestone in its path to a more mature phase of development are evident in investors' expectations that deal value will grow. Increasingly, the survey respondents told us, deals will no longer be financed solely with equity but will begin to be structured using convertible securities commonly used in the developed PE markets. They also anticipate more deals to be buyouts rather than small minority stakes, although scepticism about that prospect remains high among many experts. Finally, PE firms will be looking to take a more direct hands-on role in the operations and governance of companies in their portfolios. Rising acquisition costs and intense competition to land the best deals is turning up the pressure on PE fund managers to find creative ways to add value to their portfolio companies over the three- to five-year ownership period. They can no longer simply rely on buoyant economic growth and a rising equity market to power their returns.

Private equity's coming of age is also tied to the attractive long-term fundamentals of the Indian society and economy. Nearly 60 per cent of India's population is less than 30 years old. Increasing incomes among India's large, educated workforce have given rise to an expanding consumer class. As India's population increases to 1.25 billion by 2015, the proportion of households earning more than $3,000 annually will nearly double. Consumer spending, meanwhile, is forecast to top $520 billion by 2015, an increase of more than 50 per cent over 2010 (see Figure 3.4).

Even as the nation's people prosper, the Indian economy looks positioned to sustain its growth advantages for decades to come. For example, Bain analysis finds that India's high-tech labour cost advantage will persist over the next two decades or longer while productivity gains continue to outperform those of the US (see Figure 3.5). Those competitive strengths will provide a sound foundation for the growth of an entrepreneurial Indian economy and ideal conditions for venture capital and private equity to flourish.

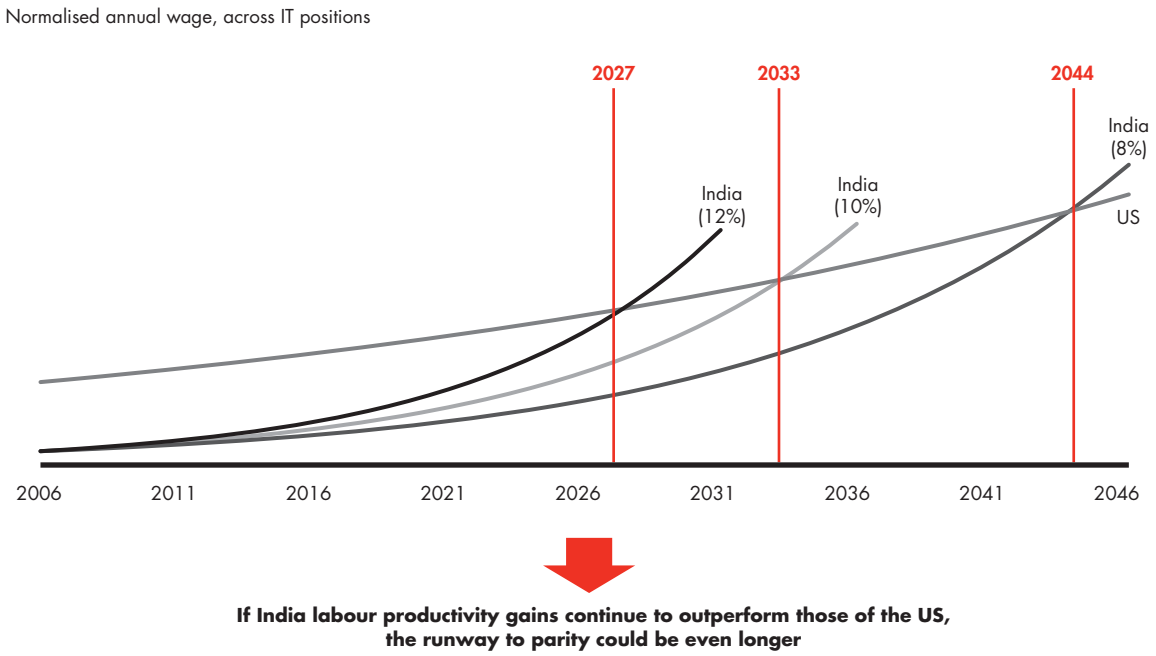
The continued expansion and sophistication of Indian private equity bode well for the industry's outlook as the economy continues to accelerate out of last year's slump. Together with China, industry experts believe, India looks poised to lead the growth of private equity in Asia, powering it beyond the levels of the cyclical peak in 2007 by 2012.

Figure 3.4: Indians overall are earning more and beginning to spend more, fuelling consumption growth as they upgrade their lifestyles



Source: Indian retail report 2007; Bain analysis

Figure 3.5: India's high-tech labour cost advantage should persist for at least 15 years given current wage increases



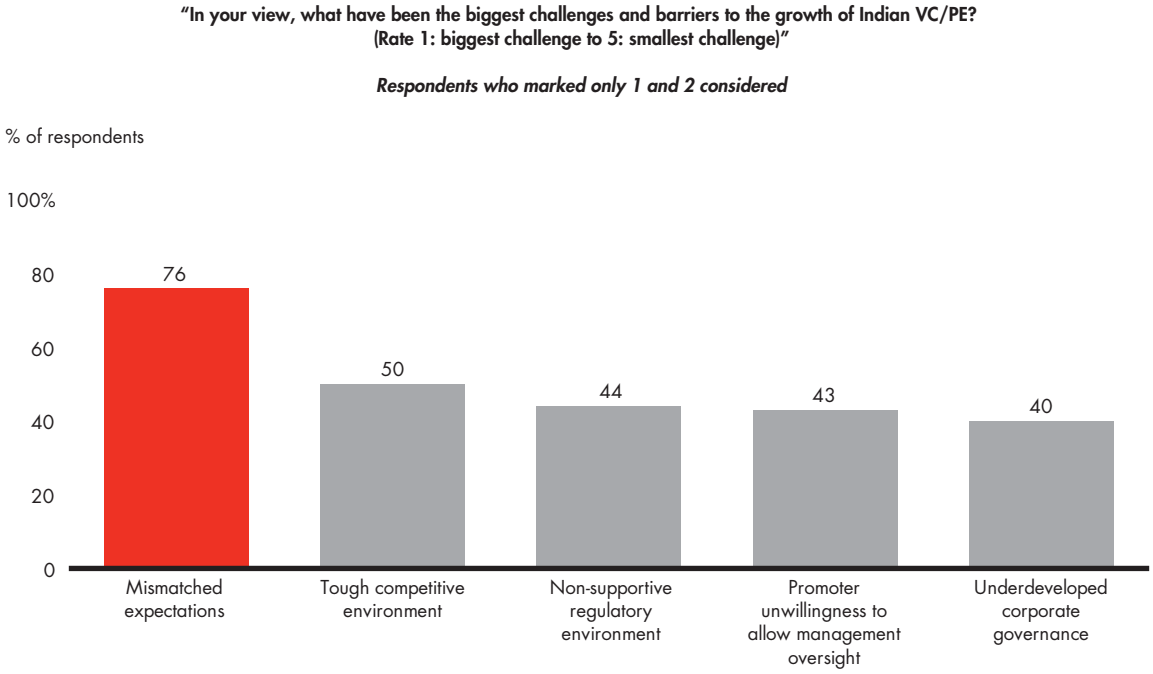
Note: Chart assumes no changes in productivity growth rates, currency volatility or other related issues
Sources: Euromonitor, Bain analysis

Key challenges

Before Indian private equity can fully realise its potential, our survey found, promoters seeking PE capital and regulators will need to address several major legal, cultural and business challenges that currently impede the industry's development. Respondents cited five barriers that they consider the most problematic over the next two years (see Figure 3.6).

Mismatched expectations: Reluctant to cede control over their companies at anything below a high premium price, Indian promoters have been cool to approaches from PE firms unwilling to meet their valuation expectations. The steep drop in Indian public equity values following the credit meltdown in late 2008 served only to lock those mismatched expectations in place. Deal making froze in 2009, as PE investors and company promoters tried to determine how low equity valuations would ultimately fall. But the quick recovery of the public equity markets since mid-2009 did not give expectations a chance to reset. In most situations, promoters and PE investors remain at odds over valuations. It will take a long, robust economic expansion and a levelling off in price-to-earnings multiples to bring the two sides closer together.

Figure 3.6: In the next two years, companies' expectations will be mismatched and competition is expected to increase



Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

Tough competitive environment: As the Indian economy rebounds from the downturn, promoters will be hungry for capital to finance growth. They have a variety of sources to tap for funds, including bank loans, Qualified Institutional Placements and initial and follow-on public stock offerings. Private equity is near the bottom of the list, because it comes with higher costs and more strings attached. The equity-market downturn and brief dip in economic activity in 2009 significantly reduced access to most of these capital sources, opening an opportunity for PE and VC investors to fill the breach. But with about 300 VC and PE funds operating in India today, competition among them for attractive deals is feverish. To succeed, it will be imperative for PE investors to position themselves as providers of expertise, besides just being a source of funds. They will also need to focus on helping the companies in which they invest meet, or exceed, earnings growth targets if they want to realise PE-type returns. Post-deal value creation will therefore take on increasing importance even in minority-holding situations.

Non-supportive regulatory environment: A lack of clarity about rules and delays by agencies with overlapping responsibility to issue clearances to operate under the Foreign Venture Capital Investment regulations burden the industry. Onerous registration requirements on offshore VC investors dampen the flow of foreign capital into India.

In April, however, new rules announced by the Department of Industrial Policy & Promotion now oblige foreign investors to obtain prior approval to invest in Indian investment funds and prohibit investments in unregistered trusts. Intended to safeguard against money laundering and restrict foreign ownership of real estate assets, the regulations have the unintended effect of constraining capital flows.

PE and VC investors in India also face complex tax burdens. For example, investors face a short-term capital gains rate of 15.8 per cent and a long-term rate of 10.6 per cent when they profit from the sale of shares in a publicly traded company. But when the gain is on a sale of a stake in a privately listed enterprise, rates nearly double. India's opaque and idiosyncratic tax laws, in place since the early 1960s, have led some foreign PE firms to purchase tax-liability insurance to protect them from their vagaries.

Investment managers also cite inconsistent tax pass-through rules as a source of confusion that clouds investment decisions. Tax-rule changes made in 2007 restricted advantaged tax treatment of investments made by domestic VC funds to sectors, including nanotechnology, biofuels, seed research, hotel and convention centre development, some infrastructure projects and a handful of other state-favoured initiatives. To improve the overall investment environment, these investment-distorting tax policies need to be reexamined.

Promoters' reluctance to allow PE investors to exert direct management oversight: Promoters and CEOs are generally not comfortable selling large equity stakes to outside investors. The result: Most deals are minority stakes of less than 25 per cent. Finding the right company at the right valuation that recognises the value of a PE partnership remains a major task for fund managers. Moreover, PE funds are often seen as a source of capital and not as an added source of expertise and best business practices. With low stakes, many promoters expect PE firms to be passive investors rather than activist owners that can provide business guidance.

Underdeveloped corporate governance: Many privately held Indian companies lack the transparent reporting and appropriate board oversight PE and VC general managers insist upon in the companies in which they invest. While having nothing to do with PE investments, the fraud and manipulation of accounts at Satyam Computer Services shook investor confidence and increased calls by shareholders for independent, tougher governance standards. Most observers expect that pressure for additional measures to strengthen corporate oversight will continue.

As we will see in the sections that follow, the long-term prospects for India's PE and VC industry will hinge on the ability of investors, promoters and government regulators to tackle the challenges that constrain its growth while, at the same time, ensuring that the industry operates with effective safeguards and efficient oversight.

Key takeaways

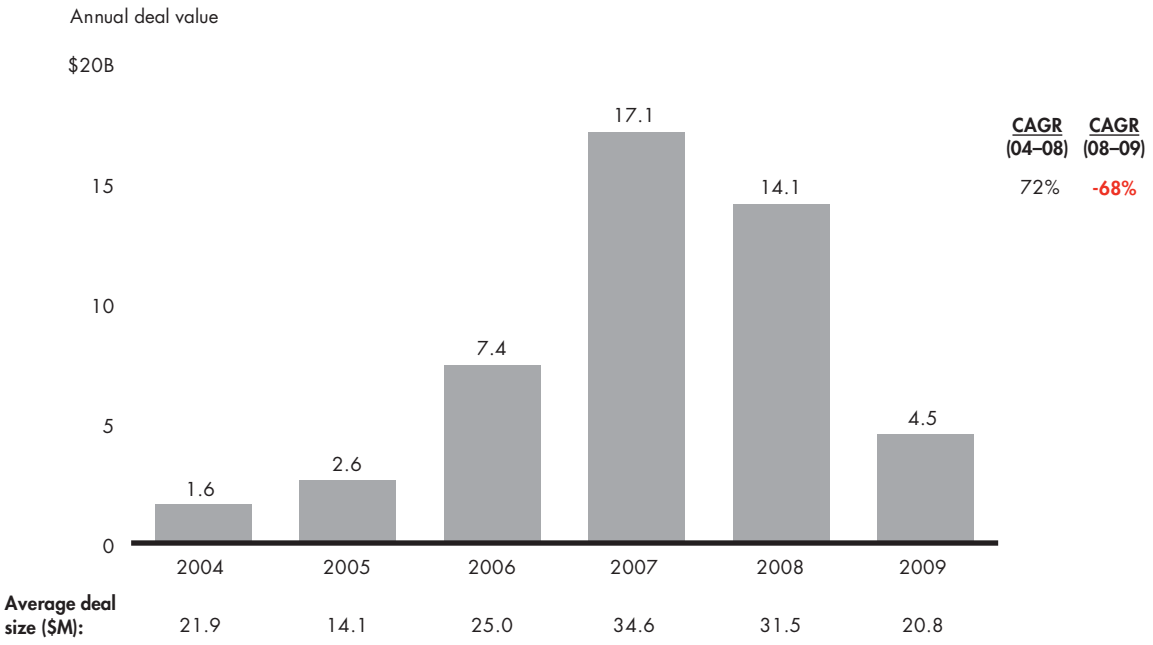
- India will need to tap every potential source of capital to continue to achieve its growth aspirations, and private equity is an important asset class that can play a critical role in enterprise value creation.
- The emergence of India over the past six years both as a destination of interest to global PE investors and home of a vibrant domestic PE industry coincided with the most buoyant period in the history of private equity globally. From 2004 to 2008, PE and VC investors have invested nearly $43 billion in India, the fastest growth rate in Asia over that period.
- More than 30 per cent of PE investments in India have been made in companies that have since grown into the nation's 500 largest firms. These investments have helped to power the growth of several of India's best-known companies.
- The continued expansion and sophistication of Indian private equity bode well for the industry's outlook as the economy continues to accelerate out of last year's slump. New PE deal activity has been picking up since the middle of last year and is gaining momentum in 2010. Together with China, India looks poised to lead the growth of private equity in Asia, powering it beyond the levels of the 2007 cyclical peak by 2012.
- Signs that Indian private equity may be reaching an important milestone in its path to a more mature phase of development are evident in investors' expectations that deal value will grow, and that the number of buyouts will increase faster than acquisitions of small minority stakes.
- Before Indian private equity can fully realise its potential, our survey found, promoters seeking PE capital as well as regulators will need to address several major legal, cultural and business challenges that currently impede the industry's development.

4. Outlook for the Indian PE market

The worldwide financial crisis hurt the PE industry around the world, and India was no exception. From a peak of more than $500 billion in 2007, global PE deal value in 2009 shrunk to its lowest level in nearly a decade. In the developed markets of North America and Europe, the credit crisis severely crimped buyers' ability to finance transactions. Also, with economies in a slump of unknowable depth and severity, PE investors in the mature markets were reluctant to trust their valuation models at a time tinged with so much cyclical uncertainty.

A somewhat different dynamic was at work in the major emerging markets last year. After years of consistently high growth, GDP growth slumped briefly in China, India, Russia and Brazil into 2009, casting a shadow on prospects for corporate growth. Although the falloff in deal activity in Asia was only about half as severe as in Europe and North America, deal value in India plunged more than 70 per cent, peak to trough, to just $4.5 billion in 2009 (see Figure 4.1). Not only were there fewer deals, but the ones that were completed were smaller, averaging less than $21 million in 2009.

Figure 4.1: In 2009, overall deal value in India was $4.5 billion, significantly off its 2007 peak



Note: Includes aggregate value of all deals (including real estate); average deal size calculated using deals with disclosed values from Bain PE deal database
Sources: Bain PE deal database; Bain analysis

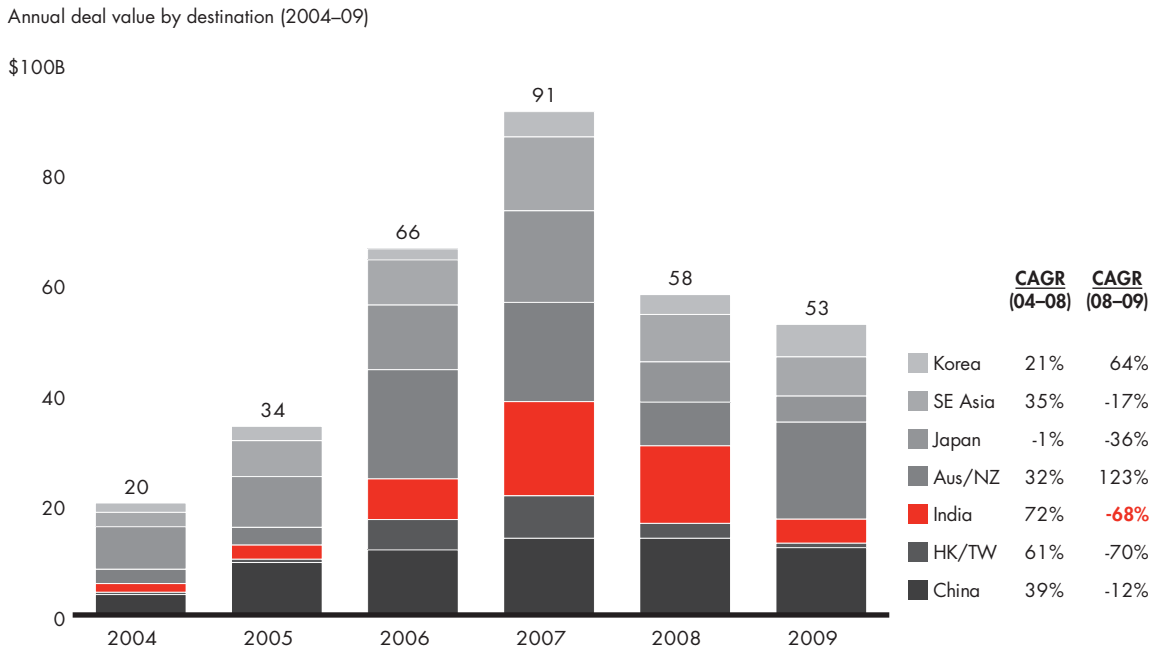
Indeed, India's young PE industry experienced the most dramatic swings in deal activity of any country in the Asia-Pacific region. Between 2004 and 2008, total annual deal value rose dramatically, to a peak of $17.1 billion in 2007 and an annual growth rate of 72 per cent compounded over the five-year period—the fastest in the region. But in the turbulence that followed the financial meltdown, India's PE deal activity was matched only by Taiwan in suffering the biggest decline.

Now that signs of economic growth and less-turbulent credit conditions are restoring life to global PE activity, global forces at play suggest that India will be a major beneficiary. While it is far from clear how robust the worldwide PE recovery will be, it is all but certain that there will be no return to the near-ideal conditions of low real interest rates, strong earnings growth and abundant credit that powered private equity's expansion in developed markets before the downturn. Today, powerful countervailing forces are at work that will both help fuel private equity's expansion and constrain it. Two factors, in particular, will act to hold a strong recovery in check. First, credit-market conditions are improving, but they remain strained. According to a recent survey of financial sponsors by *Private Equity News*, 70 per cent think the repercussions will linger for years, perhaps changing the industry forever. Second, bargains will be hard to find. The rapid decline and quick rebound of the major global stock market indexes off their cyclical lows in early 2009 did not allow sufficient time for would-be sellers' expectations to reset. Thus, high asset prices combined with relatively tepid GDP growth forecast for many of the major developed markets in Europe and North America are likely to hold down deal activity, at least over the near term.

At the same time, PE firms have widened their search for attractive investment opportunities. Institutional investors, public pension funds, endowments and other limited partners that entrust capital to PE funds are looking for attractive returns. And PE funds have vast sums of dry powder to deploy. The current inauspicious investment climate in Europe and North America, where deal activity is only now slowly ramping up, has put Asia squarely in the sights of PE investors.

As the two biggest and most dynamic emerging markets in the region, India and China will both be major targets of PE investors' heightened attention. The comparative experience of private equity in both nations over the past six years is instructive for how the competition for capital will play out. Whereas both countries saw their economies expand rapidly through 2008, PE activity in India has been far more erratic. In terms of annual deal value, private equity in China grew at a 39 per cent rate compounded between 2004 and 2008, about half the pace of India's growth rate (see Figure 4.2). But the 68 per cent drop in India from 2008 to 2009 stands in stark contrast to the relatively modest 12 per cent decline China private equity registered in that same time.

Figure 4.2: PE in India recorded Asia's fastest climb and steepest decline in deal value from 2004 to 2009



Note: India includes aggregate value of all deals (including real estate)
Sources: *AVCJ*; Bain analysis

What do these differences portend for private equity in the expansion that has now taken firm hold in both markets? For one thing, India's more volatile experience reflects the vibrancy of its entrepreneurial business environment. In contrast with China's state-dominated economy and bureaucratic top-down management style, India's free-wheeling small-business culture fosters a deal-making environment that is conducive to private equity during boom times and is more precarious when the economy slumps. India's public equity markets, too, are more open to small enterprises, providing entrepreneurs access to capital and an outlet for companies to go public—or PE investors to unwind their positions—via initial public offerings during growth cycles but are less hospitable in downturns.

Though still heavily regulated by state authorities compared with private equity in more mature economies, Indian private equity is driven by swings in investors' expectations. PE investors have not been immune to the boom-and-bust mentality. When the economy faltered in late 2008, for example, foreign institutional investors were quick to pull out of Indian stock markets, triggering a massive sell-off. Heavily exposed to the crippled financial services sector, information technology companies, India's bellwether industry and a sector heavily favoured by PE investors, were hit hard. Pessimism was widespread as investors anticipated more bad news.

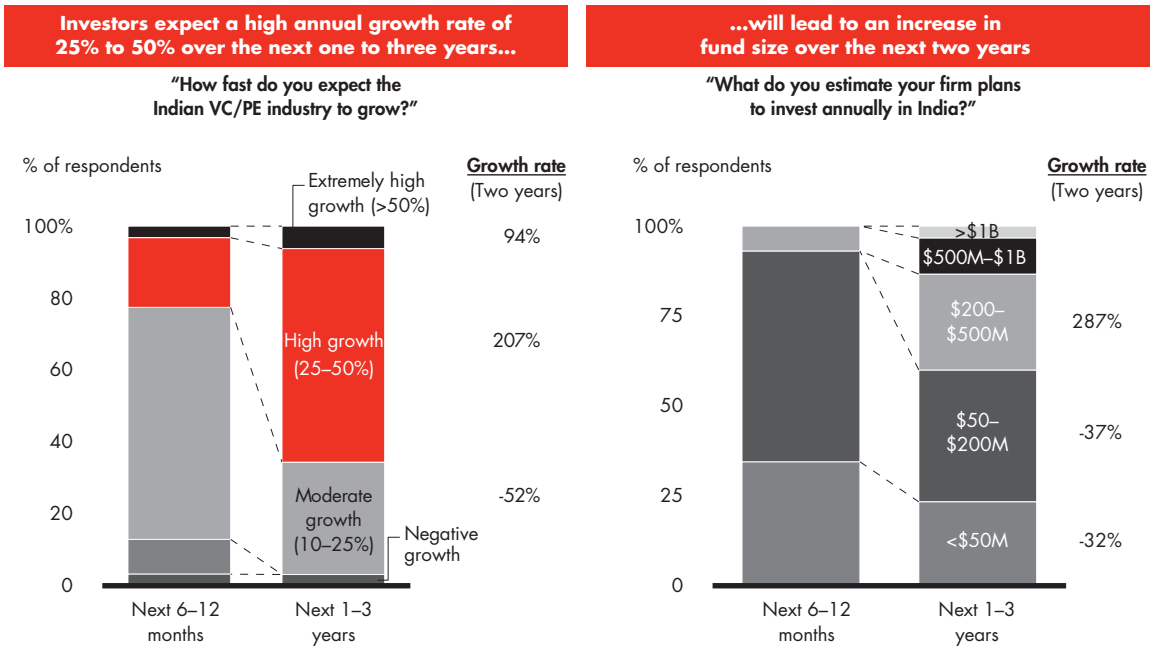
In the end, however, India's economy proved resilient and has revived quickly. Today, with strong GDP growth resuming, stable economic fundamentals asserting themselves and PE deal activity on the upswing, the upheaval of 2009 is fading as a distant memory. The PE executives we interviewed see these positive trends as mutually reinforcing. "The level of investment by the VC and PE industry has been in sync with the public markets," said the chairman of one Asia-focused venture capital firm. "This trend will continue going forward." Our survey found that PE and VC investors expect to see their industry grow strongly over the next three years—though not at the torrid pace of the past several years preceding the 2009 slowdown (see Figure 4.3).

For the balance of 2010 into the early months of 2011, nearly two-thirds of survey respondents said they expect India's PE market to grow at a rate of between 10 per cent and 25 per cent as measured by total annual deal value. Less than one respondent in five expects the industry to grow at an annual rate of between 25 per cent and 50 per cent through early 2011. However, optimism about the prospects for private equity increases along with expectations that the economy will continue to gather momentum in 2012. The percentage of respondents forecasting that private equity will grow by between 25 per cent and 50 per cent increases to about 60 per cent; 6 per cent expect the industry will grow by more than 50 per cent.

PE investors are prepared to put money behind their optimism. Asked how much their firm has targeted to invest annually in India over the next six to 12 months, about one-third of the respondents said less than $50 million. Another 60 per cent answered that their firms' investments would range between $50 million and $200 million. Only 7 per cent foresaw investing between $200 million and $500 million. Looking out beyond next year, however, the proportion of respondents anticipating making annual investments of $200 million to $500 million increased nearly fourfold, to 27 per cent. Another 13 per cent expect their firms will lift their annual investments above $500 million. Speaking for the optimists we interviewed, a managing director at a leading domestic PE firm said: "Assuming public markets continue to grow, approximately one-third of all investments will come from private equity over the next three to four years."

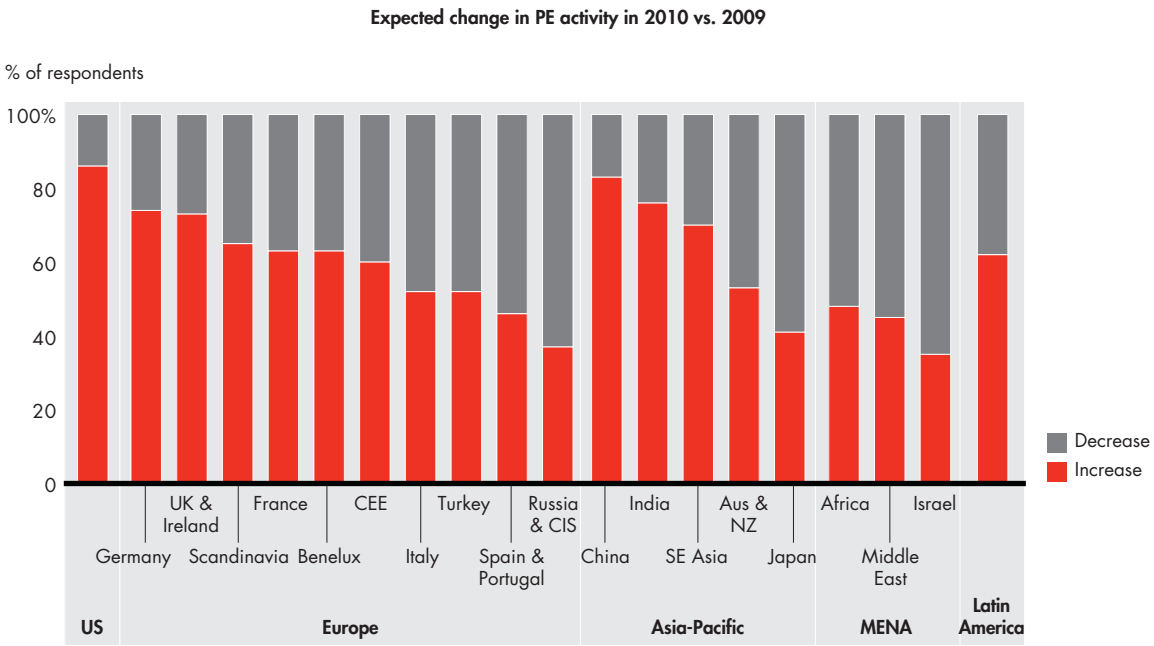
Certainly, interest in India is high among the limited partners who scout out the most attractive PE opportunities. In a survey taken in late 2009 by *Private Equity News,* the PE research firm, a plurality of LPs identified Asia as the most attractive emerging market, with India second to China as a choice destination in the period ahead (see Figure 4.4). Their willingness to commit capital to participate in the region's potential has already begun to make itself evident in Asia's increasing share of global deal value during the PE slump of 2009. While investment languished in the troubled North American and

Figure 4.3: An expectation of increased market growth is leading to an increase in investment in India



Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

Figure 4.4: Among emerging markets, limited partners believe Asia presents the best opportunities



Note: Survey conducted between November 2009 and January 2010
Source: *Private Equity News* (5th Annual Survey of Financial Sponsors, 2010)

European markets, deal value in Asia grew to 25 per cent of the global total.

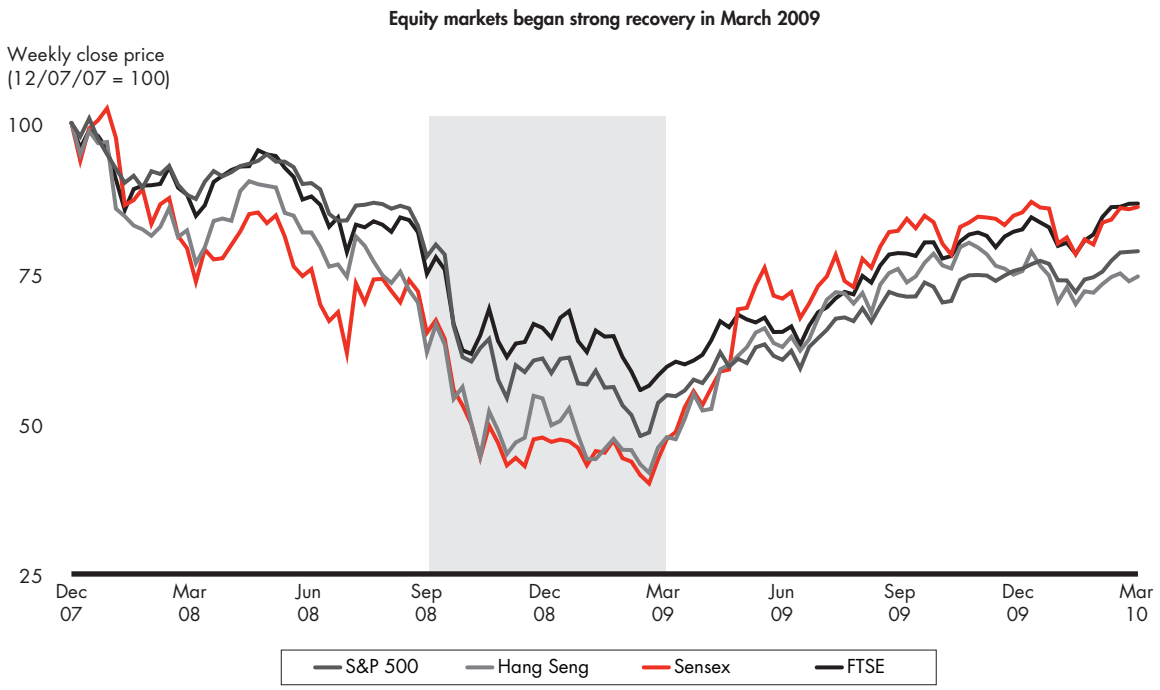
Based on interviews, prominent PE fund managers expect foreign-based LPs' interest in India to remain high, but just how active they will be depends on the kinds of deals they are able to participate in. Said a managing director for the Asian subsidiary of a European PE firm: "Most LPs and sovereign wealth funds are keen to invest in India, although they prefer buyouts to PIPE deals. PIPE deals are not popular since it is difficult to gain control over public companies." Another potentially important group of limited partners—domestic investors—may also become more active in private equity. According to the chairman of one PE firm we interviewed, the share of domestic LPs investing in India has increased, now that banks have been granted regulatory approval to make small investments in private equity. "As regulations ease, the [domestic] share will increase further, as pension funds and large corporate organisations start investing in private equity," he said.

With deal-making activity on the increase through the first quarter of 2010, Indian companies are poised to continue to attract a growing share of global PE capital. However, the true test of whether Indian PE lives up to investors' expectations depends not on the absolute number of deals they complete or their total value but on the returns PE firms reap on their investments and remit to LPs as capital gains. Here, the outlook is cloudy. Like stock markets around the world, India's public equity markets—an important benchmark for what PE investors will pay—fell steeply in the aftermath of the late-2008 credit market meltdown. But following a short correction, the Sensex recovered nearly as quickly, regaining most of its paper losses since March 2009 (see Figure 4.5).

As has been the case in other developed and emerging markets over the past 18 months, the quick drop and subsequent rebound in India's equity market did not allow time for promoters' expectations to reset. This stickiness over valuations made it hard for PE firms to find attractive investment opportunities at a time when potential target companies' economic growth and profit prospects were uncertain. With valuations high and promoters looking to attract steep premiums, the lofty price-to-earnings multiples PE investors would be required to pay on the initial investment appears to leave little room for those multiples to expand over the typical three- to five-year period of PE ownership.

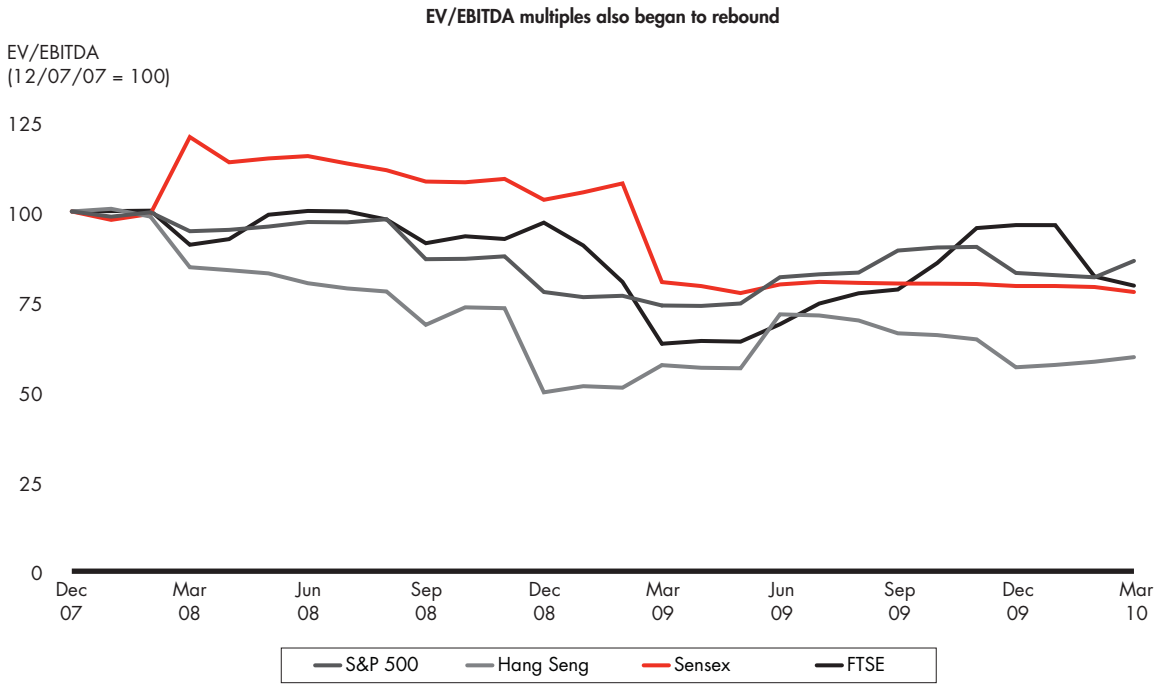
Whether high acquisition prices will put a damper on deal making or suppress returns is a major question that hangs over private equity's continued growth in India. Of course, the multiple PE firms earn and the profits they return to limited partners on deals made in 2010 and 2011 will not be known for several years when they sell off their investment stakes. The biggest factors that will influence how well those investments

Figure 4.5: The rapid rebound of public equity markets will make it hard to find bargains...



Source: Bloomberg

...as earnings multiples stayed high



Source: Bloomberg

do will be the health of India's market for IPOs and, in the case of sales to strategic buyers, the environment for mergers and acquisitions (M&As).

The following sections of this report will explore in greater depth the dynamics that will influence fundraising, deal making, portfolio management and exits in the period ahead. We will see that as India's economy continues its sustained growth, PE activity should increase commensurately from today's baseline situation. But as it does, PE and VC investors will continue to encounter scepticism from promoters, lukewarm support from regulators and intense competition from one another. Whether the PE and VC industry can break through to a new level of influence in India's development will depend on whether those barriers can be breached and challenges surmounted.

Key takeaways

- The falloff in deal activity in Asia was only about half as severe as in Europe and North America during last year's economic downturn, but deal value in India plunged more than 70 per cent, peak to trough, to just $4.5 billion in 2009. Not only were there fewer deals, but the ones that were completed were smaller, averaging less than $21 million in 2009.

- For the balance of 2010 into the early months of 2011, India's PE market is projected to grow at an annual rate of between 10 per cent and 25 per cent as measured by total annual deal value. A majority of PE investors surveyed look for growth to accelerate by between 25 per cent and 50 per cent annually over the next three years.

- PE investors are prepared to put money behind their optimism. Through 2013, 27 per cent of survey respondents said their firms would make annual investments of between $200 million and $500 million. Another 13 per cent expect their firms will lift their annual investments above $500 million.

- Stickiness over valuations has made it hard for PE firms to find attractive investment opportunities at a time when potential target companies' growth and profit prospects were uncertain.

- With valuations high and promoters looking to attract steep premiums, the lofty price-to-earnings multiples PE investors will be required to pay on the initial investment appears to leave little room for multiples to expand over the typical three- to five-year period of PE ownership.

- The most important factors that will influence how well those investments do will be the health of India's market for IPOs and, in the case of sales to strategic buyers, the environment for mergers and acquisitions.

5. The outlook in depth

Fundraising

Today's baseline

As India's economic recovery gains momentum, both local and global PE firms find themselves well armed with capital to deploy against a wide spectrum of sector opportunities. Hoarding an immense amount of dry powder, global funds have a particularly keen interest in participating in India's forecast 8.5 per cent GDP growth for 2010–2011, which outpaces every Asian country except China. Some observers estimate the committed, but as yet unallocated, funds targeted for India at nearly $30 billion. Since global PE firms commingle funds earmarked for Asia, the exact figure is hard to pin down, and potentially far larger.

Whether this vast supply of funding will match up with a strong demand is another question. It's true that India's companies may well need PE partners to finance their continuing internal growth projections of as much as 35 per cent—especially those young companies that have already gone public and cannot soon tap equity markets again for more financing.

But, as has been noted, private equity traditionally has not been the first source of funding for Indian promoters. Rather, it has usually been the last they turn to because of its higher cost and cultural issues around sharing ownership control. That will change only slowly as Indian entrepreneurs become fully convinced that private equity's expertise in management and operational improvements can indeed deliver the kind of rapid growth they seek.

While there is a significant supply of dry powder waiting to be deployed in India, most originates from foreign sources. Under stringent regulations currently in effect, insurance and pension funds are not encouraged by their respective oversight bodies—the Insurance Regulatory and Development Authority (IRDA) and the Pension Fund Regulatory and Development Authority (PFRDA)—from making major capital commitments to these alternative asset classes. The contrast with mature economies such as the US is stark. In those markets, insurance and pension funds play a major part as limited partners (LPs), contributing significantly to the pool of capital available with almost all bulge-bracket PE houses. In India today, the only domestic LPs are wealthy individual investors, and it appears unlikely that institutional investors will emerge as LPs for the next few years.

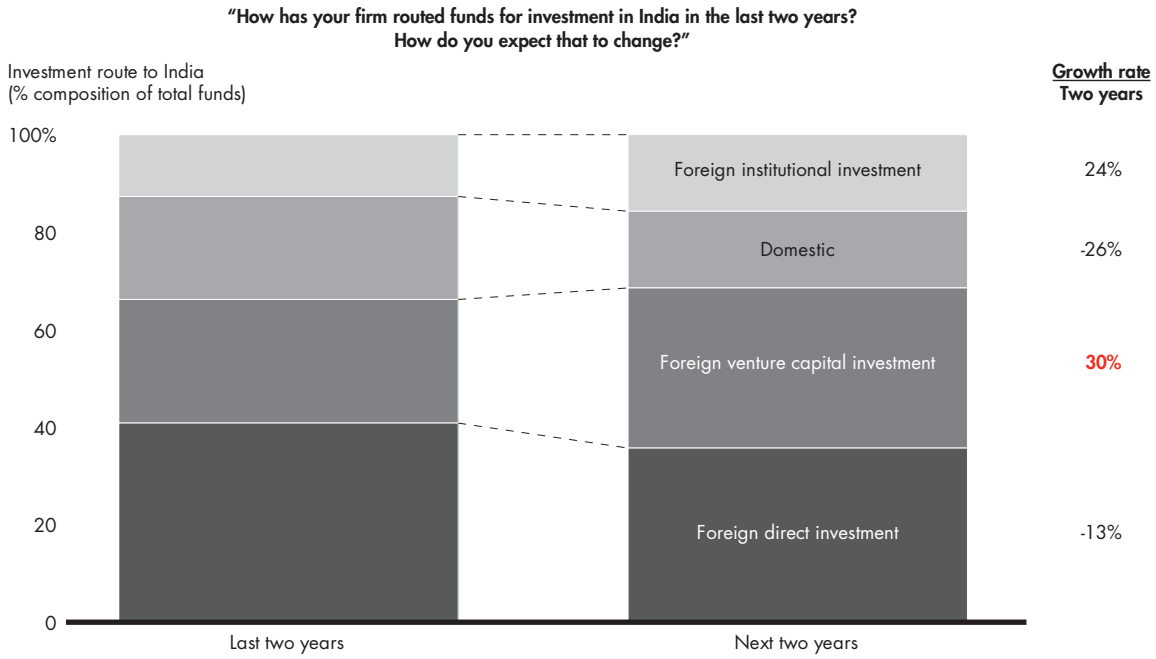
Longer-term prospects: Beyond 2010

Where will funding come from over the coming 18 to 24 months?

In the aftermath of India's brief six-month economic slowdown, our survey results show that foreign venture capital investments (FVCI) are expected to rise by 30 per cent over the coming two years (see Figure 5.1). Factors cited include the renewed strength of India's economy and the government's intention to use these funds to spur innovation in India. These tax benefits, however, come with restrictions on the sectors that can be invested in and limits on the percentage amounts of stakes. Respondents also expect foreign institutional investment, made through such vehicles as pension and mutual funds, to rise by some 24 per cent in the same period. Industry experts are sceptical about whether this will actually take place. They expect that most PE funding will continue to come via FDI for the foreseeable future, even though foreign direct investment declines as a category as it increasingly becomes reclassified as FVCI.

As the proportion of funds from foreign sources increases, survey participants anticipate that the share derived from domestic Indian sources will remain a secondary source of capital (see Figure 5.2). As in the recent past, nearly half of the domestic funding for the

Figure 5.1: FVCI funds are expected to increase over the next two years due to increasing structuring flexibility



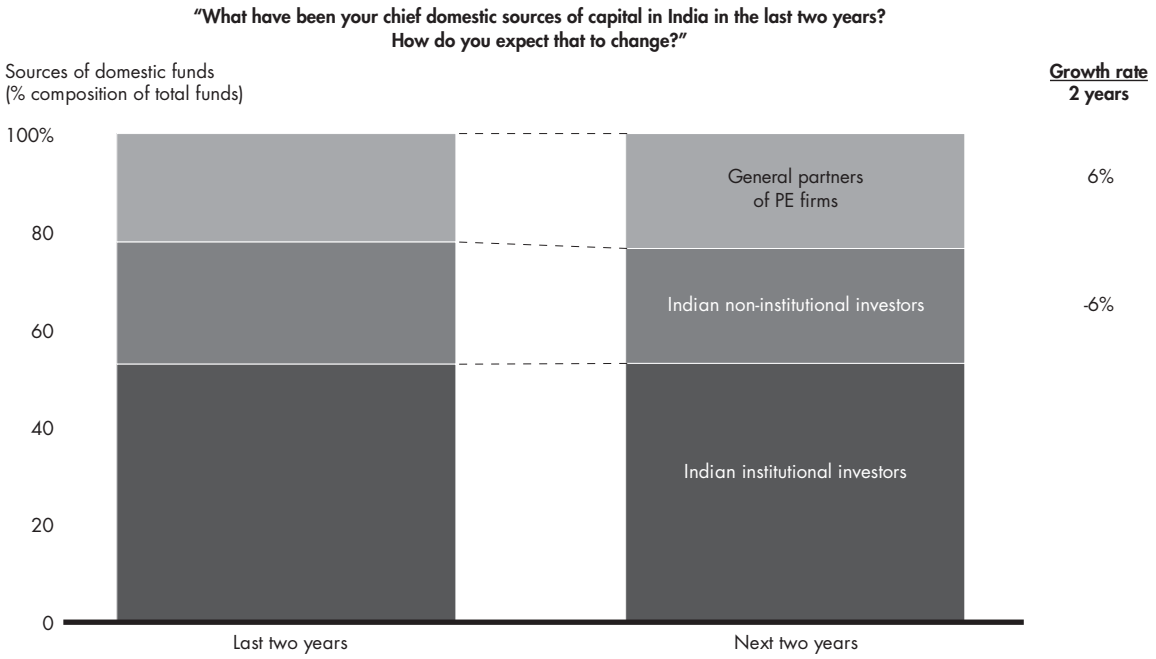
Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

surveyed firms will continue to come from Indian institutional investors, with the balance split almost evenly between Indian non-institutional investors and general partners of PE firms. The complex regulatory framework governing private equity will influence how this plays out, as regulations are more stringent for foreign investors.

However, under current rules, domestic and foreign funds cannot be pooled into a single investment fund. That means the Indian PE industry needs to develop and tap its own network of domestic limited partners to create adequate scale. But the likeliest source of large amounts of LP money—funding from insurance companies and pension funds—cannot, for the most part, be invested in private equity under today's regulations. Meanwhile, the likelihood of high-net-worth individuals being able to make up the difference is low, as is true in most markets.

Put another way, barring a revision in the regulatory regime, the composition—and relative share—of domestic investor categories will not change over the next two years, our interview respondents told us. In the interim, India's budding PE industry will continue to vie for the largest source of capital. Or, as one respondent explained, "[As] the fund house gains [an] investment track record...institutional investments are likely to increase."

Figure 5.2: Domestic funds are mostly from institutional investors; composition is not likely to change



Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

Employing another tactic, some domestic PE funds invest in Indian companies through wholly owned offshore subsidiaries. Because several jurisdictions, including Singapore and Mauritius, have double-taxed treaties with India, PE funds can use Special Purpose Vehicles based there to avoid transferability restrictions when they eventually exit from an investment.

Deal making

Today's baseline

Since private equity's arrival in India, deal making has taken on distinctive characteristics that mirror the state of the nation's economic development. As evidenced by its mostly passive, minority-stake equity investments, Indian private equity bears little resemblance to the kind of buyouts-based, value-added management practices of private equity in the US and Europe. To characterise the investments PE firms have made, they are small, opportunistic and numerous—as a matter of fact, they total the highest number throughout Asia. Indeed, the high frequency and small size of most Indian PE deals to date reflect both India's vast potential and need for the kinds of investments PE firms excel at, on the one hand, and the disorganised current state of many economic sectors that render deal making in India so challenging, on the other.

India's retail sector is a good example of why significant PE deal making has yet to gain traction. Less than a decade old, modern retailing is a relatively new concept to India. The highly fragmented sector remains overwhelmingly dominated by tiny shopkeepers, leaving very few viable retailers of sufficient scale to attract the attention of PE investors. The competition PE funds face to acquire stakes in the handful of companies that are sufficiently large and dynamic to attract their interest is intense. Promoters at these companies have found that they can easily attract capital from the public debt and equity markets, leaving little scope for PE funds to make investments that would enable them to demonstrate their value-creation capabilities.

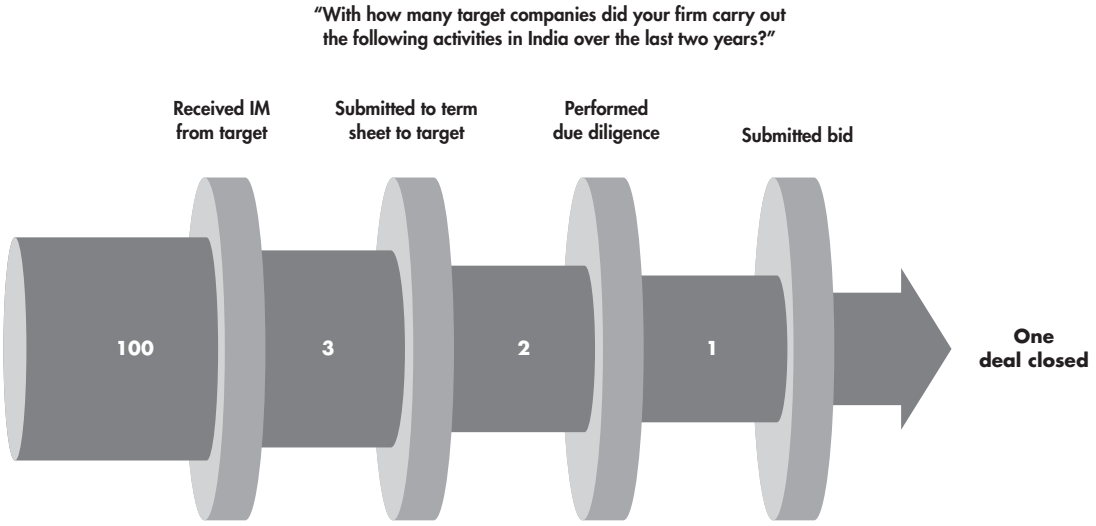
The volume of deals slowed dramatically during the global recession of 2008 and the first half of 2009, which left PE firms sitting on reserves of dry powder. Yet the return of economic activity in the latter half of 2009 proved a mixed blessing to private equity. Private equity found itself in competition with a revived equity market as a source of low-cost funds for promoters. Large companies have many funding options. But for smaller companies, the choices are circumscribed. Thus, throughout 2009, the percentage of transactions PE firms completed relative to the far larger number of opportunities they were invited to look at remained at the same low rate. That reflects an ongoing mismatch between PE investors' aggressive hunt for value early in the period of reinvigorated economic expansion and promoters' expectations that they can continue to command top value. Respondents told us that they considered around 3 per cent of the initial information memoranda

(IMs) submitted to them by fund requesters (see Figure 5.3). And, only one in a hundred went through the entire process of submitting a term sheet and doing due diligence to get to a deal closing. As a managing director at one of India's leading domestic PE funds explained, deal volume may be up, "however, valuation expectations are still rich." Another factor: Since the downturn was so short, most owners didn't feel pressured to go to alternative capital sources to supplement organic funding for growth.

Just as the number of deals decreased, so did their size during 2009. Of the top 25 deals last year, for instance, more than half totalled less than $100 million, compared with all of the top 25 deals in 2008 being at least $100 million to $200 million in size (see Figure 5.4). The average deal size for 2009 sank to $85 million, compared with $181 million in 2008 and an average of $238 million in the boom year of 2007.

Over the past six years, more than 60 per cent of all PE deals involved a minority stake of less than 25 per cent. That overall trend remained the same over the past two years. But even as the total number of deals fell from 153 to 79 from 2007 to 2009, something did change among the top 25 deals in 2008 and 2009: In more than half of these transactions, stakes rose to between 26 per cent and 50 per cent (see Figure 5.5).

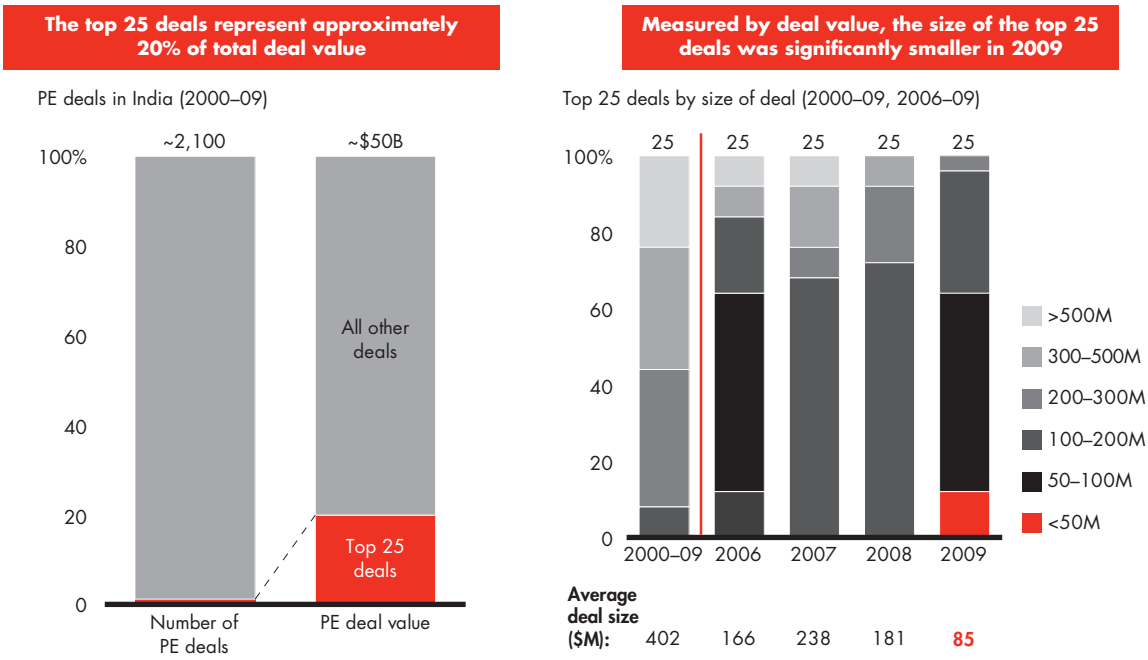
Figure 5.3: The PE market slowed down in 2008–09; around 3% of information memoranda received were considered for a deal in FY09



Investors considered only around 3% of the information memoranda they received in FY 2009; however, the market picked up in the second half of the year.

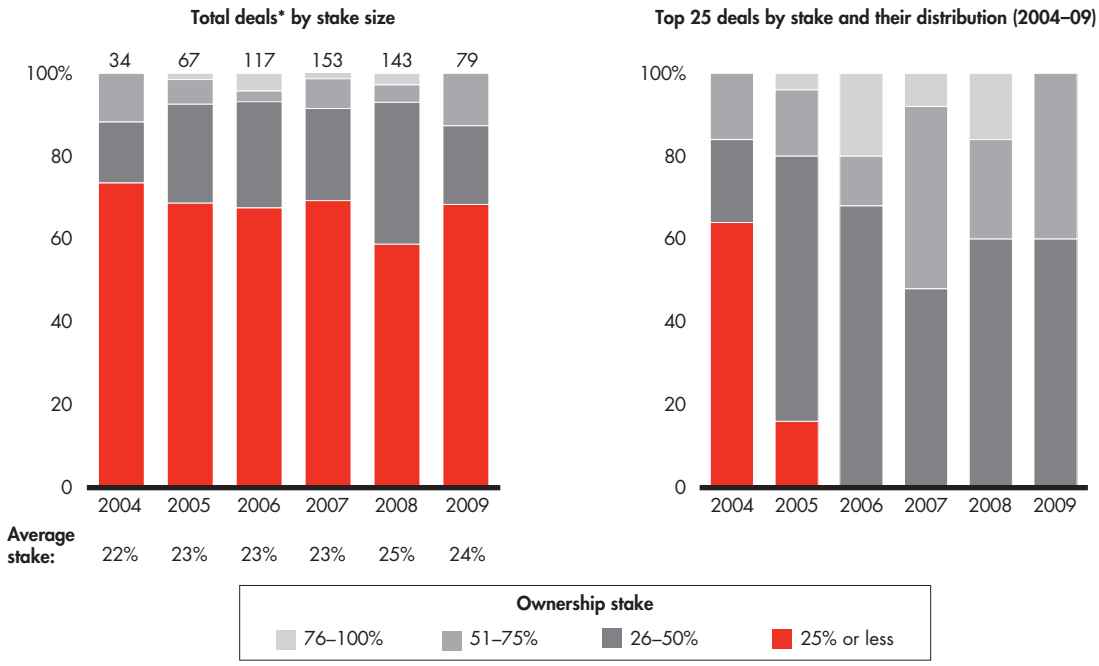
Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

Figure 5.4: While about $50 billion has been invested since 2000, average deal size in 2009 dropped significantly



Note: Top 25 deals are from Bain deal database
Sources: INDATA (India Advisory Partners); TSJ Media; Bain deal database

Figure 5.5: Most deals in India continue to involve a minority stake



*Includes only those deals where stake size is known; ~60–70% of the deals do not disclose stake sold; top 25 deals are from Bain PE deal database
Sources: TSJ Media; Bain deal database

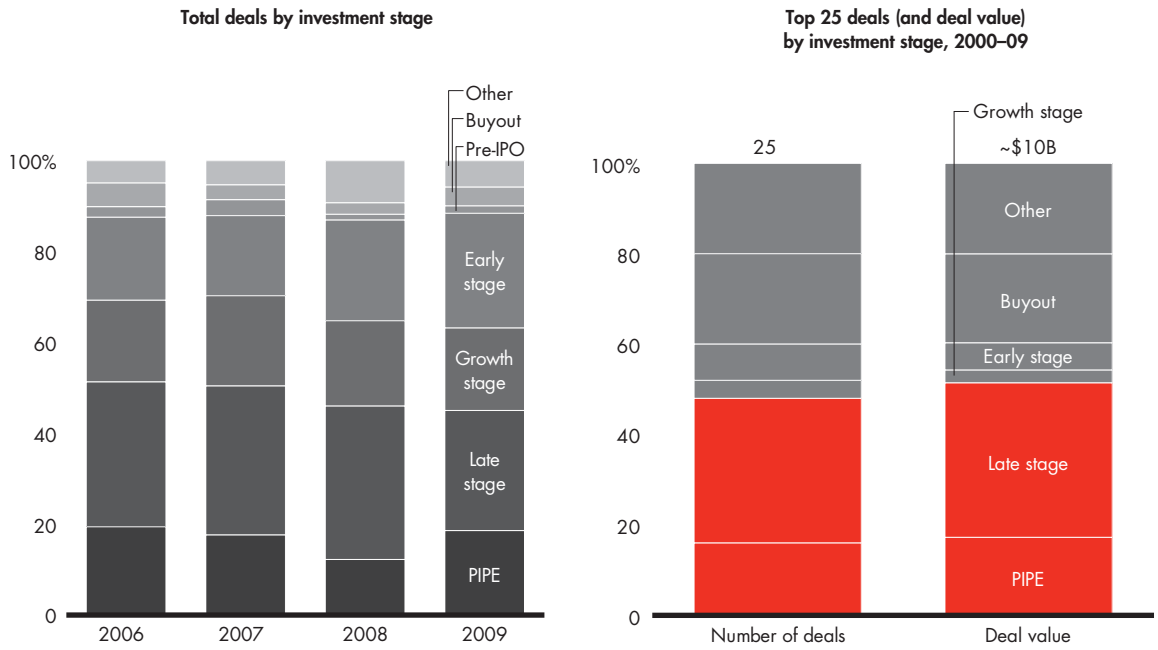
That likely reflects less the emergence of a trend than a lingering effect of the downturn. The smaller deals consummated in 2009 may reflect promoters' desire to wait out the slowdown to see if they might capture higher valuations once the market rebounds. For their part, PE funds were uncertain which direction the markets would turn and settled on doing smaller deals during this period. Of the few large transactions, most fell in the infrastructure-building sector. In 2009, many infrastructure-building companies were in the midst of multiyear projects and found themselves in need of funding.

Traditionally, promoters have also been reluctant to take large PE investments throughout their companies' life cycle, though PIPE deals are an exception since they do not dilute the owners' stakes. This remained true for the top 25 deals that closed during 2000 and 2009 and totalled more than $10 billion. Indeed, more than half of these transactions came as either late-stage or PIPE deals (see Figure 5.6).

Longer-term prospects: Beyond 2010

Despite the ongoing hurdles private equity faces in India—including regulatory and cultural factors and increasing competition that will reduce returns—fully 60 per cent of the industry insiders we surveyed expect to see "a significant pickup in deal closure(s)"

Figure 5.6: The majority of investments historically have been in PIPEs or late-stage deals



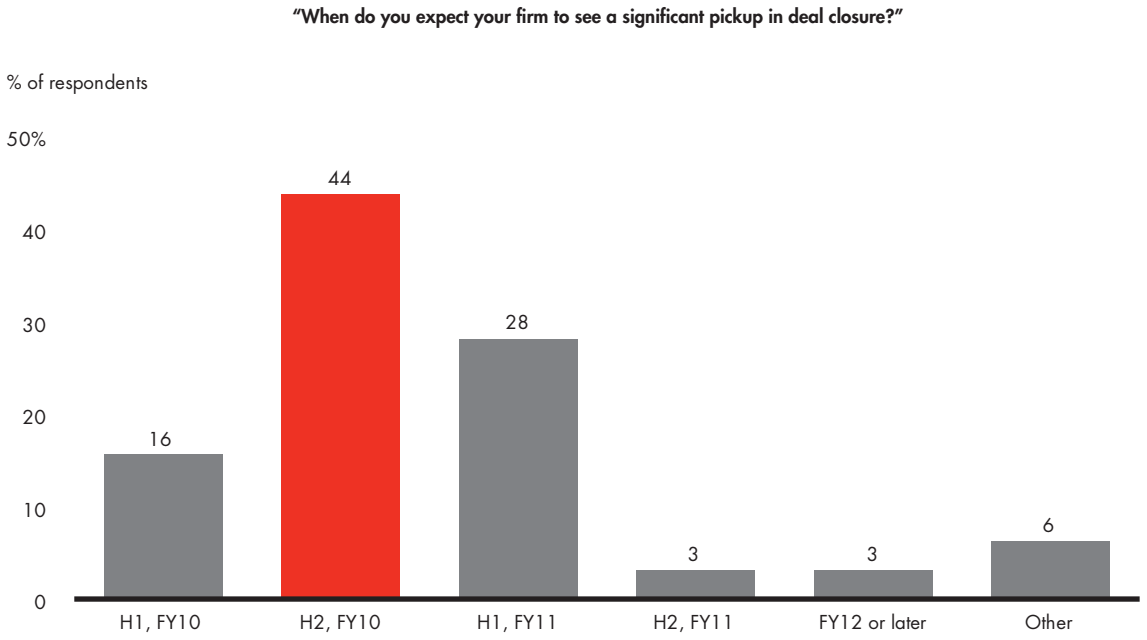
Note: Top 25 deals are from Bain PE deal database
Sources: TSJ Media; Bain deal database

this year. Another 28 per cent anticipate a large increase in the first half of FY2011 (see Figure 5.7). These growth expectations taper off in the second half of 2011 and beyond, but the strong belief in this upsurge is underscored by the fact that there are more than 100 India-focused funds raising capital in anticipation of what many believe will be the sudden release of pent-up demand for funding.

PE investors will continue to be opportunistic across many industries, but perennial favourites have been technology companies. Along with deals involving energy and real estate, these amounted to 41 per cent of private equity's total investments in 2009, and will continue to offer attractive opportunities going forward (see Figure 5.8).

PE funding has varied its focus as growth in specific sectors created demand for capital, following a path from IT in 2004 to real estate in 2005 to information technology and telecom the following year. By 2009, investment clustered in real estate, IT and energy. Real estate, in particular, attracted PE investor interest in 2009, given that many construction and development firms had overextended themselves in the boom period of 2005 to 2008. By 2009, their stock price valuations had plummeted amidst a number of ongoing projects—which meant they were very open to new sources of capital.

Figure 5.7: Private equity is expected to see a significant pickup in deal closures by the second half of FY10

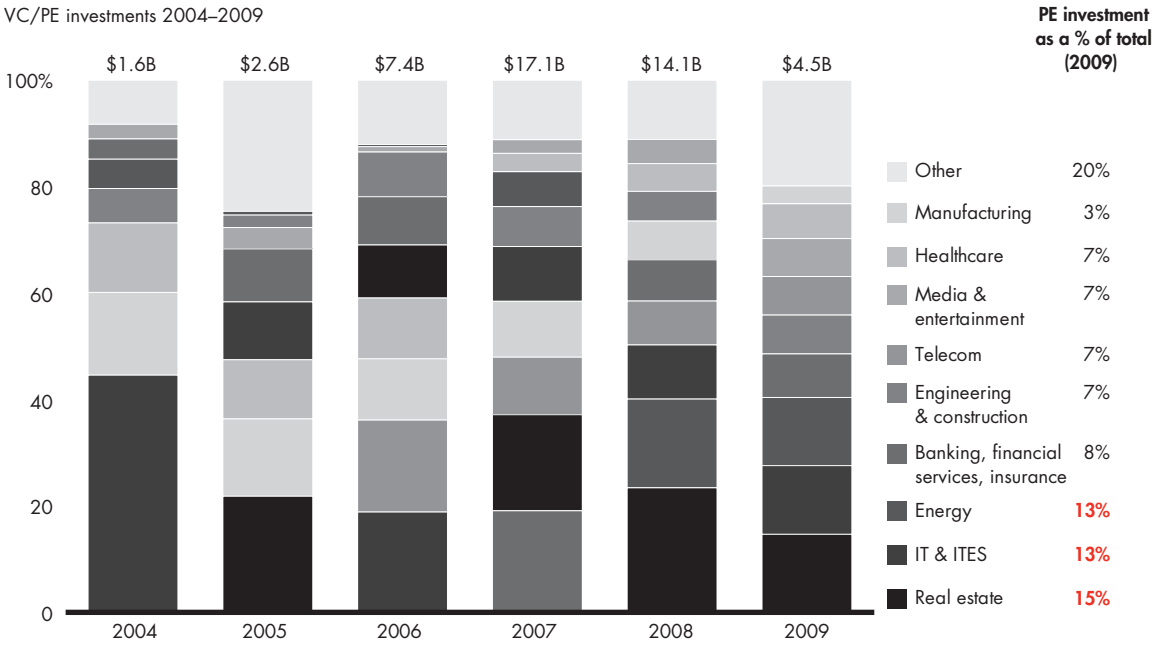


Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

As these frequent shifts make clear, VC and PE funds have been less concerned with sector specialisation than in seeking opportunities wherever conditions were most favourable. Thus, the anticipated large-scale growth in infrastructure and other new-construction efforts linked to government spending, as well as new energy projects, will act as a powerful magnet for investors (see Figure 5.9).

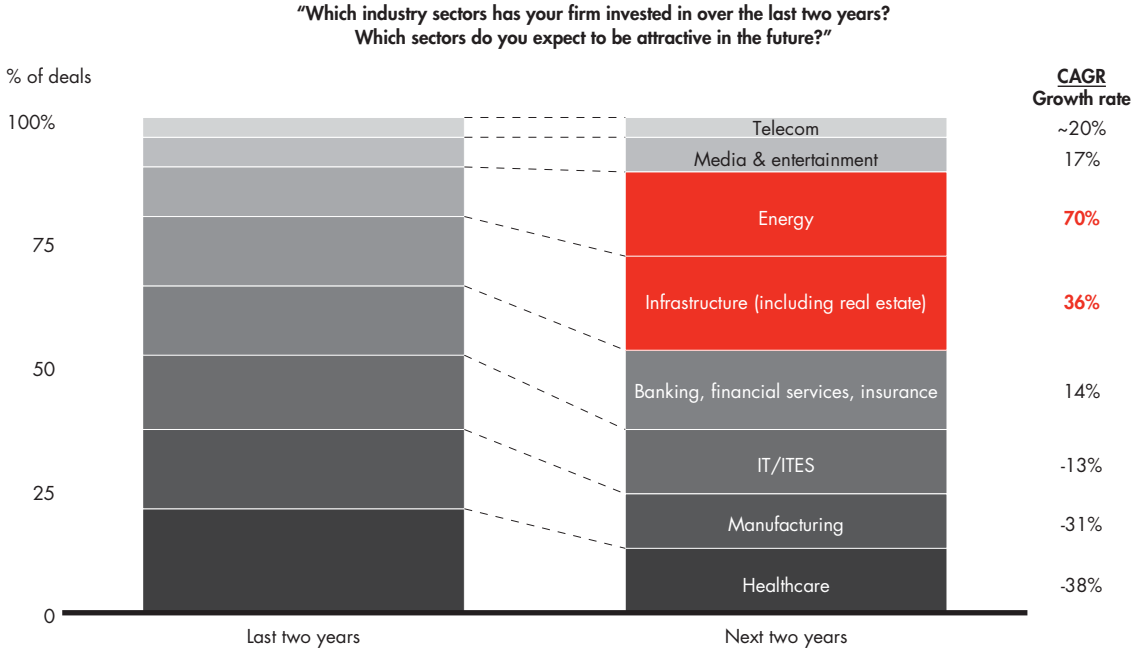
Another influence on increasing deal volumes was touched on earlier: the need by smaller publicly listed companies for financing to hit their aggressive growth targets. In the heady Indian business environment earlier this decade, many entrepreneurial firms went public too soon, given a low revenue threshold needed to issue stock. But now, without a long-term track record of stellar growth, many companies find it difficult to make follow-on public offerings. Many of these companies that are no longer actively traded are under the radar of securities analysts' scrutiny, but represent opportunities for PE funding. They will provide not only a deal opening for PE investors, but an opportunity for investors to add significant value and to increase private equity's reputation among the community of small and midsize enterprises.

Figure 5.8: In 2009, real estate, IT and IT services, and energy accounted for the highest amount of VC/PE funding



Sources: Bain PE database; Bain analysis

Figure 5.9: In the next two years, funds will focus on infrastructure and energy



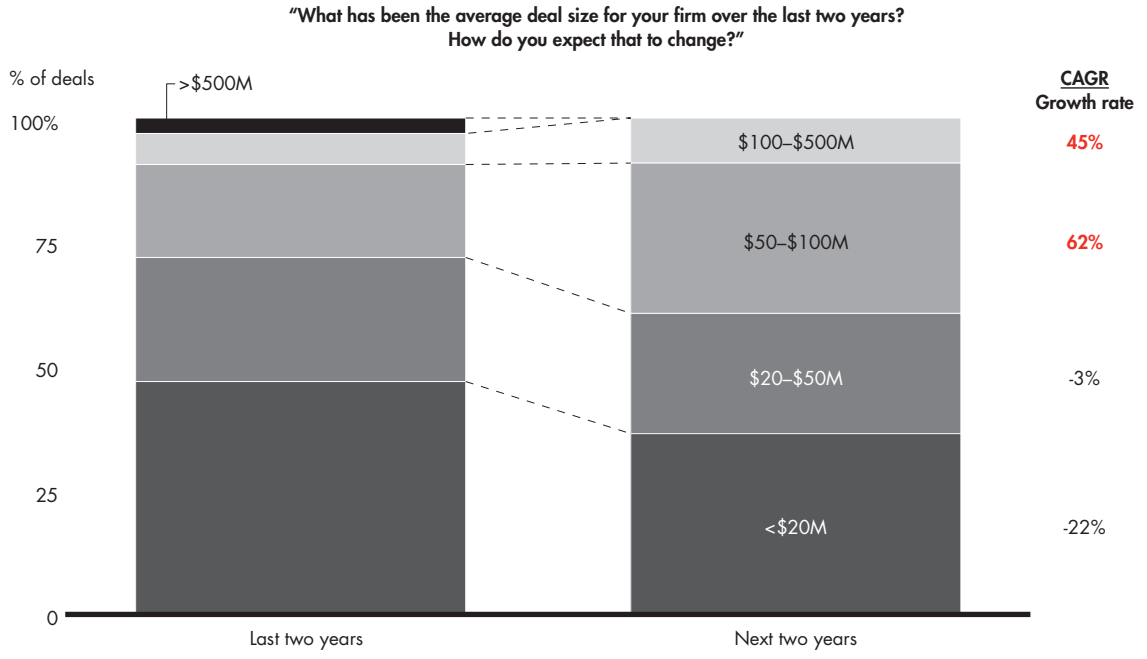
Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

With PE funding seeking an outlet in India's dynamic economy, the dollar size of the deals also is expected to increase significantly. Indeed, industry executives expect to see deals in the range of $50 million to $100 million increase by 62 per cent. And, among transactions totalling from $100 million to $500 million, they peg the increase at 45 per cent (see Figure 5.10).

What will enable this surge in deal activity? Clearly, the vast amounts of dry powder PE funds have amassed and are eager to put to work will be a major factor. A pickup in deal making will also hinge on promoters' increasing contact and experience with private equity. Indeed, the best source of proprietary, profitable deals, PE executives tell us, comes from direct contacts—such as personal relationships across business networks and portfolio companies—and, to a lesser degree, through banks (see Figure 5.11). Most PE investors say they rely far less on intermediaries or introductions facilitated by their limited partners. These opinions reflect both what PE investors say were the most important sources of deals over the past two years as well as looking ahead.

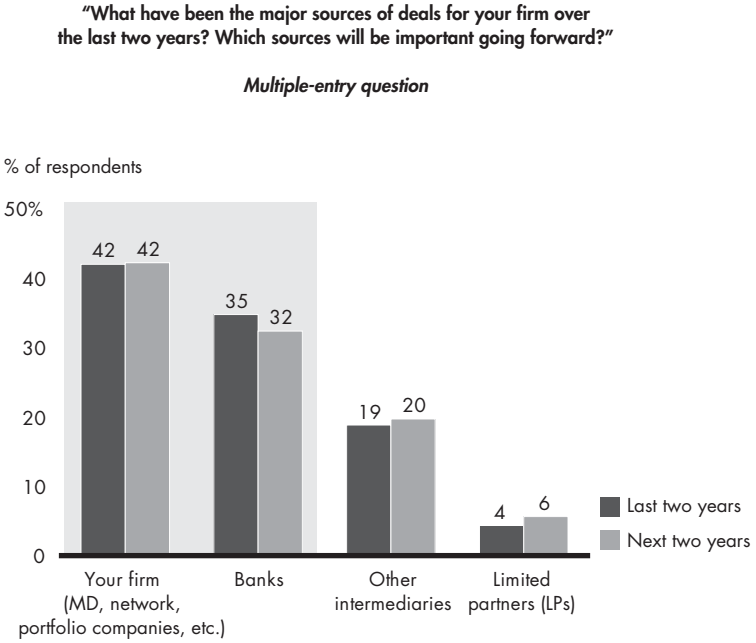
Survey respondents told us that PE investors' ability to win promoters' trust will continue to be an essential tool for accelerating deal flow. One executive explained, "As early-

Figure 5.10: The size of deals is expected to increase sharply



Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

Figure 5.11: Networks and banks are expected to remain critical to deal sourcing



"We believe we need to source and create **proprietary deals in order to have an edge** in the market."

—Survey respondent

"As early-stage investors, our focus is finding promoters with whom we can build a long-term relationship. Unfortunately, **it's difficult to establish trust in a hurry, so we shy away from intermediated deals**."

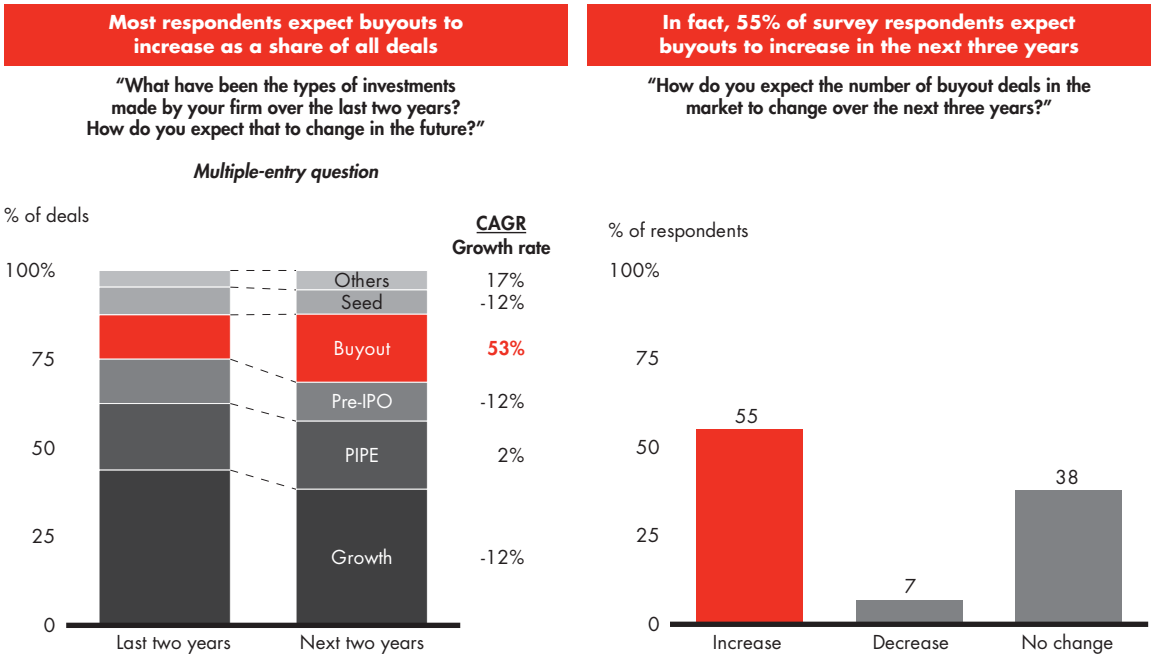
—Survey respondent

Note: Survey n=61
Sources: *AVCJ*; TSJ Media; Bain analysis

stage investors, our focus is finding promoters with whom we can build a long-term relationship. Unfortunately, it's difficult to establish trust in a hurry and so we shy away from intermediated deals." Yet, as important as having the right personal chemistry between promoters and PE investors is to the success of a relationship, most industry experts see the role of intermediaries increasing significantly going forward.

Over the past two years, the number of buyout deals represented just 13 per cent of all deals completed. Our respondents foresee these kinds of transactions increasing by 53 per cent over the coming two years. Asked specifically how they expect the number of buyout deals in the market to change, 55 per cent said they expected them to increase, while 38 per cent anticipated they would stay the same and 7 per cent thought they would fall. If expectations are realised, then, nearly 20 per cent of all deals will involve buyouts (see Figure 5.12). Again, survey respondents linked this outcome to promoters' increasing and positive experience with private equity. "As the market matures we will see more and more buyouts," is the way one put it. Moreover, private equity will itself gain in experience. Explained another executive: "There are also more funds...willing to take control and that have built their teams to have operational capabilities."

Figure 5.12: Buyout deals are expected to increase significantly in the next two to three years



Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

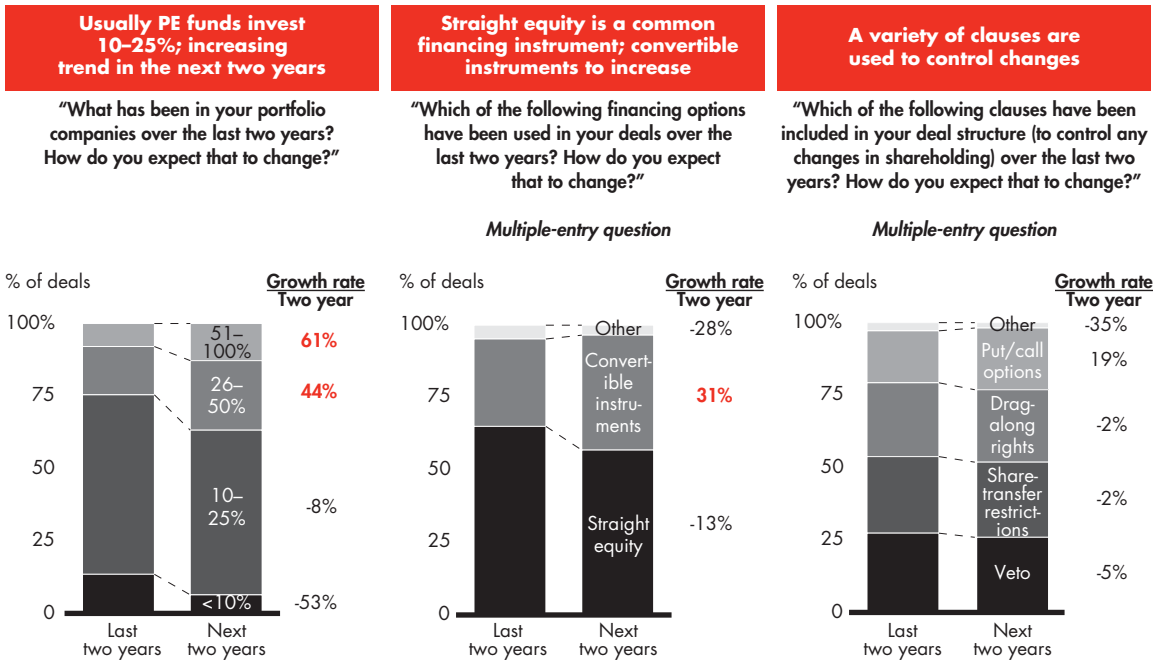
While this optimism about an upsurge in buyouts is widespread, PE investors need to reckon with the inherent reluctance of promoters to sell off their holdings. It is also difficult to square with at least one structural impediment in Indian law: The prohibition on the use of leverage in such deals—a practice used widely elsewhere that inherently makes returns more attractive. Nevertheless, some increase in buyouts will occur when larger conglomerate organisations (particularly in the real estate and technology sectors) begin a process of portfolio rationalisation—pruning non-core assets and beginning a focus on carve-outs. But until there is a change in regulations, PE funders will be obliged to continue to create offshore entities to add debt to equity in such deals. And this adds a level of complexity and expense that must be managed.

Also seen to be on at least a small uptick will be the size of stakes that PE investors will control, the survey respondents said. Although minority-stake deals will remain the norm, they see the number of deals involving a controlling interest of between 50 per cent and 100 per cent increasing to 13 per cent of all deals in the two years ahead, compared with just 8 per cent two years ago. Again, this could be a reflection of the sentiment flowing from the downturn and decreased funding choices, but respondents also anticipate that the number of deals that involve 26 per cent to 51 per cent stakes will rise from 17 per cent over the past two years to 24 per cent of all deals by 2013 (see Figure 5.13, left column).

As to financing options, straight equity purchases will remain the norm, but respondents anticipate that the use of convertible instruments will increase to 40 per cent of all deals over the next two years, compared with 30 per cent in the prior two years (see Figure 5.13, middle column). PE investors prefer creating such an investment structure as an incentive platform. They appear willing to extend credit that will enable managers of their portfolio companies to finance new projects and convert that debt into equity stakes if the growth targets are met. In June, KKR India completed a $141 million structured-credit transaction consisting of a mix of cash, fixed-income and equity through its investment in the JSW Group of Companies—the firm's second such hybrid deal in the past year. However, it remains to be seen whether PE funds will be effective in making this a widespread practice, as entrepreneurs are less keen on such instruments and would prefer a straight equity infusion. As discussed before, the level of competition for deals may prevent this from becoming the norm.

In the meantime, respondents say they will continue to employ standard shareholding controls—such as put/call options, drag-along rights, share-transfer restrictions and outright vetoes—in mostly the same proportions over the next two years (see Figure 5.13, right column). However, even if put/call options are a part of a shareholder purchase agreement, their enforceability may be problematic.

Figure 5.13: In the next two years, deals may involve higher stakes; most deals to be financed through equity



Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

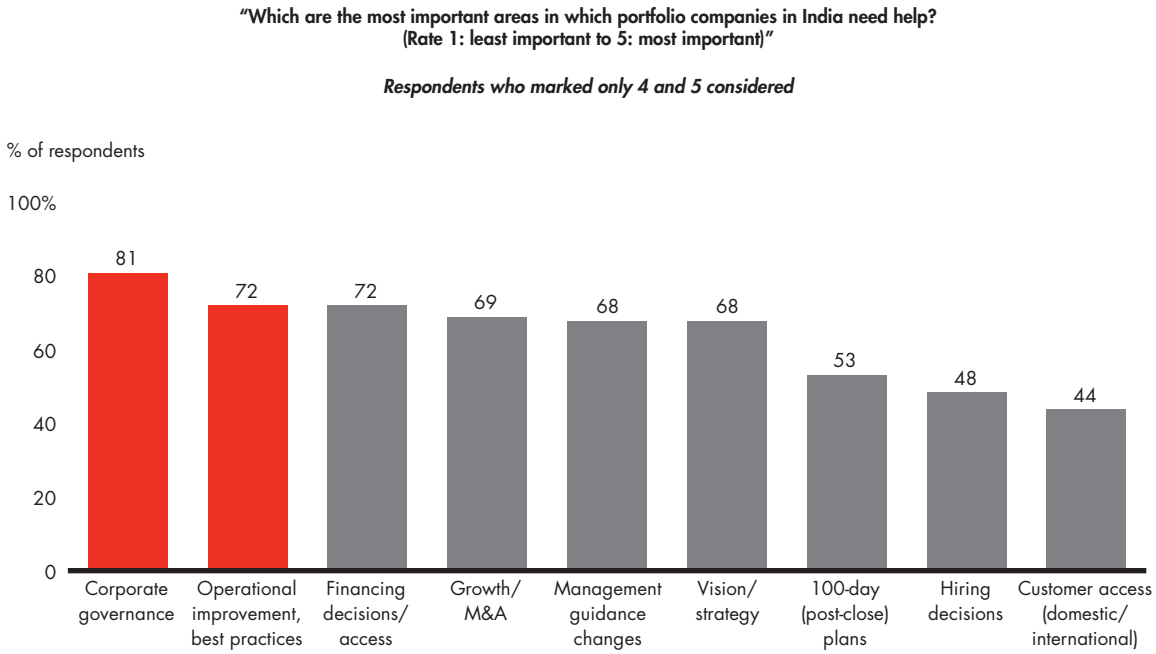
Portfolio management

Today's baseline

In the US and Europe, where private equity was born, portfolio management is an active discipline. It involves tight management control—even selection of key senior executives—to ensure attractive returns. In India, in contrast, portfolio management entails an advisory role that, at its most effective, melds persuasion and a growing sense of mutual trust to bear the kind of fruit that private equity can offer and that promoters want.

PE investors do sit on corporate boards and help develop better governance standards and management information systems, areas where company owners often know they need help. Yet promoters view private equity's working model as a bit like mutual funds picking stocks, especially in PIPE deals where shares are bought in public markets. But the story changes when fund managers acquire larger stakes. Here, they attain a higher level of influence that is literally spelled out in the investment agreement's legal language. Such deals, for instance, require management to get prior PE investor approval to make investments that would take the company in a different strategic direction from its core business.

Figure 5.14: Corporate governance and operational improvements are required by target companies



Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

Indian PE firms believe their target companies need to unlock their full potential value. This includes a strong role in corporate governance and operational improvements that incorporate best industry practices. Equally important, survey respondents said, is the power to influence financing decisions and a voice in determining with whom they are made. Indeed, the help Indian target companies need, in the eyes of industry insiders, covers a gamut of issues: growth and M&A, management guidance and selections, vision and strategy, and, to a lesser degree, the formulation of 100-day post-close plans (sometimes called "blueprints"), and hiring decisions, among others (see Figure 5.14).

Promoters have their own needs from PE firms. For the most part, they seek expertise in handling the complex process of going public, such as guidance in meeting standards and listing norms. Many also realise they need to improve their governance practices and operations. And others understand that PE firms can provide excellent counsel in the development of strategy and tap a network of relationships for a company that has reached both a critical mass and a turning point in its growth trajectory.

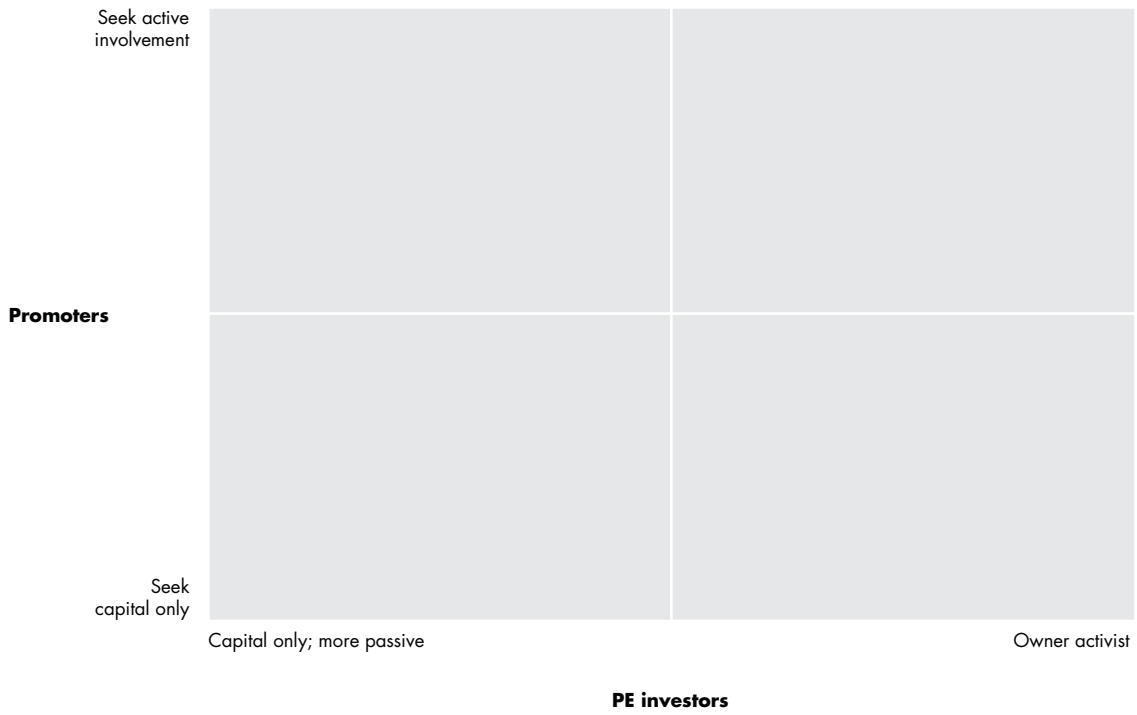
Longer-term prospects: Beyond 2010

Matching needs on both sides and alignment on the strategy going forward will be the key to success. To visualise what this will entail, think of a typical quadrant, with PE investors on the horizontal axis and promoters on the vertical one (see Figure 5.15).

PE firms will be divided between active investors and passive investors. The promoters divide between those who simply are in the market for capital versus those who want active PE involvement. The degree of involvement may extend from offering industry expertise to introducing best practices in functions, operations and governance to bringing to bear the experience needed to ready a company for an initial public offering. The question for PE and VC funders will be: "What must we do to be the preferred partner—and in each category?" For promoters, the main concern will be: "Which partner will we choose—and why?"

Today, promoters more often than not pick solely on the basis of getting the greatest value for the stake they give up in their firm, not on the kind of industry or operational savvy that's offered at a higher price. For instance, one promoter recently turned down a deal from a renowned international PE fund because other offers came in higher—

Figure 5.15: Aligning promoters and PE investors



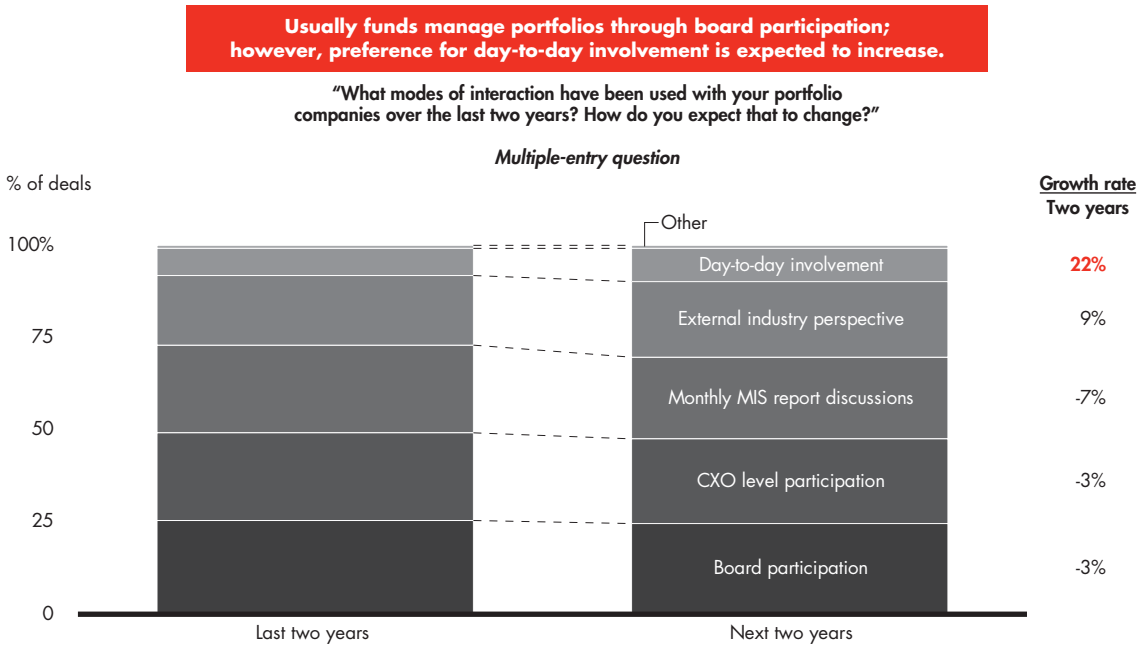
despite the fact that the PE firm ran a highly profitable European portfolio company in exactly the same industry segment. In other words, PE firms today must still surmount the valuation threshold to secure a deal.

But promoters also need to begin thinking longer term about who they are partnering with and about the real costs of spurning a firm with a proven track record that might well help their company grow even faster. Indeed, over the lifetime of a company, accepting a marginally "lower" offer could pay off in the long run.

Ultimately, PE investors and their Indian portfolio companies will need to establish good working relationships within the context of India's family-dominated business culture. That will take time. In the interim, their modes of interaction will remain roughly the same, the survey respondents reported—although PE firms' desire for more day-to-day involvement is on the rise (see Figure 5.16).

The trick for private equity is to maintain a style of interaction with portfolio companies that stops short of interference. The points of contact typically are: board participation, appointments to senior C-level positions, the sharing of monthly management information reports, broad industry expertise and counsel, and, increasingly, involvement in critical

Figure 5.16: Usually funds secure board participation, since it allows flexibility in managing portfolios



Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

short-term issues, such as working-capital management. One PE firm managing director explained the delicate balance this way: "During interactions with portfolio companies, [the] role of PE investors is advisory, with no interference." Another managing director we interviewed agreed, saying that the "interests of both PE investors and promoters should be aligned, with the former playing an advisory role to the promoters."

How does this work in practice? One example involved a global financial firm whose 24 per cent stake in an Indian technology provider went far beyond a mere board seat. This fund provided strategy and financing assistance in making a European acquisition that gave the portfolio company a global reach. Another example was when a global PE firm recently encouraged a controlling family to develop a detailed "blueprint" of the strategy going forward as part of the funding agreement, an exercise that allowed both firms to be aligned on the key issues facing the company and the path ahead.

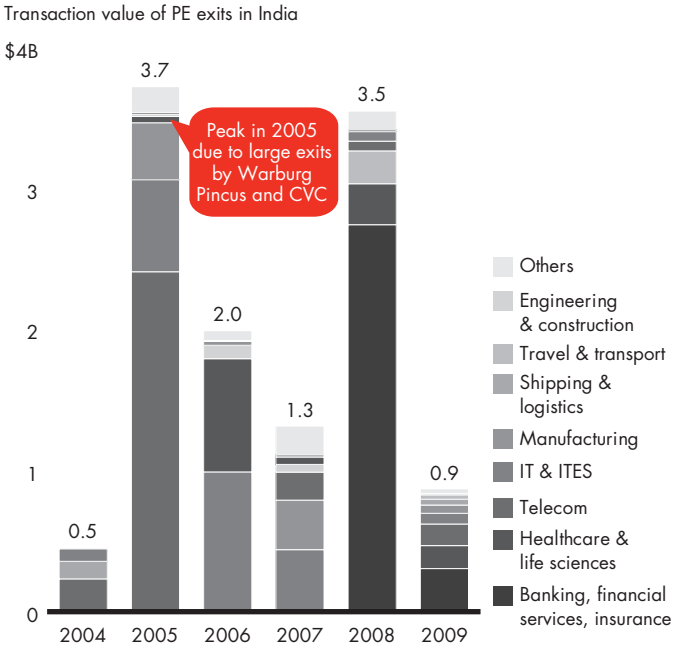
Indeed, reputations are already building about certain PE firms that work well with promoters, a group that desires a patient and collaborative approach. Yet by the very nature of the relationship, a certain tension will continue to exist between the long-term objectives of family owners and the short-term goals of the PE firms—as well as between mismatched expectations around valuations. As family-owned companies gain experience working with PE investors, they will be better able to decide whether they really want the highest valuation up front or the longer-term results private equity offers, and whether they need to cede a certain amount of control to gain them. They will also be able to figure out which firms they can collaborate with to create long-term value.

Exits

Today's baseline

Because venture capital and private equity are still relatively new to India, the deals investors undertook over the past several years have only begun to reach the full span of their ownership life cycle leading to successful exits. Thus, relative to the number and value of PE deals since 2004, the number of exits has been few. With notable exceptions, such as Warburg Pincus's sale of its large stake in Bharti Tele-Ventures in 2005, they have also been small, averaging well under $4 billion annually over the past six years (see Figure 5.17). Investors' anticipation of the 2008 peak in the public equity markets and worries about the financial services sector specifically resulted in a flurry of exits in that year, but the brief economic slowdown in 2009 chilled the climate for exits as stock prices fell. Nevertheless, investors in all sectors of the Indian economy—from high-tech and health sciences to manufacturing, construction and transport—have tested the exit market.

Figure 5.17: Overall, exit volumes have remained low relative to deals



Top five exits in 2009		
Portfolio company	Deal value	PE firm
Shriram Transport Finance	$213M	ChrysCapital
XCEL Telecom	$154M	Q Investments
Vetnex Animal Health	$75M	ICICI Venture
India Infoline	$50M	Orient Global
Max India	$49M	Warburg Pincus

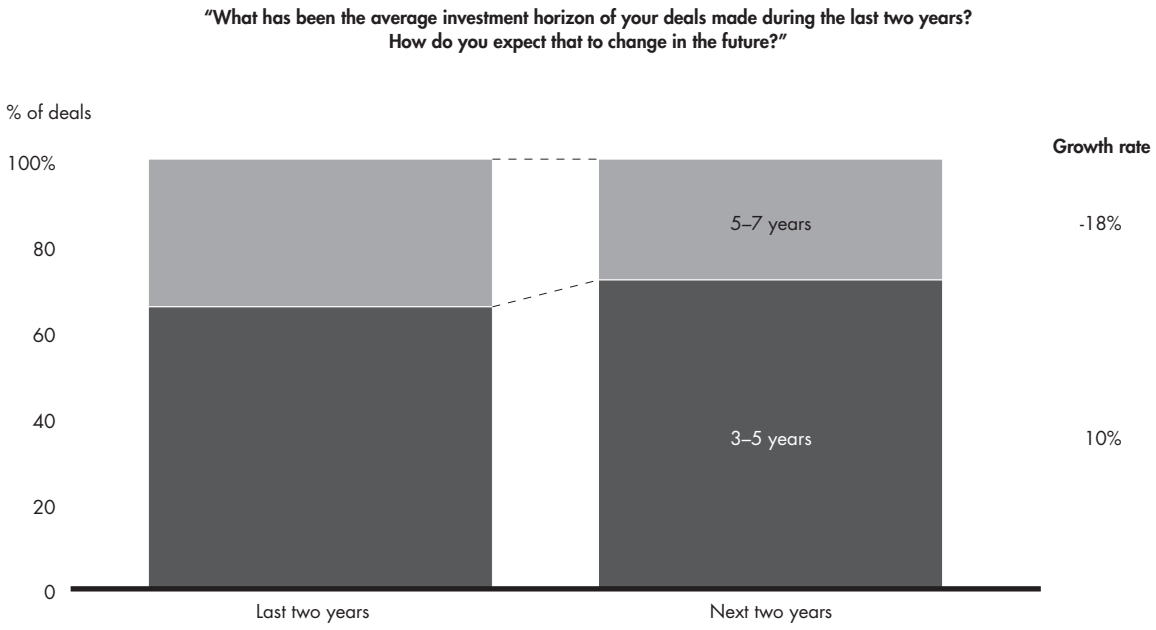
Note: The actual numbers are likely marginally higher, as these are publicly reported only
Source: Venture Intelligence

Despite an economy that started to strengthen in the second half of 2009, the number of 2009 exits—and their values—remained low. Coming off a total 2008 value of $3.5 billion, mostly among the banking, financial services and insurance industries, PE and VC investors cleared some $900 million last year in deals that covered a variety of industries. Among the top 2009 deals were Shriram Transport Finance at $213 million, XCEL Telecom at $154 million and Vetnex Animal Health at $75 million.

Longer-term prospects: Beyond 2010

The strengthening economy appears to be opening up opportunities for PE investors to unwind positions they have been holding and shortening the duration of deals. Over the past two years, the average investment horizon of the deals our survey respondents made was preponderantly from three to five years, they reported. Nearly two-thirds were in this category, with 34 per cent having a deal horizon of five to seven years. While these trends are largely stable, respondents did say they expected an uptick in the shorter horizon over the next two years (see Figure 5.18). That is a logical consequence of the recent downturn, which prevented deals with a 2006 and 2007 vintage from achieving an exit on schedule.

Figure 5.18: Deal horizon is expected to be three to five years



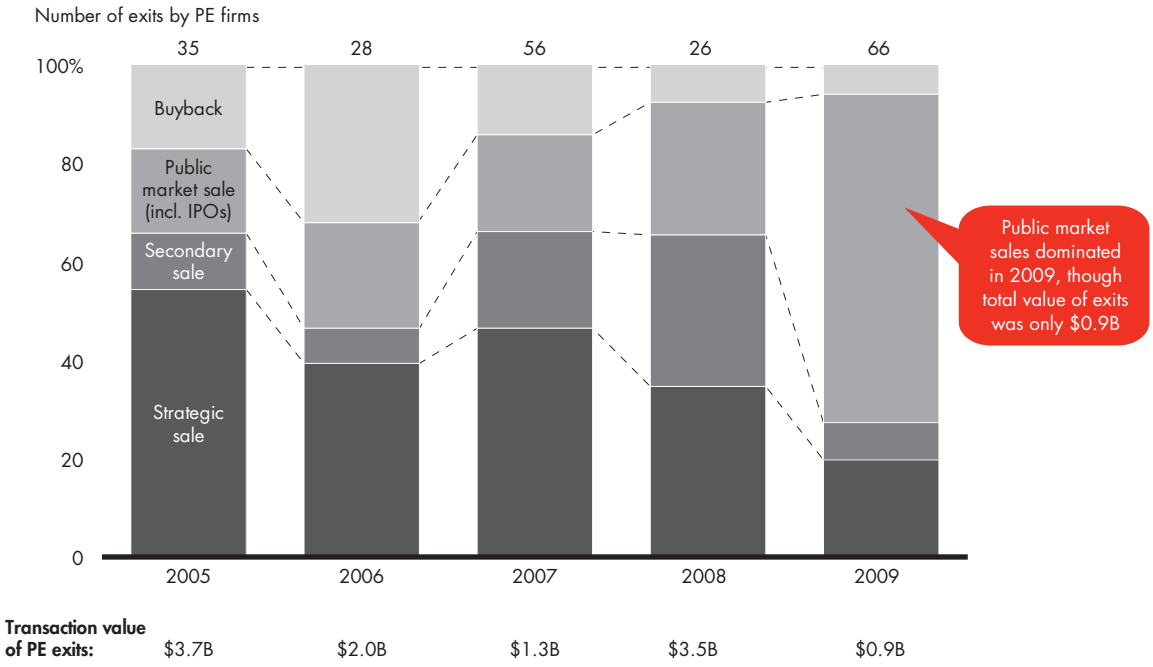
Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

A notable feature of 2009's exit activity was the dramatic rise in public-market sales, including IPOs—up more than six times over the previous year's low base, to a total of 44 exits. It may signal an upward trend in public-market sales, including IPOs, in the future, compared with the traditional exit mode of strategic sales (see Figure 5.19).

When asked whether they expected exits to increase, survey participants overwhelmingly responded in the affirmative. For the rest of 2010, they predicted exits would rise marginally and uniformly among the various categories comprising trade exits, secondary exits and IPOs. But for the period through FY2014, they were extremely bullish on the growth in exits, particularly in IPOs (see Figure 5.20). When asked to predict which mode would predominate over the near and longer term, the answer came back: mostly through IPOs.

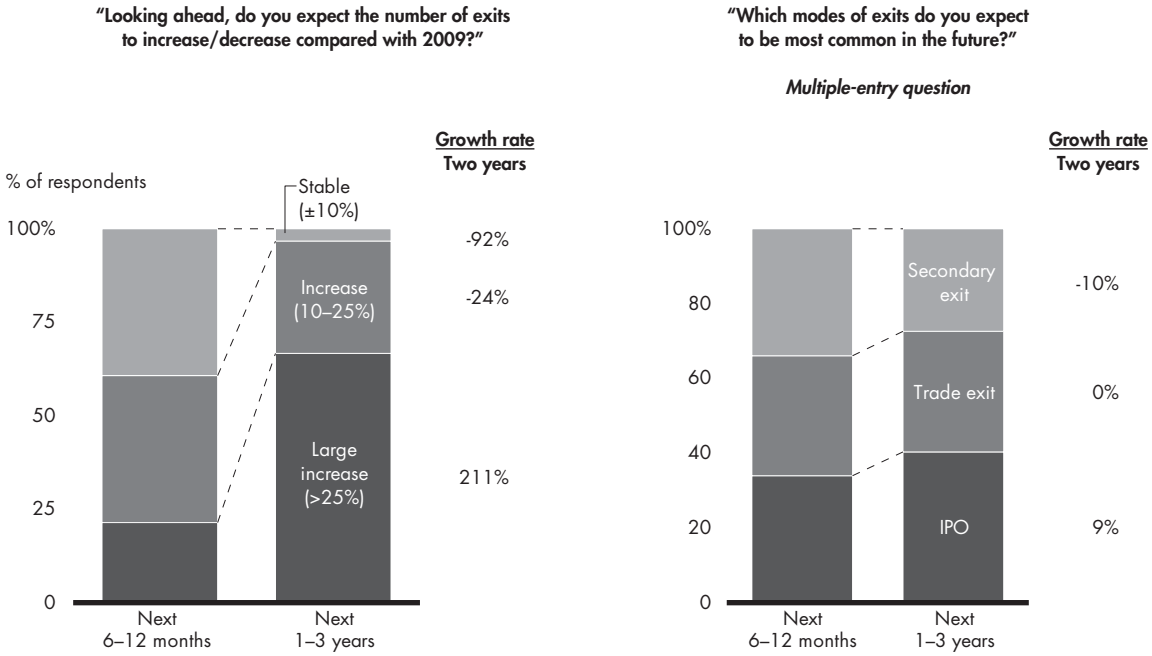
One explanation of this expected increase in IPOs goes back to last year's economic slowdown, which delayed the timing of some as growth rates slowed. That created something of an exit backlog as performance histories need to be boosted again in order to command attractive IPO prices.

Figure 5.19: Historically, exits happened through strategic sales; in 2009 about 60% of exits were through public-market sales, including IPOs



Source: Venture Intelligence

Figure 5.20: Exits are likely to increase in the next one to three years, mostly through public-market sales, including IPOs



Note: Survey n=61
Source: Bain IVCA PE/VC research survey: Outlook 2014

Key takeaways

Fundraising

- A vast supply of capital—as much as $30 billion—is earmarked for investment in sectors throughout India's resurging economy.
- Owing to rule changes granting tax-free status to foreign venture capital investments, survey respondents believe FVCI funding could increase by some 30 per cent over the next two years. Domestic Indian funds will remain a secondary capital source.
- Domestic PE funds will continue to come mostly from institutional investors, but it will likely remain subscale due to rules discouraging insurance and pension-fund participation.

Deal making

- Deal making will continue to be opportunistic and deals will remain small, reflecting both the fragmented state of most industries and promoters' limited familiarity with the kind of active PE practices employed in more mature markets.
- Deal volume and size slowed in 2008–2009, but the economic revival will not necessarily trigger an upsurge, as the valuation "mismatch" between funds and promoters continues.
- PE industry participants' expectations are high for a significant acceleration in deal activity this year, tapering off by the second half of 2011.
- The dollar size of the deals also is expected to increase significantly, with the number of deals in the range of $50 million to $100 million anticipated to increase by 62 per cent.
- Deal flow will hinge on a combination of PE firms' personal networks and third-party contacts, and promoters' growing trust and experience with private equity.
- Industry insiders foresee an upsurge in buyouts—to nearly 20 per cent of all deals—despite the continuing prohibition of the use of leverage.

Portfolio management

- Portfolio management practices are evolving gradually to a more activist role. Funds increasingly seek three things: a stronger role in corporate governance, the ability to improve operations and the power to influence financing decisions.

- Promoters have their own expectations from their PE partners, including expertise in going public, access to best practices and strategy development.
- Alignment among private equity and promoters will entail deep understanding of each other's goals. Ultimately, promoters need to weigh carefully not only the short-term cost of capital but the longer-term advantages of working with private equity's proven business-growth expertise.

Exits

- Despite an economy that started to strengthen in the second half of 2009, the number of 2009 exits—and their values—remained low. Coming off a total 2008 value of $3.5 billion, mostly among the banking, financial services and insurance industries, PE and VC investors cleared some $900 million last year in deals that covered a variety of industries.
- A notable feature of 2009's exit activity was the dramatic rise in public-market sales, including IPOs, which were up more than sixfold to a total of 44 exits, coming off the previous year's low base.
- For the rest of 2010, survey respondents predicted that exits would rise marginally and uniformly among the various categories comprising trade exits, secondary exits and public-market sales. But for the period through 2014, they were extremely bullish on the growth in exits, particularly in public-market sales and IPOs.

6. Implications

The months ahead are shaping up as an important time of transition for private equity in India. Will the coming two to three years be a period when domestic and international PE firms and Indian entrepreneurs build on the foundation they established since 2004 to make private equity a more integral part of India's economic and corporate growth? Or will private equity continue to serve as a marginal additional source of capital to finance smaller deals and minority holdings? At this point the verdict is far from clear and will depend on the actions that PE firms, promoters and government regulators take—individually and together—to further their mutual objectives.

What is clear is that PE activity has picked up following last year's brief downturn, and the path forward looks favourable for a quicker pace of deal making and exit activity. As reflected in the outlook expressed by the industry insiders who responded to our survey, sentiment about the future among PE investors is buoyant overall. Big global PE firms and well-endowed sovereign wealth funds that had been active in India before the 2009 slowdown are now stepping up their Indian commitments, and new firms are establishing a presence. Expectations among limited partners around the world about India private equity's future prospects are also high, and they are directing a greater proportion of their capital dedicated to private equity to funds that invest in Asia generally, and India specifically.

Domestic Indian PE funds, too, are increasing in number, size and sophistication. Capitalising on their extensive networks of connections in industry, banking and government, they are absorbing the investment and portfolio management skills of their global counterparts. Leading Indian-headquartered firms like ChrysCapital, ICICI Venture, TVS Capital and UTI Ventures are building high-quality capabilities that are attracting the attention of foreign investors looking to participate in the Indian PE and VC story.

India's strong economic growth, of course, is a major factor propelling PE activity. But the rush to India is also fuelled, in large measure, by a somewhat slower pickup in deal activity in the mature markets of North America and Europe coming out of the recession. The favourable outlook still appears to be based more on India's vast potential than on concrete evidence that private equity in India is poised for a dramatic leap forward. Indeed, it is likely that absent some fundamental changes, private equity in India will fall short of achieving its full promise. PE investors will continue to compete for small deals, accepting passive roles in their portfolio companies rather than bringing their

talents to bear to realise their growth opportunities. Promoters and entrepreneurs will continue to view private equity as just another source of capital, and a costly one with unattractive strings attached, at that. Add to this a regulatory environment that constrains deal making, and it is clear that private equity in India is still very much a work in progress.

What will it take to unlock private equity's potential? The passage of time, the accumulation of trust and the achievement of a strong performance track record, of course, will be essential pre-conditions. Those key traits cannot be acquired quickly, but each of the major parties to private equity's fate—the PE firms themselves, promoters and regulators—can take steps today to put in place conditions that will ensure they are achieved.

PE investors. As in other fast-developing emerging markets, India has presented PE investors with constraints that are at variance with their operating style in the mature economies. Perhaps chief among these are the rare opportunities to acquire control of target companies through buyouts. Having a dominant stake enables PE fund managers to put their imprint on the companies in their portfolios as activist owners. But operating as minority shareholders, PE investors need to exert influence to create value.

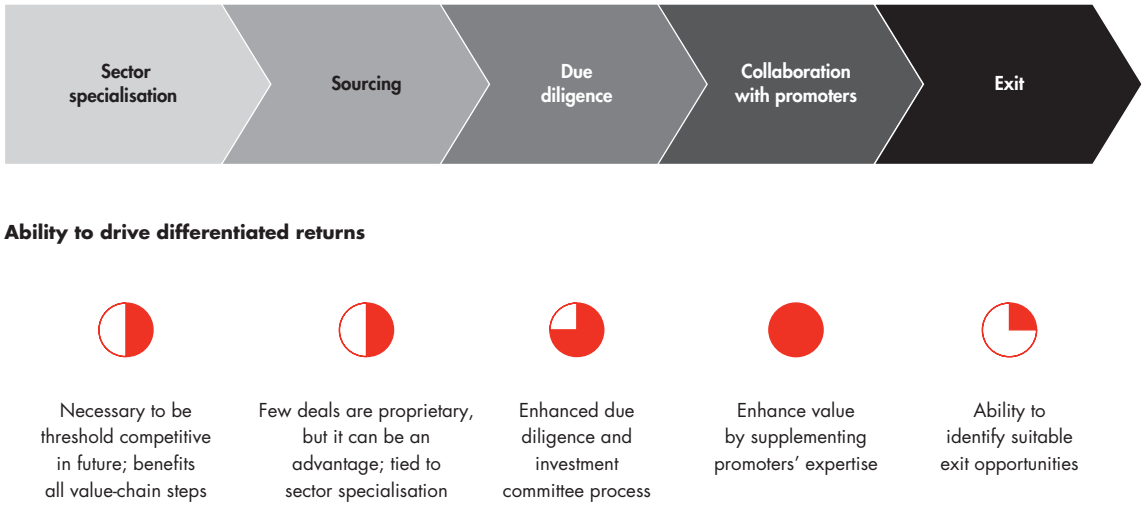
Learning how to steer from a backseat position requires PE investors to adopt a different mind-set—one of quiet coaxing and coaching rather than command and control. They need to demonstrate to promoters and family owners of the companies in which they invest that they are not out simply to maximise short-term financial returns but are willing to work with them to achieve a common growth vision over the long haul.

An example of this is the type of relationship TPG India Investments, the local subsidiary of TPG Capital, the US-based PE firm, has established with the Shriram Group, a diversified financial services holding company. Since its initial investment in Shriram Holdings (Madras) of $100 million to finance the growth of its transport finance subsidiary in 2006, TPG has provided successive capital infusions to help speed Shriram's growth. It acquired stakes in the group's retail holdings subsidiary and its consumer finance arm in 2008. Earlier this year, TPG lifted its stake yet again, investing an additional $100 million to back Shriram Group's new venture, Shriram Capital Limited, as it applies for a licence from Indian authorities to expand into retail banking. Working with Shriram on governance, providing operational advice and partnering to develop Shriram management's vision, TPG has helped the group grow to serve 4 million customers through nearly 1,000 branches and assets totalling more than Rs. 13,500 crores ($2.7 billion). Commenting on the successful working relationship Shriram has established with PE investors, a senior executive with Shriram Capital said: "We believe in partnerships, and we go out of the way to build them."

Even as they wait for the Indian market to mature, PE firms will need to prepare themselves by sharpening their capabilities along each phase of the investment life cycle, from deal sourcing to exit (see Figure 6.1). In deal sourcing, for example, the leading firms are becoming specialists in industry sectors, enabling them to differentiate themselves from their peers in the eyes of promoters. Because very few VC and PE deals are proprietary, sector-specialised firms are better able than their peers to get an early read on the most attractive investment targets. Leading firms are also strengthening their due diligence disciplines, which are especially important in India where a high proportion of companies in which PE firms invest are small, private and lacking in transparency. PE firms need to work actively with owners to identify high-priority initiatives that create value. Finally, PE leaders begin weighing how they will exit from each investment well before the time comes to sell by continuously tracking market conditions for IPOs and identifying potential strategic acquirers. As competition among PE firms in India heats up, it will be those that can differentiate themselves on these dimensions that will be positioned to make the right investments at the right price.

Businesses that accept PE investment. Promoters are deeply reluctant to cede significant management control to outside investors. Seeing private equity as little more than a last-resort source of capital to tap only after retained earnings, bank loans and issuances of new shares have been exhausted, most promoters have focused on

Figure 6.1: Winning PE firms need differentiated investment capabilities



getting top rupee for the sale of a stake in their business to a PE fund. Valuation becomes the overriding consideration in choosing a PE firm to work with to the exclusion of virtually any other. With so much PE money chasing deals in today's competitive market, the risks of fixating solely on value are likely to increase in the period ahead.

That approach is shortsighted and potentially costly. Promoters can get far more value out of their relationship with PE investors by choosing partners who are aligned with their vision for the future of their business and have the expertise to help them realise it. The time to focus on this is not after the agreement of an investment stake has been arrived at but during the period of negotiation before the deal is completed. Once both sides are in agreement about the broad direction of the company's growth over a three- to five-year period and have come to terms on the size and price of the PE investors' stake, they can transition smoothly as soon as the deal is consummated to develop a blueprint for how they will tackle the top-priority opportunities. On the margin, selecting PE partners based on their expertise and compatibility with a company's growth goals is worth far more than capturing the last 5 per cent in the original acquisition price.

Businesses new to private equity. Indian businesses that have not yet worked with VC and PE investors—or have been reluctant to accept funding from these sources—may want to give private equity a fresh look. VC and PE capital can play a critical role in the life cycle of any company. For start-up enterprises unable to secure bank financing or too untested to tap the public debt or equity markets, it can help management finance product development, bring a new product to market or scale up a distribution network. More mature companies weighing a decision to float an initial public offering may want to consider private equity before they seek a stock market listing.

Many promising Indian businesses have learned from hard experience that rushing to the public equity markets prematurely can be a mistake. Although the capital they raise in an IPO can help finance an initial growth spurt and enrich the promoters, many newly public companies discover that their shares languish once they are listed. Lacking a strong track record for revenue and profit growth, their shares are thinly traded. Many discover that they cannot go back to the public markets for more capital without seriously diluting existing shareholders. Working with private equity backers, instead, enables these companies patiently to build their businesses outside of the public glare. They are better able to choose a more propitious timing of their IPOs when their balance sheets and income statements are strong enough to withstand public shareholder scrutiny.

Public policy makers. As a complex new industry attracting vast sums of foreign capital and a mix of international and domestic firms looking to invest in India's most promising public and private companies, private equity presents a host of complex challenges to

Indian regulatory authorities. In the context of India's young and dynamic PE markets, finding the right balance between efficiency and safety will take time.

Two regulatory reforms, however, could significantly advance the development of private equity in India to the advantage both of PE investors and the companies that need growth capital—with virtually no risk to financial markets or the economy as a whole. The first would adjust the 15 per cent trigger rule. Under this regulation, PE investors who acquire at least 15 per cent of the outstanding shares in an Indian company must extend an open offer at an equal, or higher, price to the company's other shareholders and be willing to accept up to an additional 20 per cent stake in the company. Intended to protect the interests of third-party shareholders in a firm selling a significant equity stake, this requirement inhibits PE capital formation in two ways. First, it puts promoters and entrepreneurs at risk of having to give up a far bigger stake in their businesses than they may be willing to cede. Second, it leaves PE investors exposed to the likelihood of having to commit more money to a business than they planned and tying their potential returns too closely to the fate of an individual company than they may think is warranted. Raising the trigger, which the Securities and Exchange Board of India is reportedly weighing, would greatly reduce that uncertainty and increase investment flow. An initial increase of the trigger to 26 per cent would be beneficial to all parties and still protect the rights of minority shareholders.

A second reform that would facilitate better-informed deal making would be to ease disclosure rules that make it difficult for PE firms to conduct effective due diligence before investing in publicly listed companies. Under current law, any information a company shares with one potential investor must be disclosed to others without exception. That lack of confidentiality prevents prospective PE investors from making an accurate assessment of a target company's true condition, with the result that no investment will likely be made. Because so many Indian companies with listed shares are thinly capitalised and are unable to float new shares through public offerings, the inability to share critical information with PE firms can deprive them of an important source of funding at a key juncture in their development. A better solution would be to make it possible for company boards to approve the restricted release of internal data subject to the recipient of the information signing an appropriate nondisclosure agreement that is effective for a certain period of time.

As we have seen throughout this report, the long-term prospects for private equity to prosper in India appear to be excellent. The nation's strong, self-sustaining economic growth, talented workforce and creative entrepreneurs have created a fertile environment for PE and VC investment to take root. Conditions over the next year or two look especially promising. With credit markets and the economic outlook in Europe and the US problematic, interest among global PE firms and limited partners in opportunities in

Asia and the region's two most dynamic markets, China and India, is for the moment very high. VC and PE fund flows could rebound to some $17 billion through the end of 2010. Given the right economic conditions and a more favourable regulatory environment, private equity has the potential to fund up to $100 billion over the next three years, according to a Confederation of Indian Industry estimate. But international investors' attention can just as quickly shift back to the far bigger, more familiar and more welcoming terrain of their home economies as recoveries there show signs of taking hold.

To ensure that they capture this unique moment when all eyes are on India, Indian businesses and regulators will need to take visible steps towards removing the barriers—legal, cultural and attitudinal—that continue to block this promising source of growth capital from delivering its full potential. If they do, they will find that VC and PE investors will be enthusiastic partners in an effort from which all of India stands to benefit.

Key takeaways

- Strong market fundamentals make India an attractive destination for PE investment. However, the rush to India is also fuelled to some extent by a lack of attractive investment opportunities in the mature markets of North America and Europe, where deal activity remains sluggish and credit conditions are tight.

- India's PE market will continue to grow at a healthy double-digit rate over the next few years. But absent some fundamental changes on the part of promoters and regulators, its long-term growth potential could be constrained.

- Each of the major parties to private equity's fate—PE firms, promoters and regulators—can take steps today to put in place conditions that will ensure that the benefits of private equity's potential are achieved.

- PE firms need to sharpen their capabilities along each phase of the investment life cycle, from deal sourcing to exit. As competition among PE firms in India heats up, it will be those that can differentiate themselves through sector specialisation, enhanced due diligence and an ability to identify value-creating opportunities that will be positioned to make the right investments at the right price.

- Learning how to steer from a backseat position requires PE investors to adopt a different mind-set—one of quiet coaxing and coaching rather than command and control.

- Promoters can get far more value out of their relationship with PE investors by choosing partners who are aligned with their vision for the future of their business and have the expertise to help them realise it.

- Indian businesses that have not yet worked with VC and PE investors—or have been reluctant to accept funding from these sources—may want to give private equity a fresh look.
- Regulators can have a major influence in advancing the potential benefits of private equity in India by lifting the cap on the open-offer rule and liberalising disclosure norms when potential investors need confidential information to conduct their appropriate due diligence.
- Overall, Indian businesses and regulators need to take visible steps towards removing the barriers—legal, cultural and attitudinal—that continue to block private equity from delivering its full potential.

About Indian Venture Capital and Private Equity Association

Indian Venture Capital and Private Equity Association (IVCA) is the oldest, most influential and largest member-based national organisation of its kind. It represents venture capital and private equity firms, promotes the industry within India and throughout the world and encourages investment in high-growth companies. It seeks to create a more favourable environment for equity investment and entrepreneurship, representing the industry to governmental bodies and public authorities.

IVCA members include leading venture capital and private equity firms, institutional investors, banks, incubators, angel groups, corporate advisers, accountants, lawyers, government bodies, academic institutions and other service providers to the venture capital and private equity industry. These firms provide capital for seed ventures, early-stage companies, later-stage expansion and growth finance for management buyouts/buy-ins of established companies.

IVCA's purpose is to support the examination and discussion of management and investment issues in private equity and venture capital in India. It aims to support entrepreneurial activity and innovation as well as the development and maintenance of a private equity and venture capital industry that provides equity finance. It helps establish high standards of ethics, business conduct and professional competence. IVCA also serves as a powerful platform for investment funds to interact with each other.

The Association stimulates the promotion, research and analysis of private equity and venture capital in India, and facilitates contact with policy makers, research institutions, universities, trade associations and other relevant organisations. IVCA collects, circulates and disseminates commercial statistics and information related to the venture capital industry. It also encourages the formation, development and use of equity markets and funding structures appropriate to the needs of private equity and venture capital investors and investees.

IVCA organises symposia and seminars directly related to its purpose as well as training seminars and courses for private equity and venture capital industry practitioners. It publishes newspapers, periodicals, books and leaflets to promote its objectives.

IVCA has established a partnership with the European Venture Capital Association (EVCA), founded in 1987 and focused exclusively on the professional development of investment professionals.

Indian Venture Capital and Private Equity Association

C-7, Pashchimi Marg
Vasant Vihar
New Delhi – 110 057
India
Tel: + 91 11 4616 0389
Email: *info@indiavca.org*

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Bain & Company India Pvt. Ltd.

New Delhi office

5th Floor, Building 8, Tower A
DLF Cyber City, Phase II
Gurgaon, Haryana, 122 002
India
Tel: +91 124 454 1800
www.bain.com

Mumbai office

7th floor, Platina
Plot No. C-59, G Block
Bandra Kurla Complex, Bandra (E)
Mumbai, 400051
India
Tel: +91 22 4006 3850
www.bain.com

Key contacts in Bain's Global Private Equity practice

Global: Hugh MacArthur *(hugh.macarthur@bain.com)*
Europe: Graham Elton *(graham.elton@bain.com)*
Americas: Bill Halloran *(bill.halloran@bain.com)*
Asia-Pacific: Suvir Varma *(suvir.varma@bain.com)*
India: Sri Rajan *(sri.rajan@bain.com)*; David Mountain *(david.mountain@bain.com)*

Please direct questions and comments about this report via email to:
bainPEreport@bain.com

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