PE in India 2025
A 40-bn-USD decade beckons?

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Preface

India just completed her largest ever general elections. A business-friendly government with a clear majority is in place. While the stock markets began their celebrations a couple of months ahead, will the PE industry also revive and contribute to build up the India story over the next decade?

Based on conversations with over 40 partners and principals at PE houses, we believe that the answer is a resounding yes. This is not just because we all hope it to be so. The belief is that the new government will create a growth-oriented and consistently applied regulatory and policy environment and take appropriate administrative action to kickstart projects, and revive the investment cycle. The PE industry is poised to contribute to the Indian economy on a larger scale than earlier, due to a number of reasons which are fundamental to the industry's own evolution as well as to the state of entrepreneurship in India.

The PE industry, our respondents expect, will consolidate with perhaps 70 to 80 significant players. While venture and growth opportunities will continue apace, they see more buyout opportunities as India Inc deleverages and exits non-core businesses. While some respondents believe that Indian GPs will continue to be in a 'learn as you invest' phase, most believe that the lessons of investing in India have already been learnt.

Either way, GPs appear more confident of not only identifying the right partners, but also fully understanding what the promoter's objectives are, and how they can align those with theirs, to create desired returns.

There also exists greater realisation that considering the high entry multiples, hopes of multiple expansion at the time of exit are often misplaced. Considering the non-sequential growth India experienced over the last decade, earnings expansion is not guaranteed either and GPs today think of multiple exit mechanisms at the time of investment itself.

Consumer centric businesses have been big themes for equity investors over the last few years. While this is expected to continue, Indian consumerism is expected to embrace the rural markets as well over the next four to five years, as growth reaches the interiors of the country. Revival of the investment cycle is likely to spur investments in the infrastructure and manufacturing sectors over a period of time. PE investors also appear quite eager to support solid Indian companies, with a proven local presence, to expand in overseas markets.

Fund raising has been challenging for GPs in recent times, but this is expected to change as LPs regain confidence in the Indian market. Most of our respondents felt that while increased direct LP investing is likely in the near term, it is unlikely to be the norm. LPs may however co-invest with GPs in a number of cases.

Our respondents also had identified many 'change zones' in terms of the policy and and the tax and regulatory framework and anticipated several other challenges to PE growth which are captured in these pages. These challenges notwithstanding, we, at PwC together with our PE colleagues believe that the next investment cycle will represent a more mature phase of investing in India. Over the next 10 years, deals, both in size and nature, will increasingly turn closer to those seen in some developed markets. And it may be no surprise if we see over 40 billion USD of PE investments in 2025.

My sincere thanks to the over 40 GPs who shared their thinking with us. Their active and candid participation was key to our ability to pull together this survey. You'll see their comments throughout this report.

Sanjeev Krishan
Leader, Private Equity
PwC India

Contents

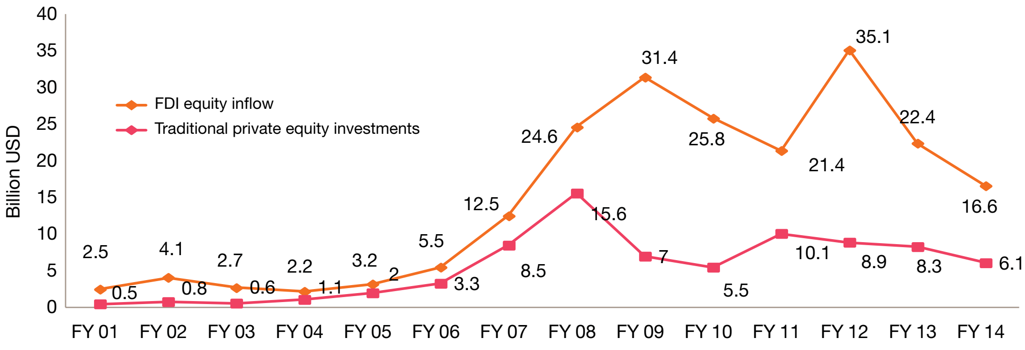
How has the private equity (PE) industry contributed to the growth of the Indian economy?

Total FDI (equity) inflow into India between April 2000 and December 2013 was 209.8 billion USD[1]. Of this, PE investments accounted for 78.3 billion USD[2], or about 37% of the total FDI inflow.

PE investors have been credited with ushering in an 'equity' culture in the country, while enabling Indian entrepreneurs to grow. They have helped nurture and scale companies such as Bharti Airtel, Paras Pharmaceuticals and the Shriram Group which are today leaders in their respective industries. PE investors have also contributed to numerous small and medium scale businesses and independent ventures. During 2000–2013, PE investors funded over 4000 businesses.

While taking minority positions, many PE investors have, in addition to providing capital, contributed to investee growth by bringing global operating experience to the table, where required. They have contributed significantly to the development of infrastructure despite the unproven PPP structure. Simultaneously, they have spurred the growth of India's service economy, funding the development of soft infrastructure, enabling higher consumption levels and boosting technology growth.

PE contribution to FDI in India

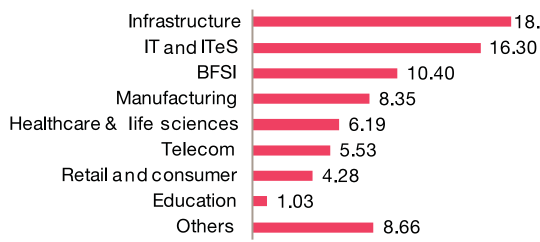


*FY 14 till Dec

Our survey results indicate that most investors are optimistic about India achieving a growth rate of 6 to 8% over the next investment cycle and there is no doubt that PE investors will play a key role in aiding this.

> *"The ultimate satisfaction for a PE investor is not only gaining manifold returns, but also realising that you have helped create a great company."*
> *– India head of a global PE fund*

PE investments: By sector (1998-2013)



1. Data from Department of Industrial Policy & Promotion
2. Excluding real estate deals, structured deals (except equity), and PIPE investments of sovereign funds.

Source: Venture Intelligence Database and PwC research

How does India's PE investing experience compare with China and Brazil?

02

PE investment in India and China started around the same time.

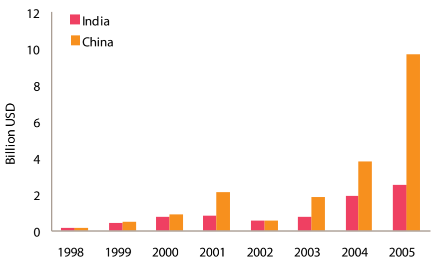
Whilst investments into India grew at a moderate pace reaching 2.6 billion USD by 2005, flows into China rocketed from 2004 onwards, reaching 9.6 billion USD in 2005, largely driven by investments in the financial sector, which attracted almost two-thirds of all capital inflows. Importantly, growth in China was also partly driven by the beginning of local currency funds in China, something that continues to elude India even today.

"The trend of local LPs and local currency funds is not going to be a major trend in India." – Partner of a global VC fund in India

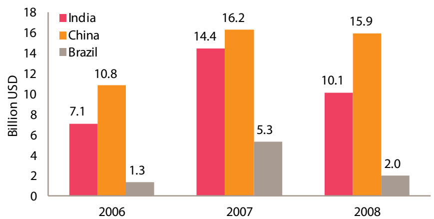
As China continued to register superlative year-on-year growth between 2006 and 2008 (before the Lehman crisis), investor appetite for India investment too began its upward curve as total PE flows soared to 7.1 billion USD in 2006 and to 14.4 billion USD in 2007 as GDP breached 9% for the first time.

PE in another similar market, Brazil, was in its nascent stage during this period and crossed the 2 billion USD mark in 2008.

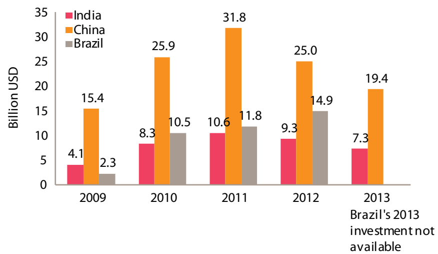
PE investments (1998-2005)



PE investments (2006-2008)



PE investments (2009-2013)



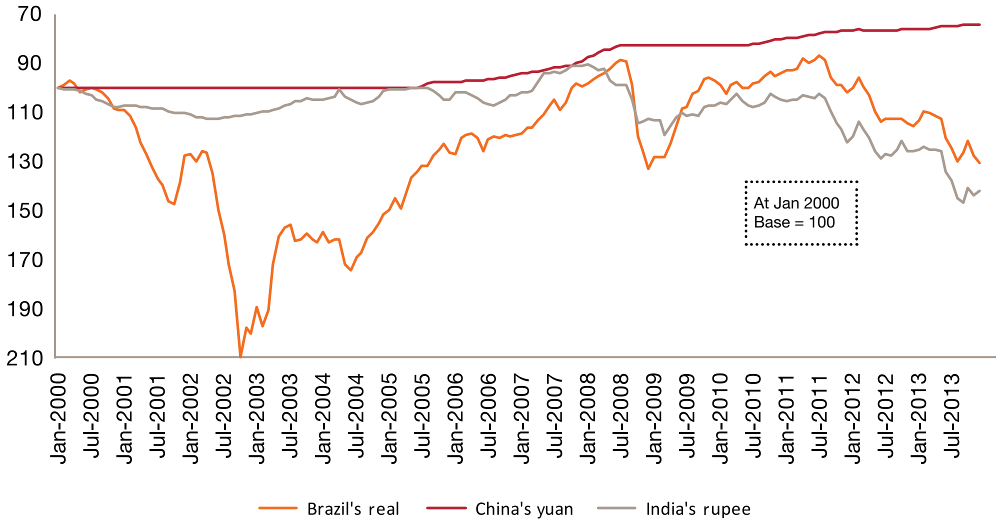
The bankruptcy of Lehman applied a temporary brake on investments into all emerging markets including India, China and Brazil. However, in contrast with these two countries, which picked up momentum from 2010 onwards, India continued to grow at a slower pace.

Whilst India's relative slowdown could be attributed to a number of factors including significant time delays in infra projects, attention-diverting corruption scandals and the slowdown in domestic demand, perhaps one of the primary factors was the clear lack of successful exits, exacerbated by the depreciation of the Indian rupee.

In simple terms, whilst the Chinese renminbi appreciated 26% between January 2000 and December 2013, the Indian rupee and the Brazilian real depreciated 42% and 30% respectively. A closer look at the movement of the India rupee across various time periods indicate that investments made in 2002-03 (when 1 dollar bought 48 rupees) and exited by 2007 (when a dollar bought 39.5 rupees) would have generated around 18 to 19% returns, merely from an appreciation of the Indian currency. On the contrary, investments made in 2007 (when a dollar was 39.5 rupees) is at least 40% negative in December 2013 due to the depreciation of the rupee since.

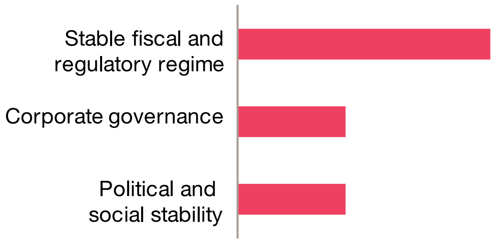
Half the respondents believe that PE investments in India annually will be more than 20 billion USD by 2025. About a quarter were of the view that it will cross 25 billion USD per year.

Movement of the renminbi, real and the Indian rupee against the US dollar



> *"A good investor keeps himself away from businesses which will be highly impacted by government decisions. There are several other areas which are not or are less impacted by such decisions and have potential to generate higher returns."*
> *– Head of a global PE fund in India*

Factors influencing future PE investment



Policy clarity

India's image as an attractive investment destination has, over the last few years, been impaired by frequent policy reversals, corruption scandals and indecisiveness. The retrospective change in tax laws and GAAR, for instance, sent out a negative message to the investor community. This combined with the Supreme Court's blanket cancellation of all 2G telecom licences has severely hurt the country's image as an investor-friendly destination.

Not surprisingly, an overwhelming majority of respondents believed that clarity and stability in the fiscal and tax regime were the most critical factors for attracting foreign capital and for India to remain as an attractive investment destination in the years to come.

Strong and investor-friendly regulatory framework

India's regulatory regime requires numerous approvals and compliances, which often results in considerable delays in the consummation of deals. This is particularly true for pharma, retail and financial services, popular sectors for investment among the PE community.

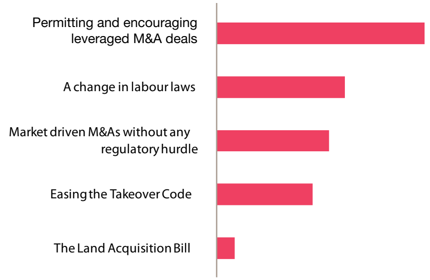
Specific to retail, while 100% foreign investment in single brand is now permitted, the requirement of a minimum (30%) domestic sourcing, continues to remain a sore point. The policy on multi-brand (capped at 51%) remains complicated with the added rider around its applicability to cities over a certain population threshold. Further, by making it a state subject, the government has made FDI in retail nearly impossible. Foreign investment in pharma has remained a contentious issue. Practically every foreign investment in an existing domestic API or formulations company requires FIPB approval. The heavily regulated financial services sector seems to be at a point of inflexion with initiatives such as the financial inclusion programme, new banking licences and fully-owned subsidiaries by foreign banks. However, with caps on foreign investment and regulatory clearances at every stage, the government has not made it easy to excite foreign investment into India.

> *"By definition, PE capital is long-term and transformational. It needs to be treated better than FIIs."*
>
> *– India head of a global buyout fund*

Leveraged financing

At least half of our respondents believed that permitting leveraged financing can change the deal landscape in India dramatically. India does not permit leveraged M&A deals except in the case of distressed asset classes, an exemption recently made by the RBI.

Factors likely to encourage M&A deals



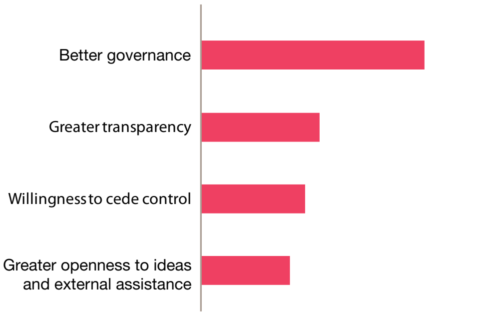
Has corporate governance proved to be a hurdle for PE investments?

Whilst the lack of policy clarity was identified by our respondents as the single biggest impediment to doing business in India, poor corporate governance was identified as the most worrying factor when evaluating targets.

Indian businesses are largely family-owned. There is often a lack of a formal governance structure with owners also being the managers. Decisions are centralised with the quality of information often lacking depth and clarity. Lack of transparency and a clearly articulated strategy is often the case. Companies looking for PE investment are not investment-ready and the management team in many cases, sub-optimal. Not surprisingly, promoters are uncomfortable with their decision-making independence being clipped. If persuading promoters to dilute their stake in their family business is a challenge, getting them to accept a more corporate structure with key decisions requiring consent from investors is even tougher.

But the good news is that investors see the emergence of better governance going forward. They believe that there is an increasing realisation among the promoter community that better governance will ensure certainty of deal closures and in shorter time periods.

Behavioural changes PE investors expect from promoters



Could general partners (GPs) have performed better?

Much to our surprise, most fund managers identified the lack of discipline among the GP community as one of the key factors for the present situation of the industry. Many were quite forthcoming in sharing the blame for encouraging 'price' as the only determinant for doing deals in the minds of the promoters.

> *"Overpricing of Indian assets has been a huge issue. It is almost impossible to get a return if you pay about 30 times PE multiple unless the company has disruptive growth."*
> *– India head of a domestic PE fund*

Simply put, the lack of leverage means that there is no segmentation of funds as growth vs buyout. In other words, even traditional global buyout funds have had to tailor their approach and compete in the otherwise crowded growth capital space. With poor financial reporting, off-balance sheet items and related party transactions the norm, a 'clean' deal often commands a premium, which in the long run has proved to be unsustainable, as an increasing number of funds have realised.

Specifically, GPs identified the following areas as their possible 'failings':

Pressure to do deals: With capital at hand, fund managers often found themselves having to bid aggressively just to be noticed and counted, lest they did not get invited to future auction processes. "We were blinded by the Indian consumption story and made some bad choices" was the common refrain.

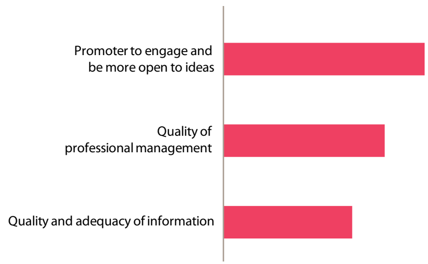
Not factoring the rupee depreciation: One of the mistakes funds believe they made was to not fully factor in the impact that a depreciation of the rupee could have on their returns. With dollar-denominated capital, LPs were looking for dollar-denominated returns and with the rupee taking a downward spiral between 2008 and 2013, most funds are sitting on negative returns.

> *"The whole idea of investing in an emerging market is to get the returns that will compensate any downside in the currency."*
> *– India head of a domestic PE fund.*

Disconnect in fund manager-promoter dynamics: The final area where fund managers felt they got it wrong was: (a) not clearly communicating what they were expecting from promoters; and (b) not fully understanding what the promoter's objectives were. In short, there was often a serious disconnect between the investor and the promoter's expectations from the partnership.

GPs feel that 'reluctance or resistance from promoters to engage and be more open to ideas' is what bothers them today, which they however, expect to be less of an issue over the next decade.

Anticipated areas of improvement: Investor-investee relationship



What should be the funds' focus for success in the future?

06

The entry valuation has to be right

Most funds are finding it increasingly difficult to justify the investment calls made in the past. Investors acknowledge that in a number of cases, the competitive process pushed them off-track, which caused the aggressive bidding behaviour. As one interviewee cited, "The basic principle of PE investing is that it is a 3-5-7 year capital. In other words, PE cannot hinge on momentum."

As the more stable GPs complete their first investment cycle in India, there is a general sense that the experience gained from it will help navigate the next one better. There is greater realisation that with high entry multiples, the hope of a further multiple expansion at exit is often misplaced. In other words, the focus has to be on 'earnings expansion' rather than merely hoping for 'multiples expansion'. This means working with investees to create value for both parties.

Importantly and notwithstanding the competitive tension to do deals for the really good assets, a number of funds are now not hesitant to walk away from a process if they think the valuation is too high or unrealistic.

"What went wrong for India during the 2007-10 period is excessive capital coupled with aggressive GPs and promoters."
– Principal of a domestic fund

Aligning GP-Promoter interest and objectives

Funds are realising that promoters are not necessarily led by a return objective and the pace at which promoters implement change is also generally slow. For example, promoters are often wary of bolt-on acquisitions or reluctant to consider markets beyond their traditional geographical reach, all pointing to the growing importance of clear articulation of objectives at the beginning and the need to be realistic on how far promoters are ready to stretch.

Another area which has increasingly come under debate is the value that a PE fund has brought to the investee. Despite a board seat, most promoters feel that PE funds have played a limited role in imparting experience to help scale the business to the next level. The lack of leverage as a tool to improving returns combined with high entry-valuation multiples means that having a strong operating performance with scalable systems and sound corporate governance structures are fundamental in helping business deliver desired growth. Most PE funds historically, left it to business owners to generate growth. However, this is changing rapidly, as fund managers are increasingly spending a lot more time with their investee companies. GPs are more involved in hiring key talent at their investee companies at CXO positions. They also monitor progress closely and participate in strategic decisions with renewed vigour.

"When you are in an evolving and emerging country such as India, there will be a play for an opportunistic manager, without any fundamental value creation. But the entire PE industry cannot function on that basis.

True value creation is essential for generating return." – India head of a global PE fund

Upfront planning for exits

Most GPs in the past believed that growth was more or less certain. However, this myth has been busted over the last few years. With the capital markets taking a complete u-turn, investors have realised that there is much homework to be done on achieving exits. This means that GPs need to take a specific view of their investees' anticipated financial condition at the end of the 3-5-7 year period while debating potential headwinds and regulations at the time of making the investment decision. In short, investors are spending more time planning exits.

Half of the respondents said that strategic sales will be the primary form of exits in the future.

How has the nature and focus of PE diligence changed?

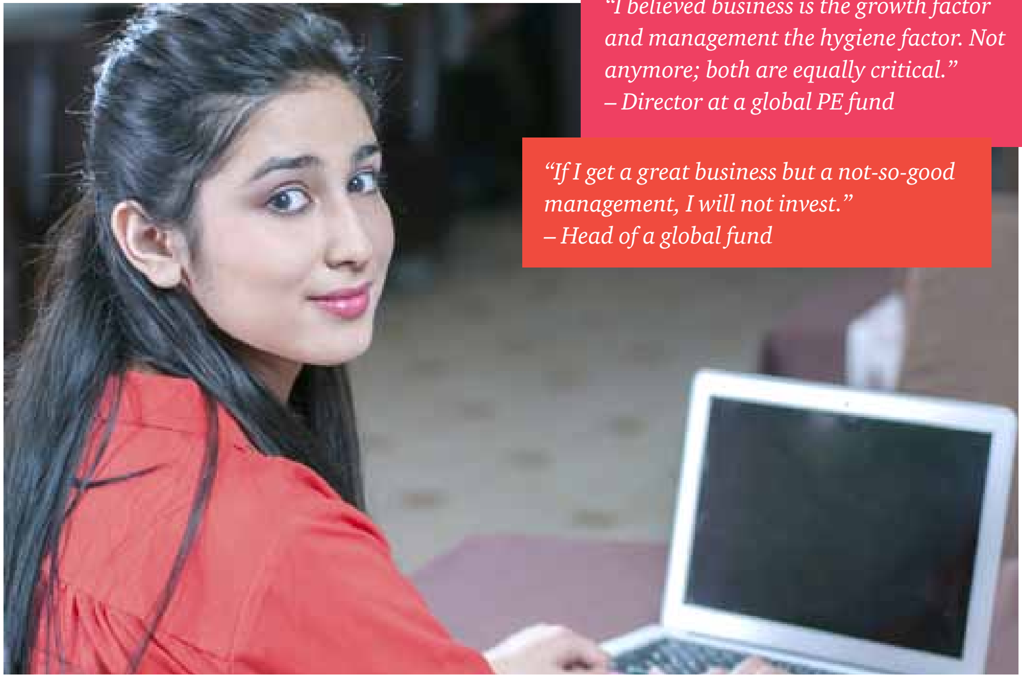
Funds have never before emphasised the importance of diligence as they do today. Even before they do a deep dive into the business, PE funds attempt to get feedback on promoters, and whether they'd be credible partners. Apart from the usual background checks on the promoters and the company, they try and learn from the experiences previous investors and business partners have had. Considering the number of first-generation entrepreneurs seeking funding, they also focus on understanding their previous operating experience, and make a distinction between a good incubator and a good operator.

The diligence itself has become intensive with much focus on getting to know the sector (including sub-segments there-of) well, which means speaking to other operators in the industry, point-of-view discussions with advisors and in some cases, learning from the previous experience of investors in the sector. They tend to spend a lot of time with proposed investees as well, to firm up their investment thesis. Strategic and commercial diligence agencies are asked to vet the thesis on a more usual basis. Financial due diligence now also includes additional elements, and some PE funds ask for specific forensic procedures to be included as part of work scopes. Managers are now actively working towards ensuring they get baseline numbers right as investment committees take a closer look at the findings of the diligence process. As a result, if they anticipate challenges in doing complete diligence (owing to process or data limitations) to their satisfaction, they tend to move away.

"Most fund managers investing for the first time don't realise that 'almost 80% of the diligence' should be done on the entrepreneur. A good entrepreneur will mean that an average business will deliver good returns."
– Partner of a VC fund

"I believed business is the growth factor and management the hygiene factor. Not anymore; both are equally critical."
– Director at a global PE fund

"If I get a great business but a not-so-good management, I will not invest."
– Head of a global fund



Is the market likely to segment further? Is India increasingly becoming a buyout market?

A significant number of respondents believe that buyouts will be the biggest investment theme over the next 10 years.

The general perception is that the market will consolidate to approximately 75 to 80 noticeable investors, with a greater degree of segmentation between the different classes of investing: i) the large buyout funds ii) the late growth investors iii) early stage investors; and iv) the venture capital investing community.

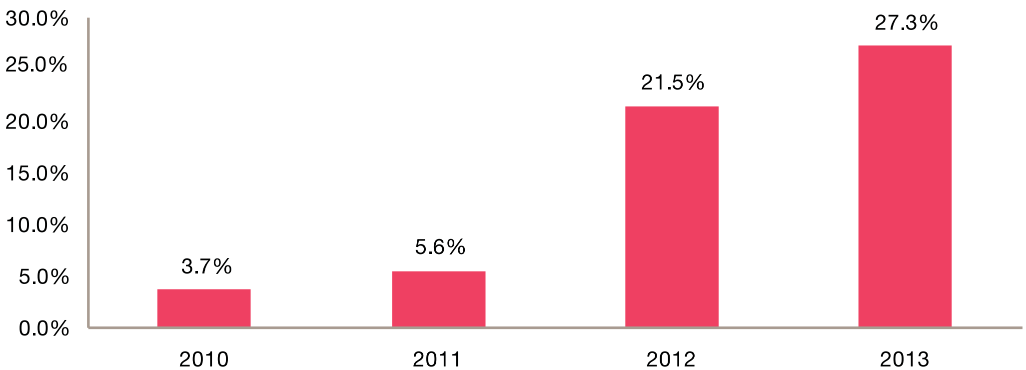
With fewer players, pricing and deal terms are expected to get more realistic. While adequate opportunities for venture and growth capital will continue to arise from the next wave of professional entrepreneurs, there is a general belief that large funds are likely to see greater buyout opportunities than ever before, as the over-levered corporate India seeks to inject fresh equity by selling its 'non-core' assets or giving up control.

Change in promoter behaviour is also expected to trigger increased buyout opportunities. In other words, although a large number of Indian businesses have scaled up over the last investment cycle through venture or growth capital, they are finding the next level of growth an uphill task, not just due to the lack of capital, but also the lack of management skills and the necessity of a 'fresh thought process'. This has resulted in a number of Indian promoters expressing willingness to cede control. In a number of cases, 'succession planning' has triggered the desire to cede control, particularly where the next generation is reluctant to manage the family business. Also the next-generation entrepreneurs are more likely to cede control or let go of their businesses and do not necessarily struggle with variables such as 'emotional attachment' to their business as the older generation.

"It requires special entrepreneur DNA to think like the owners. Most PE funds are not in that mode. Hence, it will be interesting to see how PEs will grow and evolve to place themselves in the entrepreneurs' shoes."
– Head of a domestic PE fund

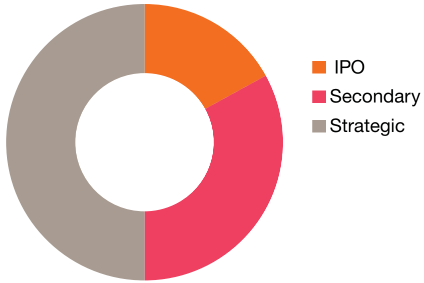
A number of respondents also believe that some LPs are likely to start investing directly in India or co-invest with GPs or both. This could act as a trigger or a buyout opportunity for small or medium size-funds, who historically have had to contend with minority stakes in the absence of availability of large capital or inability to take the entire risk on their books or both.

Buyout as a percentage of total deal value: 2010 to 2013



What will be the most likely form of exit over the next investment cycle?

Most respondents believe that as the investment climate in India turns business-friendly, strategic investors, both overseas and domestic are most likely to provide them exit. A number of early stage investments will continue to find financial buyers, and provide 'secondary' exits. While a number of respondents believe that IPOs will stage a comeback and provide an opportunity to exit some of their existing investments, most of them do not 'trust' an IPO exit. Timing becomes very critical in an IPO exit, and this is not entirely in their control.



Gazing in to the crystal ball: What will keep PEs invested in India in 2025?

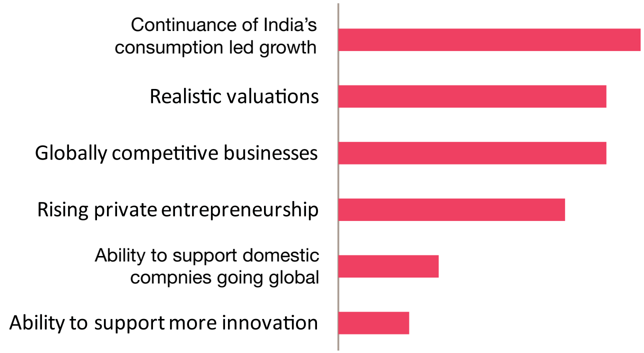
Respondents identified few factors of almost equal importance as triggers for them to stay invested in India by 2025.

Continuance of consumption led growth in India excites the majority of investors. Apart from urban consumerism, PE fund managers believe that over the next four to five years, rural consumption will grow manifold, as growth becomes more inclusive. Together with the welfare schemes announced by the government, this is likely to put more incomes in the hands of rural India.

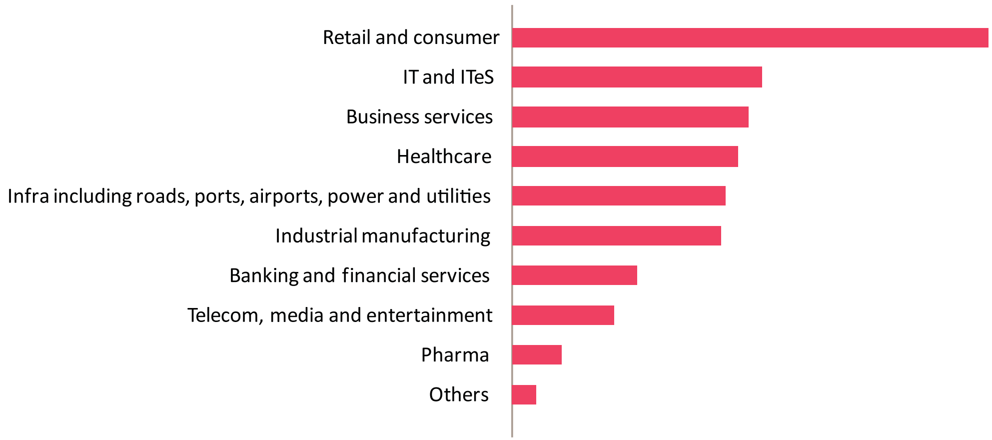
PE managers believe that there are a number of Indian businesses that are globally competitive on account of more than two decades of liberalisation. The revival of the investment cycle, together with its consequential impact on spurring manufacturing growth is likely to give a fresh impetus to these businesses. A majority of the respondents believe that this is likely to result in opportunities for them to invest in scaled businesses as they grow in India and globally. PE funds are in particular keen to support global Indian businesses as long as they continue to leverage India's low-cost manufacturing and service base. They are of course also hoping for valuations in India to get more realistic.

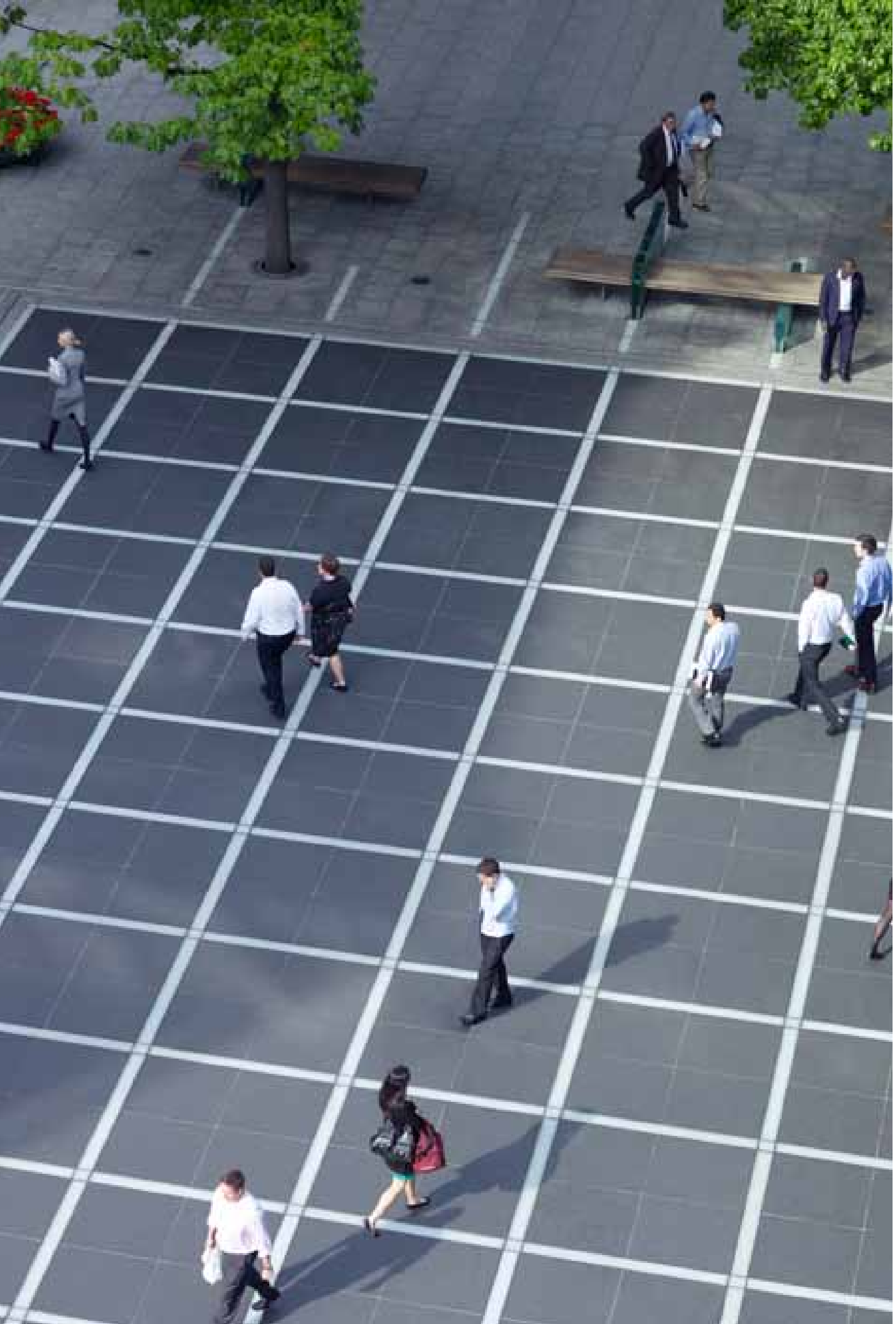
In terms of sectors, PE fund managers believe that consumer centric businesses will be their biggest focus, followed by sectors such as financial services which mirror the overall anticipated growth in the Indian economy. They also expect infrastructure to be back in investment focus in the next two to three years, and eventually contribute significantly to investments over the next 10 years.

Factors likely to drive future PE investment



Top sectors for PE investment by 2025





Glossary

API	Active pharmaceutical ingredients
BFSI	Banking, financial services and insurance
FDI	Foreign direct investment
FIPB	Foreign investment promotion board
GAAR	General Anti Avoidance Rules
GDP	Gross domestic product
GP	General partner
IPO	Initial public offer
IT/ITeS	Information technology and information technology enabled services
LP	Limited partner
PE	Private equity (funds)
R&C	Retail and consumer

Data analysis

The data used in this report is for the period January 1998 to December 2013.

Indian Deal Data has been mainly sourced from Venture Intelligence and PwC Research.

AVCJ and ABVCap Data are used for China and Brazil deals.

DIPP database is used for FDI data.

Real estate deals, structured deals (except the equity part) and structured finance by PE funds, PIPE deals by sovereign funds, etc are excluded from PE investment data.

The report is based on face-to-face interviews with private equity funds' India CEOs including global and domestic funds.

We have used the results of a survey conducted among the private equity funds' top management as well.

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