The State of Private Equity in India

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Executive Summary

While the India growth story remains intact, returns have proven elusive for many managers and investors, especially those invested in dollar-denominated funds.[1] The reasons for this shortfall are numerous, but include several macro-economic factors outweighing solid business fundamentals. While the Indian private equity market continues to mature, thereby offering hope to investors, it is unclear when and if the macro-economic environment will improve such that investors will be rewarded.

In the long run, the growth story coupled with strong business fundamentals should ultimately prevail. The question, however, is this: Can investors wait that long when attractive returns can be earned elsewhere?

A Period of Disappointing Returns

As shown in Figure 1, public equity investors who entered the market in 2004 were handsomely rewarded, but returns over the last six to seven years have been inconsistent and, in many cases, have been disappointing. Alongside poor public market returns we have seen disappointing private market returns, as the aggregate dollars invested in India based on private equity funds from 2000-2009 have produced an IRR of less than 4%.[2]

S&P BSE Sensex Index

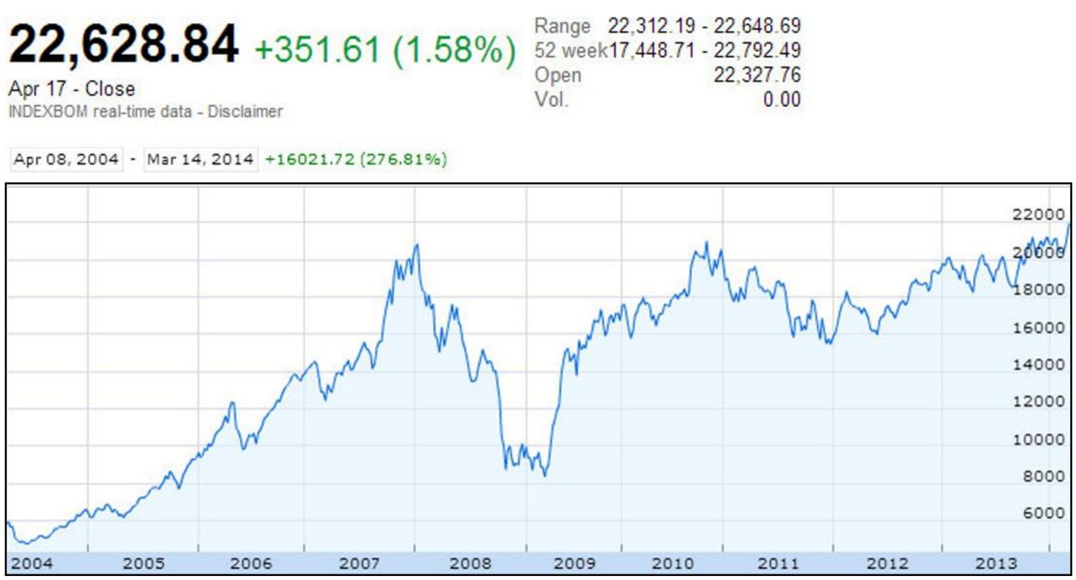

Figure 1: This chart displays the performance of the S&P BSE Sensex Index, the benchmark for Indian equities (Source: Google Finance)

[1] "World Bank chief economist on future of India's economy," BBC News
[2] Cambridge Associates

Too often during this period, private market strategies have been focused on making private investments in public companies; this, coupled with the absence of an attractive public exit market for high growth private companies, has delayed returns.

In addition, many venture capital and growth investors have suffered from poor sector or stock selection, which, combined with the uncertain macro environment, has damaged returns. Where attractive returns have been achieved, many think they do not outweigh the risks of investing in India.

An Uncertain Macro Environment

A Case Of Macro Domination – A macro environment dominated by negative fundamentals and uncertainty over the last several years has created a drag on private equity returns. Per Figure 2, GDP growth in India has averaged 6.8% from 2008 to 2014 (estimated), well below the more attractive 9.1% average growth rate that persisted from 2003 through 2007.[3]

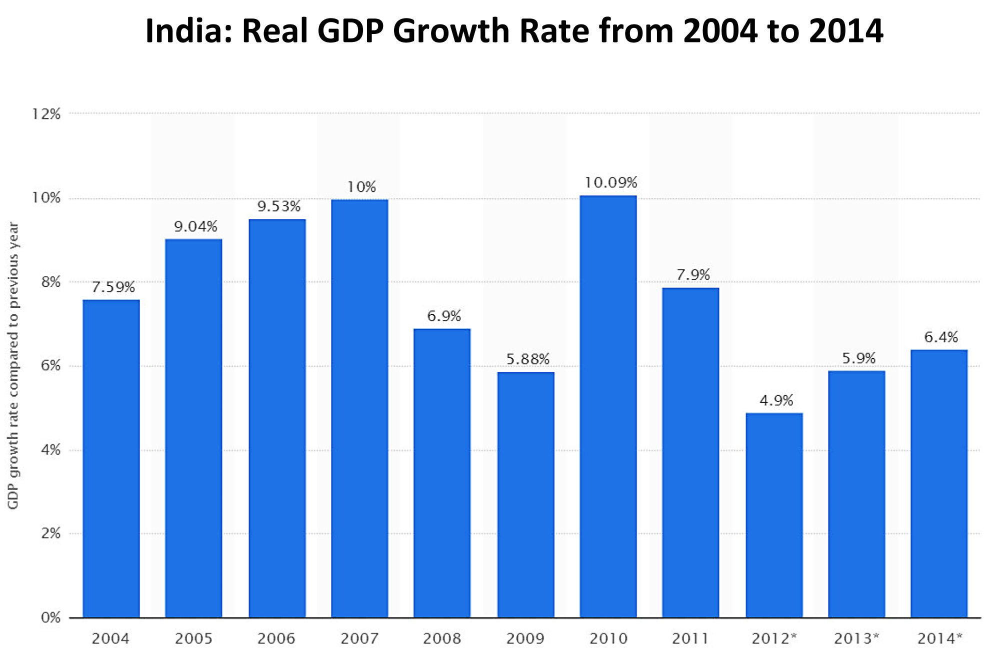

Figure 2: This graph shows India GDP growth from 2004 to 2014. (Source: Statista, 2014)

Along with slowing GDP growth, the macro-economic environment has been characterized by rising interest rates and inflation.[4] These factors have created headwinds in many sectors including those that are capital intensive and consumer oriented, where growth has either slowed or margins declined. The challenging macro environment has reduced foreign direct investment in India both in the form of "fund" investing and corporate investing.[5] As a result, the rupee has declined in value from approximately 42 rupee/dollar in 2006/2007 to 62 rupee/dollar today, and exits have grown more scarce in response to declining global buyer interest.[6]

Finally, political uncertainty has persisted in the form of an administration that has not been conducive to economic growth and reform. The results of India's most recent parliamentary elections will be counted by May 16. Many view the Bharatiya Janata Party ("BJP") and its leader, Narendra Modi, as the pro-business coalition. If the coalition is elected with enough of a majority to govern effectively, many expect it to lead a renewed period of stronger growth.

[3] The International Monetary Fund
[4] The Reserve Bank of India
[5] "Foreign Direct Investment, Net Inflows," The World Bank
[6] "U.S. Dollar to Indian Rupee," XE Currency

Sector/Stock Selection Still Matters – Some business sectors have been battered in India over the last several years, including those reliant on government support and access to cheap capital (i.e. infrastructure, energy, and finance), as well as some consumer retail sectors unable to pass price increases along to customers. The unique challenges faced by some industries in the India economy have placed a premium on sector and stock selection among managers, requiring the ability to identify and invest with those companies that can still grow revenues and margins in a challenging environment.

The Private Equity Industry Matures – From our conversations with managers in India, it appears that many private equity managers in that geography have enough experience under their belts to know their core strengths and weaknesses and where market opportunities lie. As a result, many firms are organizing their strategies and teams around a narrower, core focus area (i.e. stage and sector). This narrowing of focus has further segmented the market and created a more defined set of competitors and value-add proposition for many firms. Seemingly gone are the days of the "one-stop-shop" India private equity firms that invested across stages, sectors, and sometimes asset classes. One firm, a leading private equity investor with a long history of global investing, has jettisoned its India growth fund and is now focused primarily on early stage investing in India IT and healthcare. In addition, the firm is building out an operations services group that can add specific value to portfolio companies. Although generally there seems to be less excitement and fewer competitors in India private equity, some segments of the market have become more competitive, including seed investing in technology companies.

Valuations - Paying Up for Growth – Despite a maturing private equity market, dampened excitement, and seemingly fewer competitors in the market, none of our sources mentioned that private company valuations were low. In fact, in response to the macro-economic headwinds, capital has rotated into defensive sectors pushing some public equity multiples to their highest levels in a decade.

It also appears that the private sector discount to the public sector is 0% to 10%, which is consistent with past sentiment. As a result, investors appear to be willing to pay up for well managed private companies with strong growth expectations. For example, an early/growth stage India-focused investor recently received bids for a high growth medical business in the range of 18x to 20x EBITDA. The firm rejected these offers out of confidence that it could grow the company and achieve a higher valuation next year.

Conclusion

The private equity market in India has suffered from a period of lackluster returns, an uncertain macro environment, and a reliance on manager "stock-picking" ability rather than the opportunity of startups tackling a growing economy. For investors interested in allocating capital to the private equity market in India, the time to return capital remains a legitimate concern and the political instability poses serious challenges, especially when dollars can be earned in other geographies at a quicker rate. Given the length of partnership and long-term nature of private equity investing, this is a barrier for many investors.

For the future of private equity in India, we anticipate that the growth potential of the country, coupled with strong business fundamentals, will likely prevail in the long term. In such a challenging environment, manager selection becomes all the more critical, and we remain focused on building relationships with and investing in those managers who have the experience and skillset necessary to navigate the market and earn high rates of return. ■