

BEST FEATURE IN BUSINESS JOURNALISM



Kripa Mahalingam

Kripa Mahalingam won the PoleStar Award for her article, 'Buyer's Market', which appeared in Outlook Business, dated March 2013.

Kripa Mahalingam is the Associate Editor of Outlook Business, one of India's premier business magazines. She has over 10 years experience as a journalist and has reported on diverse areas like private equity, emerging businesses and large companies. Kripa started off by primarily covering the stock markets before moving on to other sectors.

Prior to her stint with Outlook Business, she worked with Cholamandalam Securities and IDBI Bank performing roles as an equity research analyst and investment advisor. Her initiation to writing was at her first job at Business Standard, where she wrote for the magazine's weekly edition on 'investment'. Kripa today extensively uses her understanding of equity research when it comes to reporting on other sectors as well.

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Buyer's Market

A number of private equity investors are stuck in the middle, struggling to find profitable exits

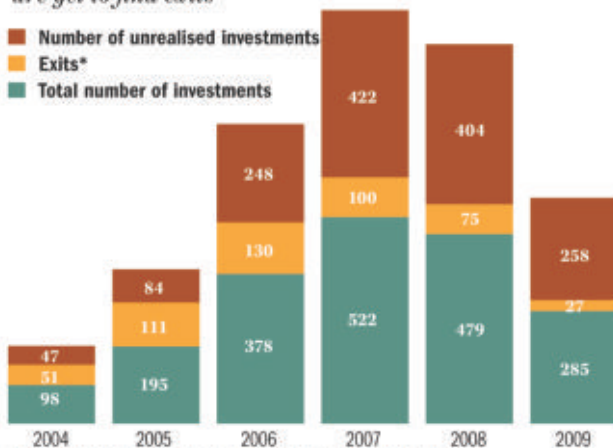
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No buyer in sight

Nearly 75% of the investments made during 2004-2009 are yet to find exits



* Exits pertain to the year of investment and not cumulative exits for that year
Source: Venture Intelligence

Too much of a good thing can be bad. Take the case of Indian private equity. The initial boom between 2000 and 2005, which saw stellar fund performance, meant India was no longer the land of snake charmers, but the place to be. Be it Warburg Pincus' 2005 exit from Bharti Airtel, where the firm made its money six times over, ChrysCapital's exit from Suzlon, where the firm multiplied its investment 10 times over, or Baring's exit from Mphasis, where the firm invested Rs 48 crore but took home a whopping Rs 1,150 crore, making money never looked so easy. Investors and bankers, some of them first-time visitors with little clue about India, came in from as far as Iceland to invest in India. Too much money in the hands of inexperienced managers ensured that the euphoria in the public markets spilled over to the unlisted space, pushing valuations to dizzy levels. "It seemed like this gravy train that you hopped on to, put \$1 in and got \$3 back. Investors assumed the growth story was linear," says Nainesh Jaisingh, managing director, Standard Chartered Private Equity.



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**Nainesh Jaisingh, MD,
Standard Chartered PE**

Fund managers sold the India story to global investors and how. More than \$32 billion was invested between 2006 and 2008, almost five times what was invested since the beginning of the decade. Before the gold rush, in early 2006, there were only 75-odd funds; by end-2008, there were over 200. With the capital influx much higher than the market could handle, a race ensued to snap up companies. Funds ended up outbidding each other and paying bizarre valuations. “This business is all about getting your entry multiple right. This is difficult when valuations are stretched,” says Nitin Deshmukh, CEO, Kotak Private Equity. And at times, shortcuts were taken. “Most funds did not understand the risks that came with scaling up a business and the executions risks involved. Since they were running after the same deal, some of them didn't do enough due diligence,” says the India head of a US based limited partner (LP) who didn't want to be named. Limited partners are investors who invest in private equity funds. They can be pension funds, endowment funds of universities or ultra-rich family offices.

Apocalypse now

The orgy lasted till the world came crashing down on back of the 2008 sub-prime crisis. Lehman went out of business and Iceland barely survived. The unprecedented slowdown threw out of the window all growth assumptions that, on an ExcelSheet at least, had looked easy to achieve. It also means that thanks to fancy valuations they paid during the market peak of 2007, many private equity investments are still underwater. “2006-2007 was a tough year for the industry, not just in India but also globally. Deals were done at high valuations and exit options were not properly evaluated,” says Shashank Singh, managing director, Apax Partners India. “In the majority of cases, an IPO was the only exit option negotiated and that has not worked out.”



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In 2006-2007, deals were done at high valuations and exit options were not properly evaluated. An IPO was the only exit option negotiated”

**Shashank Singh, MD,
Apax Partners**

According to E&Y research, out of the 461 exits in the past three years (2009-12), only 50 exits were through an IPO and even there, the returns have been nothing to write about. In the past two calendar years there have been 10 exits through IPOs including Bharti Infratel which raised \$760 million. Temasek, KKR, Goldman Sachs and Citigroup invested \$1.25 billion in 2007 to acquire a 14% stake in Bharti Infratel at Rs 220 per share. Five years on, they have not much to show for their investment, with the stock currently quoting at Rs 205. “Many attribute the ability to exit to market conditions but as an LP we attribute it to skill. Apart from a few, funds haven't returned enough capital,” says Nirav Kachalia, managing director, Morgan Creek Capital Management, a New York-based global investment firm that has invested in two funds in India.

So far only 494 of the 1,957 deals made during 2004-09 have been exited according to Venture Intelligence, a private equity data bank. This of course does not include the 1,200-odd investments worth \$19 billion that have happened during 2010-12. In the next five years, then, the industry will not only have to cut through a considerable deal backlog but also work on exits for the fresh investments made. “In India, a lot of invested capital is challenged from a return perspective. Even where the returns are good on paper, a liquid exit is not a given” says Pavninder Singh, managing director, Bain Capital.



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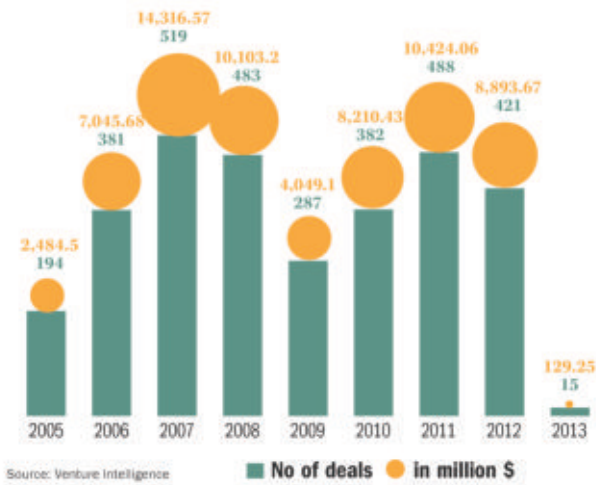
If you do minority deals, you are reliant on the market for an exit. But if you do control deals, you have the option of strategic exits”

**JM Trivedi, partner &
head, Actis South Asia**

In 2006-08, about \$32 billion of private equity was invested and there is no way the IPO market — which in its best year, 2007, raised \$8.65 billion — can absorb the capital waiting to get out. “If someone is hanging on to their hat, hoping for a great IPO exit while sitting in some nondescript mid-cap company, they are deluding themselves,” says Standard Chartered's Jaisingh. Even in PIPE (private investment in public equity) deals, funds haven't been able to exit their investments. Many private equity funds placed their bets on mid-caps, hoping to ride the expansion in their earnings growth and market cap. Now as their businesses take time to scale, the stock liquidity remains low, as in the case of Allcargo Logistics where Blackstone has invested, Himadri Chemicals where Bain Capital has invested, Nectar Lifesciences, where New Silk Route Advisors (NSR) has invested, or GOL Offshore, where Carlyle has invested. “You can't just press a button and sell mid-cap stocks in the market. Some of the funds overestimated their ability to liquidate just because the stocks were listed,” says Dhanpal Jhaveri, CEO, Everstone Capital, which manages \$1.5 billion and focuses only on private deals.

Lemming rush

Nearly 50% of investments made were between 2006-08



First in, first out

Only a handful of funds, such as ChrysCapital, Actis, Warburg Pincus (despite its misses) and General Atlantic, have had big bang exits, although India Value Fund and ICICI Venture have also had some good exits in their earlier funds. While peers are quick to point out that many of ChrysCapital's profitable exits have been in listed large-cap companies (Infosys, Shriram Transport, Mahindra Financial Services and Idea Cellular) rather than unlisted private firms, return-starved LPs are not complaining. In fact, they chose to back the fund for the sixth time when it raised \$510 million in 2012. "When valuations heat up in the private space, we have the option of backing good entrepreneurs with quality management in the listed space as growth investors. This strategy has worked very well for us," says Gulpreet Kohli, managing director, ChrysCapital. According to him, it is crucial to know when to take money off the table because public markets in India tend to be cyclical. "We have been disciplined about our exits. We have a narrow window for exits and if we are not disciplined, we will miss out on opportunities," he says.



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You can't come for quarterly board meetings and expect results. We have to work with promoters to ensure things go as planned"

**Dhanpal Jhaveri, CEO,
Everstone Capital**

While a lack of exits haunts the PE industry, it has also discovered that it has to work harder to raise new money. The days of easy money are over and generating a superior return will be a function of a much more hands-on approach says JM Trivedi, partner and head, Actis South Asia. He adds, "The

arbitrage between entry and exit multiple is no longer there. In the absence of a multiple expansion, tangible value can only be added by significantly improving operational metrics."

Actis, which has invested more than \$1.2 billion in over 55 companies since 1996, prefers to go after control deals where it can work closely with the management to scale up the business. Its biggest success came in 2010 when it sold its 60% stake in Paras Pharma for \$457 million. That bounty was three times its original investment of \$145 million in 2007. "If you are doing minority growth capital deals, you are reliant on the IPO markets for exit. But if you do control deals, then you have the option of strategic exits," Trivedi says.

In India, according to E&Y, control deals still form less than five per cent of the deal mix with minority growth deals and PIPE deals still forming the major chunk. "India remains a growth market, so promoters are unwilling to give up a majority stake in their company. Only in companies where there is no succession plan or the promoter's immediate family is not interested in running the business, are promoters willing to sell out," says Bharat Banka, managing director, Aditya Birla Private Equity.

In a growth capital market like India, most PE funds operate as minority shareholders. "You can't just come for quarterly board meetings and expect results," says Jhaveri. "Formulating strategies is easy but it is the execution that is challenging. As investors we have to work with promoters closely to ensure things go as planned."

I said, you said

But things don't go always to plan. Private equity investors have realised that transparency is not a given for private businesses in India. As for first-time entrepreneurs who ran their business as their personal fiefdoms and viewed private equity interchangeably with bank debt and public equity, they resented that some of the investors came waving agreements in their faces, demanding change. Soon it became an "us versus them" scenario, with PE investors complaining of the lack of corporate governance and promoters complaining of too much interference. "You need to know when to help and when to step back as a partner. There has to be an alignment of interest with the promoter," says Gopal Srinivasan, chairman, TVS Capital. In some cases the experience has been a bitter one, with the funds having either to write-down or write-off their investment. Take the case of Bain and TPG, which had invested \$60 million and \$26 million, respectively, for a 45% stake in kids' apparel manufacturer Lilliput. According to sources, the firms chose to write-off their investment after they discovered financial irregularities in the firm's accounting followed by an acrimonious court battle. While refusing to comment on that specific deal, Bain's Singh, says, "I think a big part of minority growth investing is who are you partnering with and what their aspirations are. If you get that wrong, there is a chance it will not be a good investment."

Before the gold rush in 2006, there were 75 private equity funds. By end-2008 there were over 200

Mumbai-based Biotor Industries is another case in point. In 2008, Morgan Stanley Private Equity picked up a 30% stake in the bio-fuel firm for \$40 million, which it later hiked to 45%. In 2011, the company was accused of committing serious fraud and forging documents to avail loans worth Rs 1,500 crore by three banks. With the company going out of business soon after, the firm is now looking at a Rs 200-crore loss. If Lilliput and Biotor are two instances of ugly divorces, there have been many cases of uneasy marriages. Consider Nilgiris, where Actis picked up a controlling 67% stake in 2006 for \$65 million. It's been a tempestuous relationship ever since. Sources say both parties have sparred over how to run the business, raising of capital through a rights issue and exit options. Actis without alluding to the Nilgiris deal points out that wherever differences have cropped up, the fund has managed to sort it out and work with the promoter. There are similar stories in KS Oils and JRG Securities, where investors — NSR and Baring, respectively — and promoters have been involved in public slug fests.

Redemption time

As their investments take time to scale up, the clock is ticking for private equity funds. Failing to exit in time would mean the next round of fund raising may not happen. In the past, some firms have managed to raise their second round of funds despite not having too many exits but, this time, it's different. "Some of the LPs are disappointed with the illiquidity and lack of exits in the market, and the high management fees charged for what are often public investments," says Apax's Singh. LPs concur with that. "India has been under-performing relative to other emerging markets and that is not going to change in a hurry. Most of the funds need to focus on better fund execution and correct their high fee structure, which is killing the returns for LPs," says the India head of a US-based LP. Most of the industry operates on a 2/20 model where they charge a 2% fund management fee and a carried interest or performance fee of 20% on the returns generated over the agreed hurdle rate. But in today's scenario, for some of the funds, carried interest is a bit like God. They know it is there, but nobody has really seen it.



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Right now valuations are starting to look expensive, not in absolute terms but relative to growth, due to fund flows"

**Neeraj Bharadwaj, MD,
Carlyle Asia Partners.**

According to LP some funds have raised money just because it was easy to, without exploring whether there were enough opportunities in the market. "There are investment opportunities but they are not as large as you would think. Once you have too much money in your fund, you are under pressure to deploy those funds," he adds. A few funds have returned money to their investors due to lack of investment options. ChrysCapital and India Value fund have returned \$300 million and \$100 million respectively to their LPs.

The rupee depreciation is not helping their cause either. Since almost 80% of funds raised since 2007 are dollar denominated, the 25% depreciation has knocked off a significant chunk of the capital. "Apart from the high valuations paid in 2006-07, the currency depreciation in the subsequent years didn't help either. In dollar terms, the realised returns on some of the investments are much lower," says SM Sundaram, partner, Baring Private Equity Partners.

The countdown

So, what's next for the industry? In the next 12-18 months, given a discriminating public market, funds will actively focus on exiting their investments via trade sales. Secondary sales are already on the rise, increasing from \$122 million in 2009 to \$1.6 billion in 2012, the largest deal being the \$1 billion sale of

Where big money was made

Good exits have been a function of attractive entry valuations and timing

EXIT YEAR	PE INVESTOR	INVESTEE COMPANY	AMOUNT INVESTED	EXIT AMOUNT	RETURNS	INVESTMENT YEAR
2004-05	Warburg Pincus	Bharti Airtel	\$292 million	\$1.9 billion	>6X	1999 - 2001
2006	Baring	Mphasis-BFL	\$10 million	\$250 million	>25X	1998
2007	Actis	Punjab Tractors	\$60 million	\$144 million	>2.4X	2003
2009	ChrysCapital	Shriram Transport Finance	\$27 million	\$304 million	>11X	2005
2010	Actis	Paras Pharma	\$145 million	\$457 million	>3X	2006
2011	ChrysCapital	Idea Cellular	\$108 million	\$170 million	>1.5X	2006
2011	Blackstone	Intelenet	\$200 million	\$634 million	>3X	2007
2011-12	Warburg Pincus	Kotak Mahindra Bank	N/A	>\$661 million	>3X	2004-06
2012	Carlyle	HDFC	\$650 million	\$1.11 billion	>1.7X	2007
2012	General Atlantic & Oak Hill	Genpact	\$550 million	\$1.62 billion	>3X	2004

Source: company, media reports



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A big part of minority investing is who you partner with. If you get that wrong, there is a chance it will not be a good investment"

Pavninder Singh, MD, Bain Capital

Genpact, where General Atlantic and Oak Hill sold their stake to Bain Capital. While selling to another tough bargaining private equity investor is not always preferred, funds under pressure to show exits are now more open to secondary deals. Standard Chartered PE used the route for Endurance Technologies, an auto component company where it had invested \$50 million in 2007. The firm was initially looking to exit through an IPO in 2010, but couldn't. Eventually, Actis picked up the stake for \$71 million. Similarly, of the four IPO exits that Kotak Private Equity had planned in 2010, only one sailed through; for the rest it had to find exits through strategic and secondary sales.

What should help is that India-dedicated PE funds are entering 2013 with an estimated \$12 billion worth of 'dry powder' (industry speak for unutilised funds), albeit lower than the \$17 billion at the start of 2012. "We will be happy to look at some of the secondary's ourselves," says Vishakha Mulye, managing director, ICICI Venture. "Many companies haven't scaled up as expected due to the slowdown, but they are still interesting companies to invest in. You can hold on for the next three or four years and then take them public." Specialist secondary firms such as Paul Capital, Partners Group and Collier Capital are also on the hunt. Secondary funds provide a liquidity option to existing LPs and also provide private equity exposure to new investors. "There are discussions going on. You could see funds buying out an LP's position in a portfolio at 40-50 cents to the dollar," says a private equity head who didn't want to be named.



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The risk premium for India has increased because of political and economic uncertainty. So, raising new funds will be challenging"

SM Sundaram, partner, Baring Private Equity

That enthusiasm solves only part of the problem as many funds are finding it difficult to raise a second round of funding. The number of active funds has come down to 100 (excluding the early stage funds) from about 250-odd in 2010. Then, even in secondary deals the bias is towards companies involved in catering to domestic consumption while most investments made during the market peak were in the infrastructure sector. Given the execution delays in the sector, most funds are now wary of committing money there. PE investors put in almost \$6 billion in energy, power and infrastructure between 2006 and 2008. In 2011-12, the infra space saw exits worth just \$227 million. For the rest of the investment, there seem to be few takers.

Already, the LPs are an uneasy lot, thanks to the lacklustre performance of the funds here as well as the regulatory and economic climate — the general anti-avoidance rules (GAAR) proposed in the Budget last year especially spooked global investors. While the subsequent recommendation to defer it for another three years and clarifying the parameters where it can be applied did soothe some ruffled feathers, the damage was done. "The risk premium for India has increased because of the uncertainty in the political and economic environment. So, raising new funds will be challenging since LPs will look for investors with track record of managing multiple complexities,"

Where it was lost

Deals that did not work out are largely weak businesses that wilted under tough business conditions

INVESTMENT YEAR	INVESTOR	INVESTEES	AMOUNT INVESTED	INVESTMENT STATUS
2000-04	Warburg Pincus	Moser Baer	\$220 million	Has sold 80% of investment in 2012 at over 90% loss
2005	Temasek	Welspun India	\$27 million	Exited in 2012 at 50%+ loss
2005	Warburg Pincus	Vaibhav Gems	\$53 million	Exited for ₹18 crore in 2011, making a loss of 92%
2006	Warburg Pincus	Amtek India	₹200 per share*	Sold over half its holding in 2010 at over a 60% loss
2007	Blackstone	NCC	₹202.5 per share*	Stock quotes at ₹42.65 and the loss stands at 79%
2007	Warburg Pincus	Punj Lloyd	₹275 per share*	Stock quotes at ₹50.70 and the loss stands at 82%
2007	Blackstone	Gokaldas Exports	₹275 per share*	Stock quotes at ₹65.30 and the loss stands at 76%
2008	Nalanda Capital	Mastek	\$16 million	Exited the investment in 2012 at over a 50% loss
2007	Carlyle	Great Offshore	₹860 per share*	Stock quotes at ₹79 and the loss stands at over 90%
2011	Apollo Global	Welspun Corp	₹225 per share*	Stock quotes at ₹93.80 with losses standing at 58%

Note: Stock prices are as on Feb 6, 2013; Source: company, media reports;

*Price at which stock was picked up

says Baring's Sundaram. "Investors will walk away if they perceive inconsistency in policy implementation, which is what happened in the first half of 2012."

As fund raising is now tough, the number of active funds has come down to 100 from 250-odd in 2010

The going is expected to be tough for the industry in the next 12-18 months. "Happy stories don't make for great learning experiences. There will certainly be rationalisation of funds and people in the current environment," says Standard Chartered's Jaisingh. Lessons have definitely been learnt. Funds are strengthening their own teams by inducting more operating partners who can help scale up their portfolio companies. Deal cycles are also getting longer with more emphasis on due diligence and exit options. Funds are also doing a double take as

valuations have moved higher over the past year. "Right now valuations are starting to look expensive not in absolute terms but relative to growth since they are getting benchmarked to public market valuations," says Neeraj Bharadwaj, managing director, Carlyle Asia Partners. "I don't think the fundamental performance of companies justifies the market being at current levels, it is being driven by fund flows."

Meanwhile smaller funds are already feeling the heat. Blue River Capital (founded by ex-ChrysCap managing director Shujaat Khan in 2005) is finding it difficult to raise its second fund. Eight Capital wound up its private equity business to launch a NBFC; and Kubera (founded by ex-Cognizant chairman Kumar Mahadeva) has shut shop. If the current state of affairs continues, many more funds may be staring at hard options. "In this business you have to prove yourself every four years to your investors, because if you don't find someone to back you, you are out of business," says Apax's Singh. As they say in the PE business, you are only as good as your last exit.