India Private Equity Report 2011

BAIN & COMPANY

IVCA

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Contents

Key takeaways

Overview of current conditions

- India saw the largest increase in deal activity among the big Asia-Pacific markets in 2010. Although still far below the 2007 peak of US$17 billion, last year's total deal value more than doubled from that of 2009 to US$9.5 billion, including venture capital, infrastructure PE investments and real estate investments.

- The fundamentals look auspicious for PE in India to continue to grow and evolve in 2011 and beyond. Short-term nervousness in the capital markets in 2011 and high-priced corporate debt are expected to keep valuations down. That is likely to help open up interesting deal-making opportunities for PE investors. Healthy macroeconomic conditions continue to support India's status as a preferred destination for investors.

- India's fundamentals will continue to attract eager PE investors and bolster the confidence of limited partners. The pace and strength of the industry's future growth would be accelerated if valuations in India become more attractive and exits continue to build on the momentum established in 2010.

- Indian promoters are gradually coming to recognise PE as a patient source of active capital that can help build their businesses. The PE industry will need to work closely with their investee companies and invest in further educating other Indian promoters about the PE and VC value proposition.

- India's PE and VC industry is far from reaching its full potential. The biggest barrier holding it back is lack of regulatory support. Indian policymakers still do not regard PE and VC as a distinct asset class, nor have they given sufficient attention to creating a regulatory environment more conducive to the industry's growth.

Fund-raising

- In proportion to the size of India's economy, today's capital overhang is huge. Industry watchers put the total amount of committed but uncalled "dry powder" at nearly US$20 billion—enough to fund all deal activity at 2010 levels for the next two years.

- Investors' appetite for exposure to India's PE market remains strong. Some 120 PE funds seeking to raise approximately US$34 billion in 2011 are currently on the road. The bulk of new capital will continue to come from offshore investors that face fewer restrictions investing across sectors and are freer from complex tax and legal burdens.

- Even as more domestic firms compete in the PE asset class, the bulk of new capital will continue to come from offshore funds. Our survey found that almost 80 per cent of funds will be sourced through foreign institutional investment, foreign direct investment and foreign venture capital investment.

- Another set of PE funds gaining prominence are the ones that have broken out from the larger funds. We expect this trend to continue as LPs gain access to Indian markets through successful GPs setting up funds domiciled in India.

- LPs are becoming more discerning about the funds in which they will choose to invest their capital. Their greater scrutiny makes it imperative for PE funds to differentiate themselves in their investment approach and portfolio management skills.

Deal making

- With PE funds loaded with dry powder, the competition to buy quality assets will intensify.

- Average deal size (US$24 million) increased marginally but remained relatively small in 2010. Deal size remained well below the US$35 million average value of deals concluded in 2007 at the peak of the PE cycle. As in the past, most deals were for minority ownership positions of 25 per cent or less. That is not expected to change any time soon.

- Industry insiders anticipate that deal activity will increase moderately in 2011 from the already improved levels of 2010. Although they see deal-making opportunities across all sectors, they are most bullish on banking and financial services, healthcare, infrastructure and consumer products.

- Indian PE deal activity was spread across various stages in the growth of a company during 2010. Private investments in public equities (PIPEs) fell to less than 10 per cent of deal value last year, owing to increased valuations in the capital markets and the cautious investment mindset of PE investors. Industry watchers expect them to pick up in 2011. Most experts also believe that buyouts will increase in number and in proportion of funds invested, but the buyouts will not be a significant piece of the Indian PE pie anytime soon.

- While intermediaries will continue to play a critical role in deal sourcing, PE investors will still look for proprietary deals by cultivating strong relationships with promoters well before term sheets are drafted.

- Promoters are looking to lay the foundations of a strong working relationship with a PE partner. They are receptive to PE firms that understand their business and bring a solid reputation for working in a collaborative manner to create value in their companies as well as pursuing higher financial returns.

Portfolio management

- Promoters value PE investors that understand their needs and are willing to discuss upfront how to align their interests. They are looking to work with PE firms that act as a promoter's trusted adviser.

- While valuation is still critical in closing a deal, PE firms that can bring operational expertise to the table will enjoy a clear competitive edge. Having that skill set could lead promoters to favour them over other potential PE buyers, even in the small number of cases when they do not offer the highest bid.

- When PE owners are more actively involved in the operations of their portfolio companies, they strengthen corporate governance, bring rigour to business systems and processes, assist in raising new rounds of capital, provide access to their business networks and help with hiring to fill critical management roles.

- Even though the vast majority of PE investments are for minority stakes and the young Indian deal market does not yet permit very many to specialise, most firms now have a wider team of advisers and are striving to nurture a more collaborative relationship with promoters.

Exits

- Following several years when exit volumes were low relative to the number of new deals being done, 2010 was a record year. PE funds unwound positions in 120 companies last year, taking in US$5.3 billion.

- PE funds looking to sell in 2010 were able to choose from among several healthy exit-route options, including sales to strategic buyers and through a growing secondary sale market. Public market sales were—and will continue to be—the most important exit option, chiefly because the IPO market is expected to be buoyant despite a short-term correction.

- Industry experts remain bullish about exit prospects through the end of 2011—and are even more optimistic about conditions over the next one to three years.

- There is a deep inventory of future exits in the PE pipeline. Approximately 60 per cent of PE deals made through 2007 remain in PE funds' portfolios. Now reaching the upper end of their investment holding periods, many of these holdings should soon be coming up for sale.

PE in the infrastructure sector

- One of India's biggest challenges, infrastructure is becoming one of the largest areas of investment opportunity for PE. Public infrastructure outlays will double over the next five years, to US$1 trillion, with the private sector accounting for between 40 per cent and 50 per cent of the total.

- The range of subsectors attracting PE interest is broad and evolving. The power sector has attracted the most interest from PE investors, increasing to 45 per cent of funds' total PE infrastructure investment between 2008 and 2010. Over the next five years, the construction industry alone will need an additional US$150 billion to US$200 billion to fund assets and working capital.

- PE funds wrestle with the decision whether to invest in construction companies or in individual projects. In general, investing in construction companies is easier than acquiring stakes in project-holding companies, because they have more certain short-term margins and cash flows. But more PE funds are and will remain active investors in asset companies structured as special purpose vehicles (SPV), holding companies and blends of both, depending on a combination of risk appetite, return expectations and holding capacity.

- PE's role in infrastructure will deepen going forward. While three-quarters of the deals were for investments of less than US$50 million, the share of equity investments greater than US$100 million is increasing. PE investors are acquiring assets of greater size and complexity. And they are bringing expertise, not just capital, to the companies and projects in which they participate.

- Prospects for further expansion of PE infrastructure investment are bright. But to reach its full potential, regulators will need to eliminate or lower barriers that currently constrain PE activity. Reforms that would help most include measures that would make land acquisition easier, end double taxation of SPVs and streamline the project bid and award process.

Implications

- Savvy promoters understand that the PE investors' interests are congruent with their own. They should ensure that this alignment of interests is in place at the outset, during the deal-making stage, by ascertaining that the PE firm they ultimately commit to brings value-creation skills to the deal.

- Businesses contemplating accepting their first PE investment need to look beyond the value of the bid to weigh whether they will be able to establish a strong working relationship with a PE suitor.

- Now that the Indian PE industry has gone through a business cycle, LPs are using the experience they have gained in the market to subject PE firms that are seeking to raise new rounds of capital to greater scrutiny. GPs will need to differentiate themselves not only through a proven track record of value creation but also in their investment philosophy.

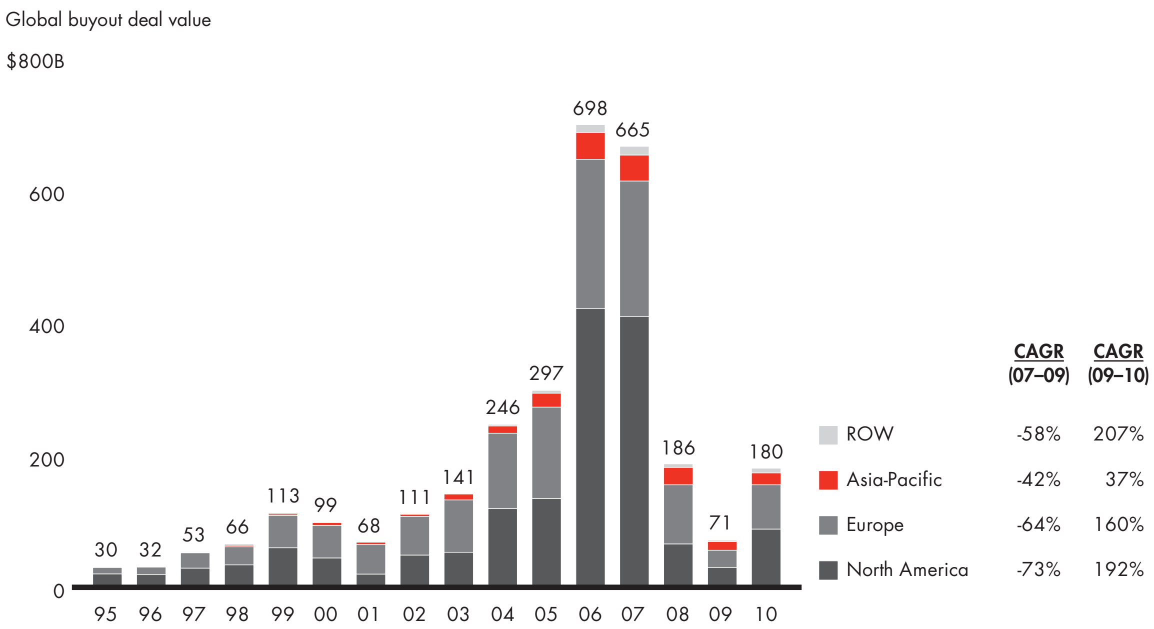
- To ensure better that PE and VC fulfil their role as growth enablers, a host of regulatory changes will be needed to remove ambiguities about their treatment under Indian securities and tax laws. That will need to begin with regulators recognising that PE and VC are a distinct asset class apart from promoter holdings, creditors and public investors.

1. Introduction: Indian private equity rises in the global ranks

Private equity (PE) has established firm roots in India over the past decade, drawn by the nation's phenomenal growth, dynamic entrepreneurs and hunger for capital to finance opportunities in nearly every business sector. As its role increased in significance over the past decade, PE has shaped itself to the contours of the Indian economy and unique business culture. Yet, while this quintessentially adaptable industry has taken on many distinctive traits in India's hothouse growth environment led principally by domestic consumption, it is important to bear in mind that PE and venture capital (VC) are chiefly influenced by the overall health of the global economy and investment climate. That is because PE and VC fund investors are still predominantly based outside of India.

The impact of this global linkage was especially salient in 2010, a year of recovery for PE worldwide from the 2008 credit meltdown that followed the bursting of the US housing bubble and subsequent recessions that hobbled the world's biggest economies. One closely watched indicator of PE's worldwide revival last year was the smart rebound in buyout activity (see Figure 1.1). According to data provider Dealogic, announced

Figure 1.1: Healthy recovery in global buyout deal activity



Notes: Excludes add-ons, loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on the location of targets
Source: Dealogic

buyout deal value totalled US$180 billion for the year worldwide, with big gains in deal activity in all major markets. In Europe and North America, the epicentres of the global credit crisis, deal values were up 160 per cent and 192 per cent, respectively, from the cyclical trough. Although buyouts play a distinctly smaller part of total deal value in emerging economies generally and the Asia-Pacific region specifically, deal making resumed its strong growth even in these markets.

As the year unfolded and credit-market conditions improved, new forces that influence PE's continued expansion—and ultimately affect PE's prospects in India—began to assert themselves. For one thing, a large and rapidly growing number of PE funds worldwide are sitting on nearly US$1 trillion in committed but uninvested "dry powder", and they are scouring the globe for attractive investment opportunities. With so many funds looking to put that money to work in today's revived deal-making environment, competition to acquire high-quality assets and the pressure to bid up prices is expected to be intense.

In line with its revival in developed markets in 2010, PE activity in India, China and other leading emerging markets also recovered quickly. With India's GDP growth pegged at around 8.7 per cent over the past year on the back of increased consumer and public infrastructure spending, the confidence of global investors in India's longer-term prospects has strengthened. Including real estate, venture capital and PE investments in infrastructure, deal values in the Asia-Pacific markets rose to US$51.4 billion in 2010, approximately 20 per cent of which was invested across 380 deals in India.

Along with other fast-growing Asian markets during the past year, India's economy continued its uninterrupted expansion, while those in the US and Europe slumped. That gave PE investors fresh reasons to look to the subcontinent as an attractive destination for investment capital. Including investments in infrastructure and real estate, the total value of new deal activity in India rose to US$9.5 billion in 2010, more than double the US$4.5 billion PE funds had invested a year earlier.

This record of impressive growth makes it clear that PE is becoming more integral to India's business landscape. It is also a testimony to the many lessons learned both by PE investors and India's entrepreneurs through the experience of working together through the peak and trough of the business cycle. Through the end of 2010, the number of international and home-grown PE firms has increased to some 450, according to Venture Intelligence, an industry data provider. Since 2005, more than 1,900 Indian companies have accepted venture capital and private equity investments, including nearly 340 in the past year alone.

While these healthy indicators bode well for the next wave of PE growth, India's PE industry stands at a major inflexion point as it enters a new decade. Despite PE's many triumphs ushering young Indian companies to success on the world stage and the many lessons learned through that experience, Indian entrepreneurs, corporate leaders and policymakers are only beginning to appreciate the distinct advantages PE has to offer as an asset class. The message still has not entirely broken through that PE and VC firms are sources of hands-on capital that can groom their investee companies across all phases of their life cycle.

Over the past decade, PE firms have helped Indian entrepreneurs by providing institutional financing and supporting capital investment in new plants and equipment. They have helped reinvigorate companies in their portfolios 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. PE funds become partners as value creators and their significance is not limited to providing capital. Thus, the PE value proposition is distinctly superior in many respects to that offered by conventional sources of capital such as commercial banks, mutual funds and individual or institutional investors. Despite having compelling stories to tell, PE firms will need to continue working hard to win over the sceptics, both in 2011 and beyond. To realise their full potential, PE firms must continue to demonstrate how they help management of start-up and fast-growing enterprises formulate and execute on agreed strategies and operational plans.

About this report

As an active participant in PE's growth and development in India since its inception, Bain & Company has helped all PE stakeholders create economic value. Over the past decade, we have tracked the trends and changes that have marked the emergence and evolution of the PE and VC industry. We have codified the insights we have gained from our work with leading PE firms, sponsors, limited partners (LPs), promoters and other PE stakeholders. Last year, in collaboration with the Indian Private Equity and Venture Capital Association (IVCA), we published our seminal India Private Equity Report 2010, reaching a wide audience of business leaders and policymakers.

This year, we build on the themes in that report as we take measure of how PE activity played out in 2010 and what lies in store for 2011 and beyond. Our analysis is built upon Bain's extensive proprietary deal database. It has been enriched by the perspectives we gained from extensive responses to our survey and through more than 25 in-depth interviews with a wide range of industry leaders, insiders and PE funds in India. And once again, we benefitted from the indispensable collaboration of the IVCA, which generously made its members available to participate in surveys and interviews that provided the data and perspectives that inform our findings.

The report is organised to help readers understand PE's emergence and evolving role in India. In Section 2, we take a comprehensive look at the current state of the Indian PE and VC industry. We trace the major milestones in its evolution over the past decade, appraise its current state and anticipate its future direction.

Section 3 begins with Bain's detailed assessment of the major developments at work during 2010, influencing PE fund-raising, deal making, portfolio management and exits. It goes on to present our in-depth analysis of how each of these critical dimensions of PE activity will unfold in 2011 and beyond.

We devote particular attention to PE's potential role in the development of India's infrastructure sector in Section 4. Because roughly 40 per cent of all PE investments in India are now targeting infrastructure projects, we think it timely to explore how PE can tap this exciting opportunity and help India close the huge infrastructure gap on which India's future prosperity so critically depends.

In Section 5, we use the report's findings to draw major implications for action that each of the industry participants and stakeholders will need to consider taking to enhance the PE investment climate.

The contents of this report reflect Bain's ongoing commitment to furthering PE's success in India. We will continue to help PE firms and promoters foster a better understanding of each other's expectations and highlight the opportunities, challenges and changes that will mark their evolving relationship. We also hope this report will help deepen the partnership between policymakers and the PE and VC industry by drawing attention to some of the regulatory barriers that funds operating in India face.

We hope you enjoy this second edition of the India Private Equity Report. 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. Private equity's passage to India: Charting a new course

It is no accident that the arrival of private equity and venture capital in India coincided with the remarkable economic boom that propelled India to the top of the emerging-market league tables. PE firms and the capital they mobilise are inherently attracted to big growth opportunities available in a market-oriented economy. Over the past several years, India provided both in abundance.

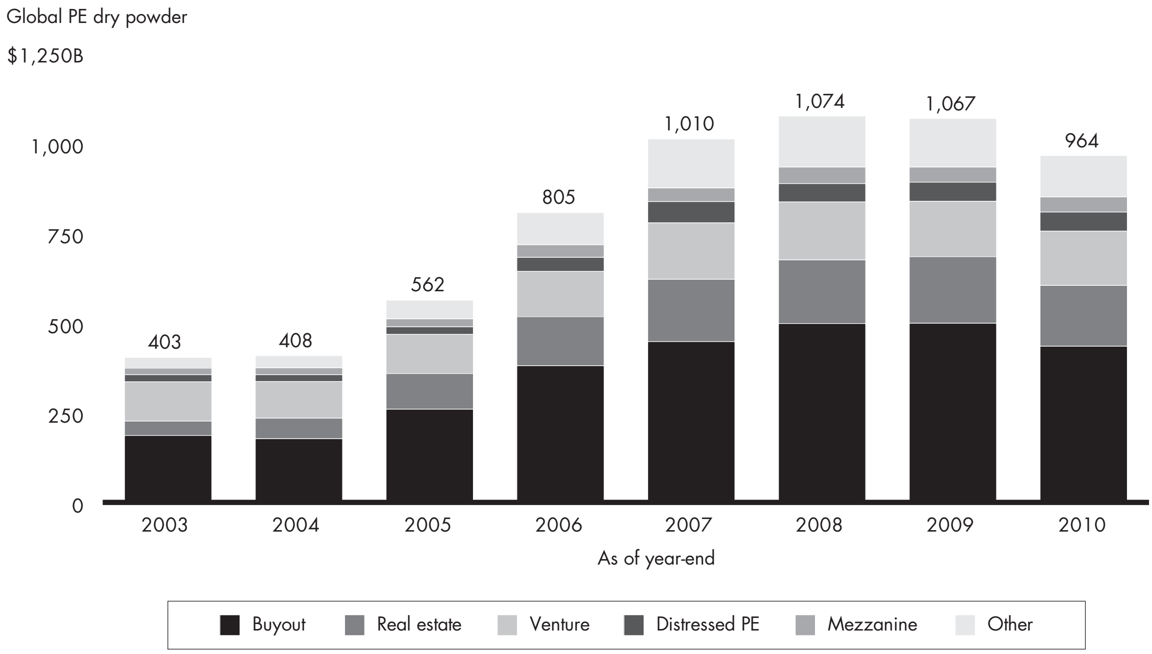
2003 to 2008: A rapid take-off

PE firms were in a uniquely advantageous position to help accommodate India's capital-investment needs. Low interest rates, benign credit conditions and buoyant equity markets in the developed markets created ideal conditions for the Indian PE industry to flourish. As US and EU pension funds, insurance companies, foundations, endowments and other institutional and affluent individual investors sought to profit from attractive returns, PE funds found themselves flush with capital. From 2003 when the global economic expansion kicked in until just prior to the collapse of Lehman Brothers that helped trigger the global credit meltdown in 2008, total capital committed to PE worldwide but not yet invested soared from US$403 billion to some US$1 trillion (see Figure 2.1). Seeking new outlets where they could put that so-called dry powder to work, PE firms increasingly turned their focus to India, China and Asia's other emerging economies.

In India's economy, PE funds found competitive advantages that squarely hit their sweet spot. Its dynamic economy created fast-growing companies that are open to the world. Its fast-expanding middle class has given rise to a vibrant consumer culture fuelled by steadily increasing disposable incomes. Currently, more than 50 million Indian households have annual incomes above the US$4,000 level that frees them to indulge in discretionary spending. Moreover, government outlays on long-deferred infrastructure needs have added stimulus to economic growth and helped lay a foundation for future economic expansion.

With these promising background conditions to work with, PE funds made their presence felt quickly. From 2004, when PE deal-making activity began in earnest, to the cyclical peak in late 2007, PE and VC firms invested more than US$28 billion in India, with nearly 60 per cent of that total coming in 2007 alone. Capital flowed to some 1,000 companies from across every major sector of India's economy—including service companies from healthcare to telecom, manufacturing enterprises, technology firms, energy producers and real estate ventures. The sheer number and variety of deals moved

Figure 2.1: PE firms wielded nearly US$1 trillion of dry powder globally going into 2011



Note: Distressed PE includes distressed debt, special situation and turnaround funds
Source: Preqin

India from the sixth position among the largest PE markets in the Asia-Pacific region (including Australia) in 2004 to the top spot by 2007.

Though the macro fundamentals suited the needs of both PE investors and the Indian economy, the pairing of the private equity business model and India's distinctly home-grown variety of capitalism has been an awkward fit in many respects. Government regulations and complex tax laws have impeded PE investors' freedom to manoeuvre effectively. But the bigger challenge PE and VC funds have faced is persuading promoters that PE's ownership model has more to offer them than just capital.

By providing a critical new source of patient capital, management expertise and deep networks of connections, PE has helped catalyse the growth and expansion of companies in which they invested. Included among the companies PE and VC investors discovered and backed are one-third of India's largest 500 companies today. For their part, many successful Indian companies have rewarded PE investors with exceptional financial returns.

Entrepreneurs who control India's closely held businesses were reluctant to sell stakes in their companies to PE and VC investors whose capital often came bundled with requests for a hands-on role or, at a minimum, greater oversight. Despite early signs of openness, many promoters in India's business community viewed private equity sceptically.

Unrestricted public market access, deepening of the bond markets and lower cost of bank borrowings made it more likely for entrepreneurs to seek growth capital through public share offerings, debt issues or bank loans than to accept relatively more expensive PE funding and cede control over their companies. As a result, most PE investments have been for small minority positions, often in the form of private investments in public equities (PIPEs) or as late-stage growth capital in private companies.

For all of PE's early promise and investors' hopes, conditions in India remained only moderately attractive during this initial growth phase. The number of PE deals grew rapidly. Indeed, PE transactions and deal values soared to record levels in 2007 and 2008. But competition among PE funds intensified even faster, driving up valuations. Paying those high valuations to acquire a minority stake in a company whose business the PE owners could do little to influence, PE funds were not in a very comfortable position to justify the potential to generate market-beating returns to their investment committees. Thus, even as India gradually became more accommodating towards private equity and the PE and VC industry learned the business realities in India, the industry operated far below its full potential.

2008 to 2009: PE hits a plateau

The first leg of India's PE journey came to an end in late 2008 with the bursting of the US housing bubble and the ensuing financial meltdown that crippled credit markets across the US and Europe. The abrupt end of the mid-2000s boom in the developed markets also led India's economic growth rate to slow. The resulting drop in PE activity has shown that Indian PE is cyclical, although the rebound has been much quicker in India than in the developed markets.

The dynamics of the global PE downturn affected Indian PE in two very different ways. The first and most immediate effect was a significant fall-off in deal making, with the total value of PE and VC investments in 2009 plummeting to just US$4.5 billion—a decline of nearly 70 per cent from the previous year. Indeed, in a year when total PE and VC investment across the Asia-Pacific region declined by less than 10 per cent to US$52.8 billion, India's total deal value suffered the biggest reversal. The drop affected all sectors of the economy, as the number of PE deals tumbled from nearly 450 in 2008 to 216 in 2009.

A major factor behind the deal-making drought was falling public equity market valuations. Stronger Indian companies were simply not interested in selling stakes to PE investors at what they considered to be depressed prices driven by knee-jerk market reaction. The mismatch in expectations between PE funds and promoters—a perennial problem even during good times—grew wider throughout the first half of 2009. As promoters held out for higher valuations for their companies, PE funds ratcheted down what they were willing to offer as a sign of investor caution. For those deals that did come to fruition as the markets hit bottom in the final quarter of 2008 and the first quarter of 2009, the multiples that PE funds paid dropped.

The global downturn's second big effect was to shift global PE investors' focus from the developed economies to markets in India and the other emerging markets of Asia. While recession and adverse credit conditions continued to curtail investment activity in the US and Europe, continued GDP growth across Asia barely took a pause. India's economy slowed only modestly to 6.7 per cent in early 2009 from its pace of between 8 per cent and 9 per cent across the peak years of the business cycle. However, India's rebound was as quick as its reflexive downward slide, and the economy regained its torrid momentum. By the second half of 2009, growth rates between the slumping developed economies and the robust emerging markets had diverged sharply. With India's GDP climbing again, PE deal flow picked up in its wake.

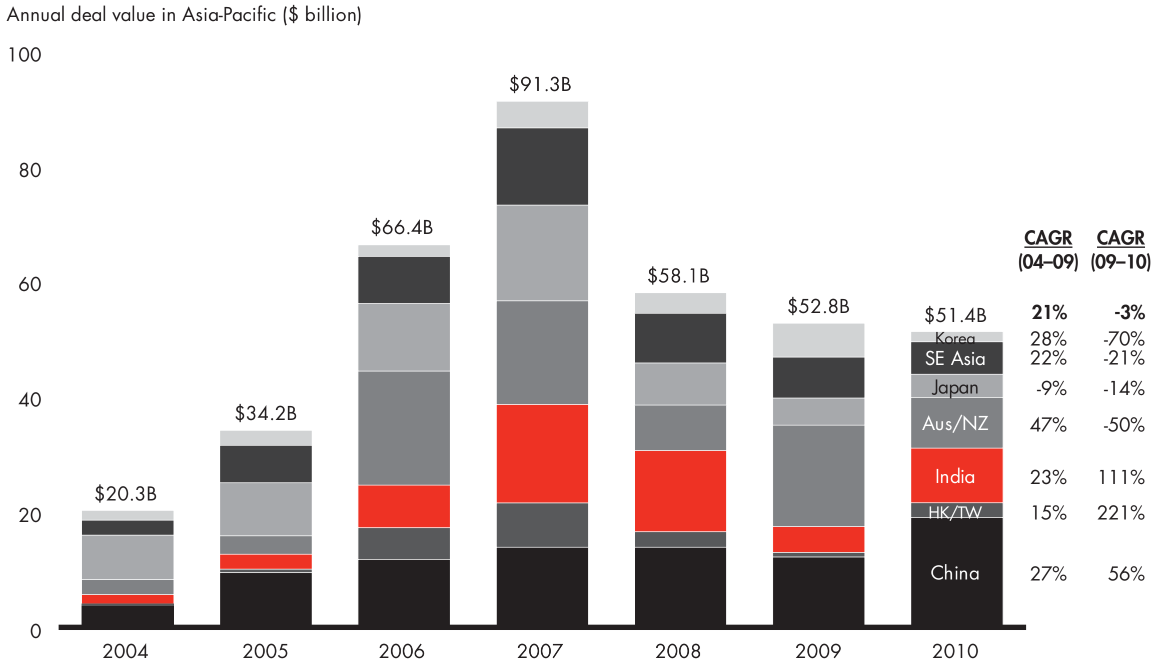
2010 to present: The recovery takes hold

As economies and credit markets in the US and Europe stabilised in 2010, PE investors returned to deal making with cautious optimism and took advantage of rebounding public equity markets to sell mature portfolio holdings to lock in gains. But the recovery of PE activity in the West did not come at the expense of PE investors' continued interest in India, China or any other large emerging economies. In sharp contrast to 2009 when Indian deal value saw the region's biggest decline, India saw the largest increase in deal activity among the big Asia-Pacific markets (see Figure 2.2). Total deal value more than doubled, in 2010, to US$9.5 billion, and the number of deals rose to 380 (see Figure 2.3). Nearly every major sector of the Indian economy participated in the strong deal-making recovery, with the energy sector attracting the most capital.

In 2010's more stable market environment, price expectations of PE acquirers and promoters contemplating sale of stakes in their companies came into closer alignment. Although high relative to what PE investors pay in more mature markets, multiples in India were less volatile than and well below what they had been at the cyclical peak in 2007.

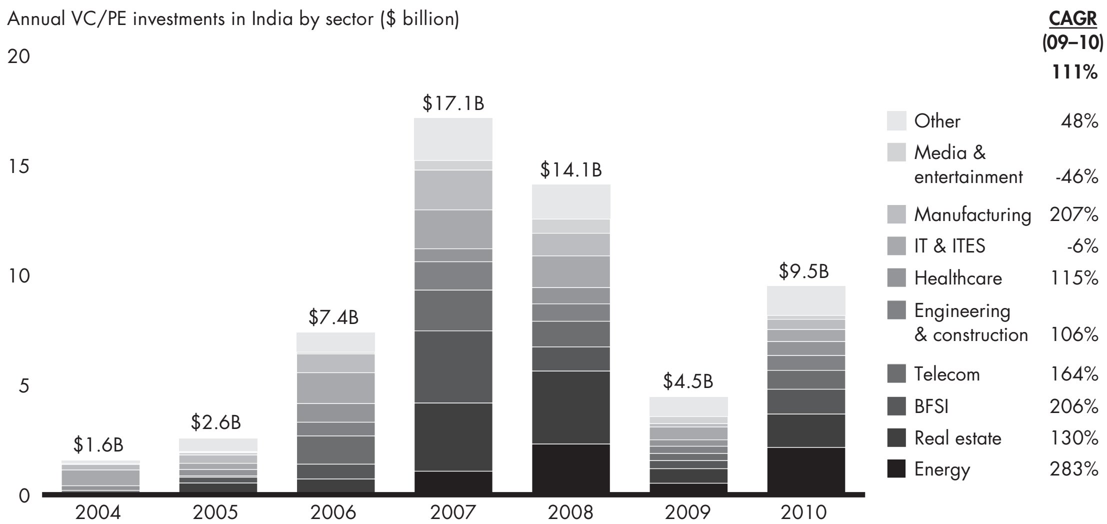
Yet for all the indicators pointing to private equity's renewed strength in 2010, PE deal activity still remained well below what it had been during the boom years of 2007 and 2008. Industry experts attribute this sub-par growth to a tendency on the part of Indian promoters to wait out choppy capital markets rather than lower their expectations to sell at peak valuations. Indeed, one seasoned industry observer Bain interviewed estimated that "When valuations fall below promoters' aspirations, as many as 70 per cent of them put their capital-raising plans on hold as they weigh the trade-off between deferring growth versus diluting their ownership stake at a lower price".

Figure 2.2: Deal value in India rebounded in 2010



Sources: Bain PE deal database; AVCJ

Figure 2.3: Deal making increased across all major sectors in 2010



	2004	2005	2006	2007	2008	2009	2010
Number of deals:	73	185	296	494	448	216	380
Average deal size ($M):	22	14	25	35	32	21	24

Note: "Other" includes consumer products, hotels & resorts, retail, shipping & logistics, textiles, education and other services; BFSI refers to banking, financial services & insurance
Sources: Bain PE deal database; Venture Intelligence

Conditions in 2010 were favourable for PE firms to demonstrate the strength of the private ownership model and the value-creation skills they can bring to their portfolio companies. Strong economic growth, a revival in M&A activity and rising public equity markets allowed PE owners that had patiently helped their portfolio companies to grow to reap sizeable returns. Last December, Actis and Sequoia Capital sold their 70 per cent ownership position in Paras Pharmaceuticals to Reckitt Benckiser Group, a UK-based global household products manufacturer, for US$726 million, earning a return of approximately four and a half times the original acquisition cost over an investment horizon of about four years. According to VCCEdge, a financial research organisation, PE firms made 120 exits worth US$5.3 billion in 2010, compared with just 66 exits valued at US$2.1 billion a year earlier.

Issues to watch in 2011

Despite some short-term nervousness in the capital markets as 2011 began, the fundamentals look auspicious for PE in India to continue to grow and evolve. An imbalance in supply and demand is creating inflationary pressures, leading to rising interest rates and increased pressure on corporate earnings. However, investment opportunities look attractive both in the near term and over the longer run. Consumer spending continues to increase on the back of rising disposable household incomes. The government remains committed to its goal to close India's infrastructure gap and pursue its growth and reform agenda in key sectors like financial services and energy, among others. At the current rate of GDP growth, the total value of goods and services produced by India's economy should approach US$1.3 trillion by the end of the year. Our interviews found that most investors see the corrections and short-term uncertainty in the capital markets as contributing to an attractive environment for acquiring assets at more favourable prices.

Certainly, the number of new domestic and international PE firms setting up operations in the country is increasing, as are the capital commitments earmarked for Indian investment. Many of the new PE firms are bringing veteran experience with them. Several are spin-offs from larger firms and are run by general partners who have operated in India for years. Others are sponsored by seasoned domestic business houses such as Aditya Birla Group, Reliance Industries, Future Group and TVS Group, among others, that have also earmarked capital for investment in India through the PE and VC route. Most importantly, years of deepening relationships between PE firms and Indian promoters are yielding fruitful business partnerships that are now contributing powerfully to India's dynamic economic growth story.

As the cyclical expansion gathers momentum, a major development to watch will be how quickly this still-adolescent industry gains maturity. One sign to look for will be whether today's generalist and largely opportunistic PE and VC firms begin to focus, think and act more like specialists, focusing on specific sectors, deal sizes or deal types. Of all the PE funds in India, only half closed on an investment in 2010. Investors in India largely continue to build their investment portfolios opportunistically. Intensifying competition to land attractive deals should push more funds in the direction of taking a more sophisticated and distinctive investment approach. In addition, the increasing depth of the PE market and evolving attitudes of Indian entrepreneurs about diluting control would allow funds to define their strategic position more sharply. Supportive regulatory changes—beginning with a clarification of PE's status as a distinct class of capital separate from promoters—are essential pre-requisites if the PE and VC industry is to fully ripen.

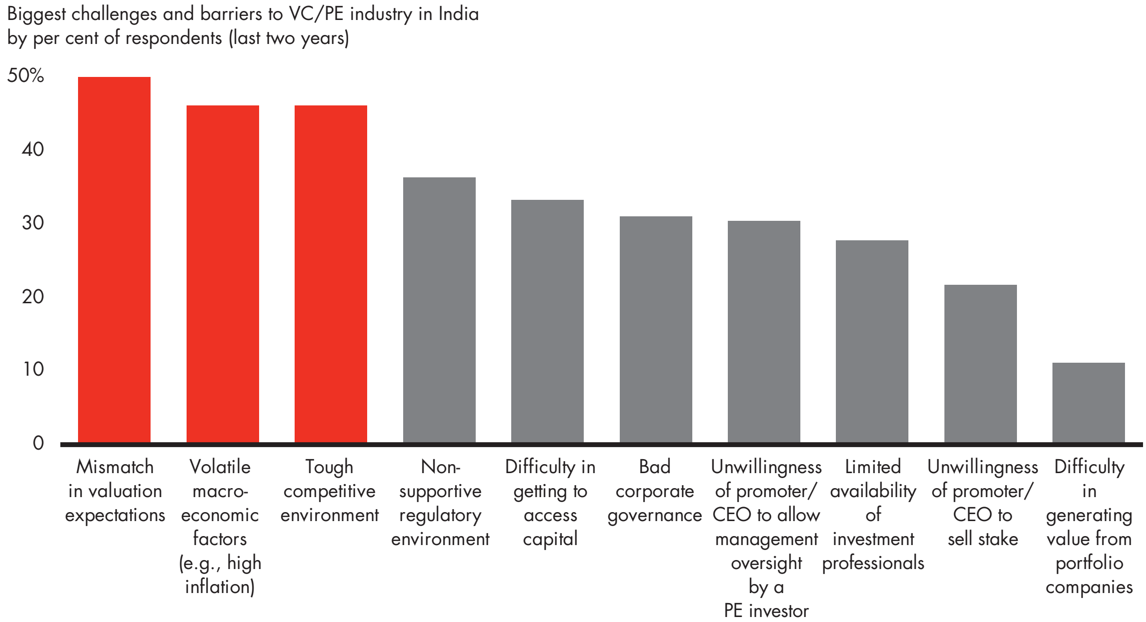
For PE truly to begin to live up to its potential, a broader set of Indian entrepreneurs will need to learn to see PE as "activist" capital that can help them build their businesses. Attitudes are beginning to change but very slowly. Although it did increase modestly in 2010, the average PE deal size remains small at about US$24 million, and buyouts remain exceedingly rare. PE is still far from being seen as a preferred funding source by a large cross-section of promoters, who are inclined to raise expansion capital through initial or follow-on public offerings, which they perceive to impose fewer operational constraints. PE often ends up as an option of last resort for promoters who cannot tap public markets, access financial institutions or arrange debt financing.

Bain interviews with PE executives and promoters conducted in early 2011 found that the eventual emergence of a healthier, more mature PE industry hinges on overcoming impediments in five key areas:

Expectations mismatch over asset valuations: Expectations over asset valuations on the part of PE investors and company owners need to come into closer alignment. The expectations mismatch showed up in the Bain survey as the principal challenge the PE and VC industry faces, with one-half of all respondents identifying it as the principal barrier to the industry's growth (see Figure 2.4). A tough competitive environment for high-quality assets has further driven up prices. With rare exceptions, the high price-to-earnings multiples India's PE investors pay put India at a relative disadvantage to China and other fast-growing emerging markets, where deals at single-digit multiples are still available.

Another factor widening the valuations gap is that India's debt and equity markets are more open and accessible than they are in China. The valuation mismatch between promoters and PE funds widened when the economy slowed in 2008, as PE investors resisted paying the high prices promoters still sought. However, the speedy rebound of the public equity markets in 2009 had not allowed enough time for promoters'

Figure 2.4: The biggest challenges and barriers to the PE/VC industry



Note: Per cent refers to number of respondents who considered challenges as very important (score of 1 or 2) vs. total respondents; 1 refers to "very important challenge" and 5 refers to "least important challenge"
Source: Bain IVCA VC/PE research survey 2011 (n=50)

expectations to reset and hence, the gap continues to remain wide. Through the first quarter of 2011, the stock market has seen a 10 per cent correction, and valuations could remain in this range through the balance of the year. It remains to be seen, however, whether this will be sufficient to close the valuations gap partially. While some market watchers thought the climate at the time of publication of this report was good for cherry-picking assets, many continued to expect that Indian promoters will ride out the correction, waiting for higher valuations.

Macroeconomic uncertainties: India's growth story remains intact owing to sound fundamentals, but India's powerful economic engine has lately shown some signs of strain. Mounting inflationary pressures and occasional friction between India's economic expansion agenda and political pressures risk introducing distortions in the growth trajectory. Not only do these conditions have the potential to suppress adjusted earnings, but they could also derail PE deal making in sectors where the regulatory direction is unclear. Sectors like infrastructure and microfinance are particularly sensitive to these concerns. If left unaddressed, investors' worries about these barriers could slow fund-raising in the long run, as LPs could seek greener pastures in other markets.

A tough competitive environment: Survey respondents cited the tough competitive environment as one of the biggest challenges they faced over the past two years. Nearly

80 per cent said that competition for deals had intensified in 2010 from already high levels of just a few years before. In interviews, industry insiders reported that the launch of many new funds and the resulting capital overhang has sharply ratcheted up competition for the most attractive deals.

In large measure, competitive conditions have been made more challenging by the fact that PE is still a fledgling industry in India. Seasoned talent—particularly experienced investment professionals—remains relatively scarce. Most PE firms currently operating in India have been around for fewer than five years, and they have yet to see more than a few investments through the complete deal cycle from entry to exit.

Beyond the competition among PE funds, private equity faces tough competition from other sources of capital like private placements, corporate debt markets and the public stock exchanges. Government has actively regulated and modernised the public markets, corporate bond market and private placement activity; but it has given little recognition to PE as a distinct asset class and often lumps PE investors together with the “promoters”. Compounding PE’s challenge, Indian promoters see PE and VC as an expensive source of capital and believe that equity markets offer better valuations. That has made it more difficult for PE investors to make their case with promoters that they are providers of expertise, and not merely another source of funds.

Unclear and complex regulations and tax laws: Government has a critical role to play addressing an urgent need—removing regulatory barriers to put domestic and international PE firms on a more level playing field. Greater transparency and consistency in how rules are applied are important preconditions for regulatory reform. But the PE industry is waiting for policymakers to take several other concrete steps that would facilitate PE capital formation and deal making.

For example, relaxing guidelines affecting foreign direct investment into venture capital funds under the automatic route would deepen capital pools available for investment. A committee on PE and VC investment established by the Confederation of Indian Industry (CII) recently recommended a different rule change that would achieve the same goal. Under its proposal, foreign capital whose sole purpose is to invest in domestic venture capital funds would be eligible to be granted registration by the Securities and Exchange Board of India.

Another change that would lower investment barriers would be to ease current rules that can be deal killers for the PE and VC investors seeking to make significant investments in publicly traded enterprises. Under current regulations, any PE bid to purchase 15 per cent or more of the equity or voting rights in a publicly listed company triggers a requirement that the PE fund make an open offer to all of the remaining shareholders to acquire 20 per cent of the company’s equity. The CII has recommended that the threshold be raised from 15 per cent to at least 25 per cent and that insider trading guidelines be liberalised for registered PE and VC firms.

PE and VC investors also find their hands tied because any material information a target company shares with the prospective PE or VC fund but fails to disclose to all other shareholders is considered a breach of insider trading laws. That obligation effectively renders a serious due-diligence process difficult. It effectively requires PE funds to engage a wide network of experts and to rely on secondary research and extensive surveys before finalising the investment recommendation.

Onerous tax burdens and opaque tax laws are another big set of challenges PE funds face. When a PE investor sells off a portfolio holding, the tax burden is much higher than what investors trading shares in a publicly listed company pay. Tax pass-through rules are often inconsistent and vary by sectors, but an even bigger problem is a lack of clarity and consistency among various regulations and the tax regime. Addressing that issue would go a long way towards lifting PE and VC investor confidence in India.

Post-deal collaboration between PE investors and promoters: Although there have already been major changes on both sides, developing greater trust and rapport between PE investors and entrepreneurs is a key area where survey respondents see potential for much more improvement. For entrepreneurs, the fruit of that closer collaboration would be to benefit from PE investors' value-creation skills and experience. But even lacking a direct hand in helping to set operational goals, PE owners can bring considerable financial sophistication to their portfolio companies. They can also provide access to their networks of relationships and experience derived from their work with companies across a broad spectrum of industries. Furthermore, the two sides can work together to strengthen corporate governance by making boards more professional, recruiting more seasoned executive talent and sharing best practices in systems and processes. Suboptimal corporate governance and a tendency on the part of some entrepreneurs not to be fully forthcoming with a current or prospective PE partner can hinder the value-creation potential in the PE investment.

There is much riding on how these five issues are resolved. There is no doubt that India's fundamentals will continue to attract eager PE investors. The pace and strength of the industry's future growth hangs on whether valuation and pricing issues will continue to impede deal making.

To understand better what is in store for India PE, let us take a closer look at the forces that influenced Indian PE fund-raising, deal making, portfolio management and exits in 2010 and how they are apt to play out over the course of 2011 and beyond.

3. In-depth outlook for Indian PE now and over the intermediate term

How India's PE and VC industry evolves in the months and years ahead will be determined through ongoing shifts in attitudes and behaviours of PE fund managers, limited partners that invest with them and promoters whose companies accept PE financing. How the firms approach new fund-raising, identify and structure deals, manage their portfolios and navigate the paths to exit will shape the industry's future. When looking for direction in any of these activities, context is critical. The economic and regulatory environment in which those attitudes and behaviours are shaped will exert a powerful influence on the tempo of PE's change.

Judged by industry participants' actions in the early months of 2011, their outlook can be described as "reasonably optimistic". Based on responses we received to our recent survey of industry leaders' opinions, PE insiders are influenced more by India's strong growth prospects than by the shadows hovering on the horizon. They recognise that inflation pressures are building and are acutely aware that they can lead to a significant bump up in interest rates and disrupt investment activity. Likewise, they are taking note of the volatile equity markets. But the numbers they are watching most closely are for GDP growth to continue strong over the next 12 months, so the belief in the India long-term growth story remains intact.

PE insiders appear to be willing to write off the other signs of market nervousness as temporary. Indeed, the PE experts we surveyed see current conditions as quite favourable to PE's continued growth and express the belief that alternative investments could increase in importance given the prevailing high interest rates in the debt markets and volatile public equity markets.

Judging from our analysis of the latest PE deal data and overlaying the insights derived from the survey and interviews, it appears that attitudes of both PE investors and promoters are beginning to shift. As we will see in the following review of PE insiders' expectations along the four key dimensions of fund-raising, deal making, portfolio management and exits, the industry continues to mature, incrementally but steadily.

Fund-raising

Today's baseline: More capital than opportunities to invest. As the growing number of PE funds that focus on India attract the attention of more and more institutional and wealthy individual investors from around the world, the amount of capital looking to be placed with promising Indian companies continues to grow. In proportion to the size of India's PE and VC market, today's capital overhang is huge. Industry watchers estimate the total amount of committed but uncalled "dry powder" to be at least US$20 billion. To put that estimate in perspective, that amount is more than the value of all PE and VC investments made during the peak of 2007, and it is more than sufficient to fund all activity at 2010 levels for the next two years.

Even at those levels, the capital earmarked for investment in India represents only a portion of the full potential investor interest. Nearly 80 per cent of the money committed to India during the past two years has originated from foreign sources, which is in line with what respondents we surveyed for our 2010 report expected. With the exception of investments targeted towards infrastructure, regulations do not permit conventional sources of PE capital like insurance companies and pension funds in India to participate in PE, VC or other alternative investment classes. Domestic PE firms are limited to raising funds from affluent individual investors and non-financial institutions. They are also restricted in how they can put the funds they raise to work, being barred from investing in select sectors like non-banking finance companies.

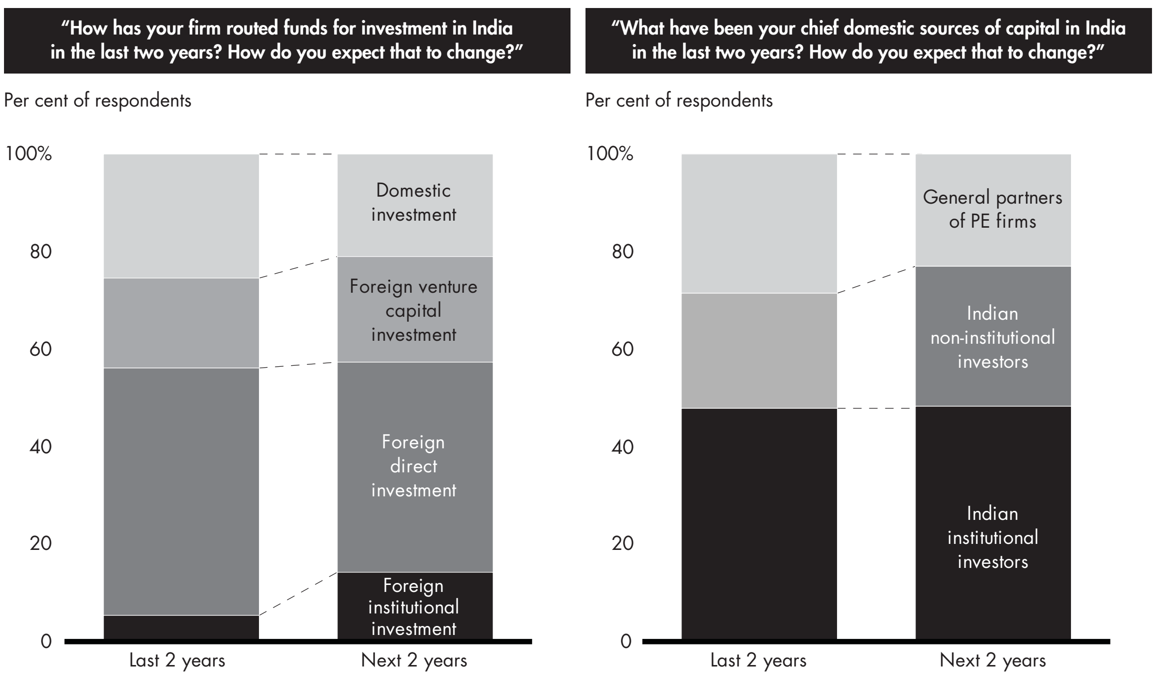
Longer-term prospects for 2011 and beyond: Demonstrating a strong performance track record will be more important than ever. With fund-raising continuing to outstrip deal activity as in the big developed and hot emerging markets, the backlog of dry powder will take time to work through. Investors' appetite for more Indian exposure remains strong to date, and PE firms are eager to nourish it. In interviews, most PE fund general partners (GPs) told us that they have not faced pressures from limited partners (LPs) to return committed capital their funds had yet to invest.

According to Preqin, the PE research firm, some 120 PE funds seeking to raise approximately US$34 billion in 2011 are currently on the road in India. Although there is plenty of capital looking to invest in India, not all of these funds will succeed in raising capital. One LP Bain interviewed said, "Over time, high-quality GPs have emerged in India, and we now have a better understanding of which ones should be at the top of our list". Forward-looking GPs that aim to continue hitting their fund-raising targets are preparing now for a time when LPs will be more circumspect about who they invest with. GPs are organising their firms to differentiate their investment approach by, for example, targeting select industries, such as education, healthcare or infrastructure, with the potential to generate superior growth and returns or by focusing on specific investment themes such as increasing consumer spending.

Adding reasons for fund-raising firms to refine and focus their approaches is the emergence and continued growth of well-connected domestic spin-off funds. Led by experienced managing directors who have broken away from global PE firms to set up their own boutique shops, the spin-offs capitalise on their intimate knowledge of the local markets and strong networks of relationships with LPs, promoters and regulators. The emergence of the spin-off funds gives LPs more choices to invest their capital directly with India-domiciled funds.

Even as more domestic firms compete in the PE asset class, the bulk of new capital will continue to come from offshore because those firms face fewer restrictions investing across sectors and are somewhat freer from complex tax and legal burdens (see Figure 3.1). Our survey found that in the coming two years almost 80 per cent of funds will be sourced through foreign institutional investment, foreign direct investment and foreign venture capital investment. If anything, respondents said they expect the share of new capital originating from domestic investors to decrease slightly over the next two years. Among the domestic sources, respondents see the proportion coming from Indian institutional investors to hold steady at just under 50 per cent. Overall, the fund allocation picture for India will remain bright, and GPs will have to work overtime to claim a bigger share of the deal pie.

Figure 3.1: PE funds will shift towards domestic sources over the next two years



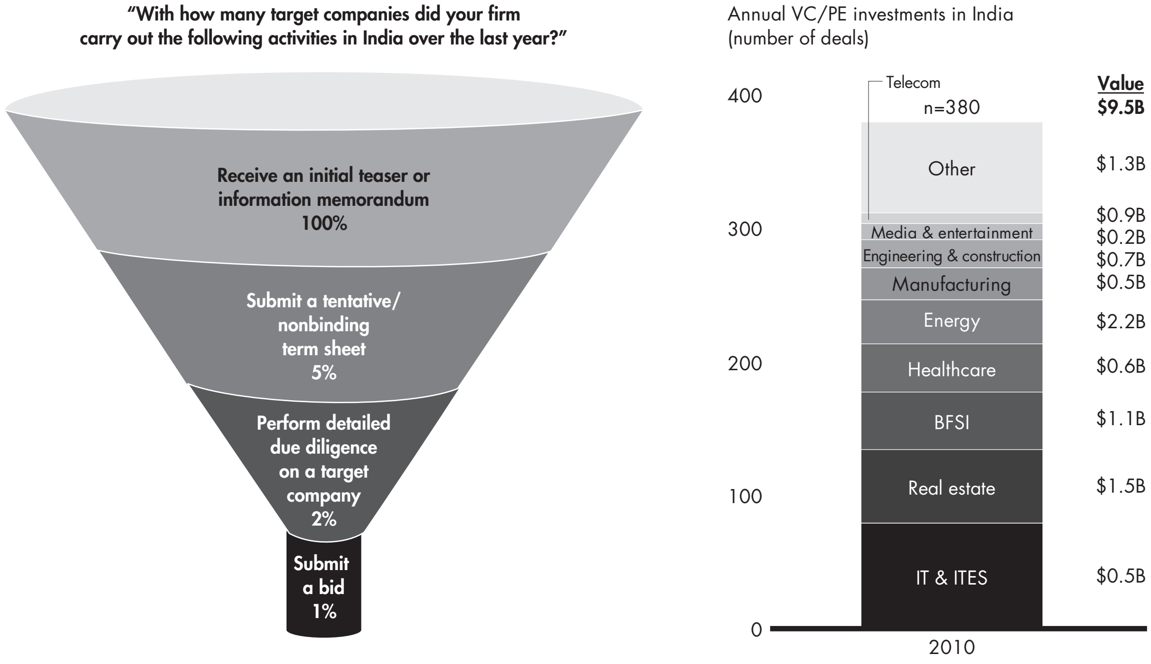
Source: Bain IVCA VC/PE research survey 2011 (n=50)

Deal making

Today's baseline: Broad-based strength across sectors but deal size remains small. With the number of deals completed in 2010 increasing by 75 per cent to 380 from 2009 levels, India was the most active PE and VC market in Asia. But that whirlwind activity does not capture the immense effort that PE investors made to bring deals to completion. For each deal that ultimately came to fruition, PE funds submitted formal initial expressions of their interest through 100 "information memoranda" (IM) to potential target companies, of which just two resulted in the fund conducting a detailed due diligence (see Figure 3.2).

Deal making in 2010 was strong across nearly every sector of India's economy. Particularly active industries for PE and VC included energy (33 deals, US$2.2 billion), banking and financial services (43 deals, US$1.1 billion) and telecom (8 deals, US$900 million)—all of which saw their investment values more than double in 2010 from 2009. The 55 investments in real estate last year continued to make that sector one of PE's favourites, although real estate began to cool in the year's second half following a surge in 2009 and the first half of 2010. Likewise, investments in information technology (IT) and IT-enabled services, long mainstays of India's growth and PE interest, ended 2010 somewhat lower than they had been historically. The slowdown reflects PE deal

Figure 3.2: Deals closed in 2010 represented just 1 per cent of companies attracting PE interest



Note: "Other" includes consumer products, hotel & resorts, retail, shipping & logistics, textiles, education and other services

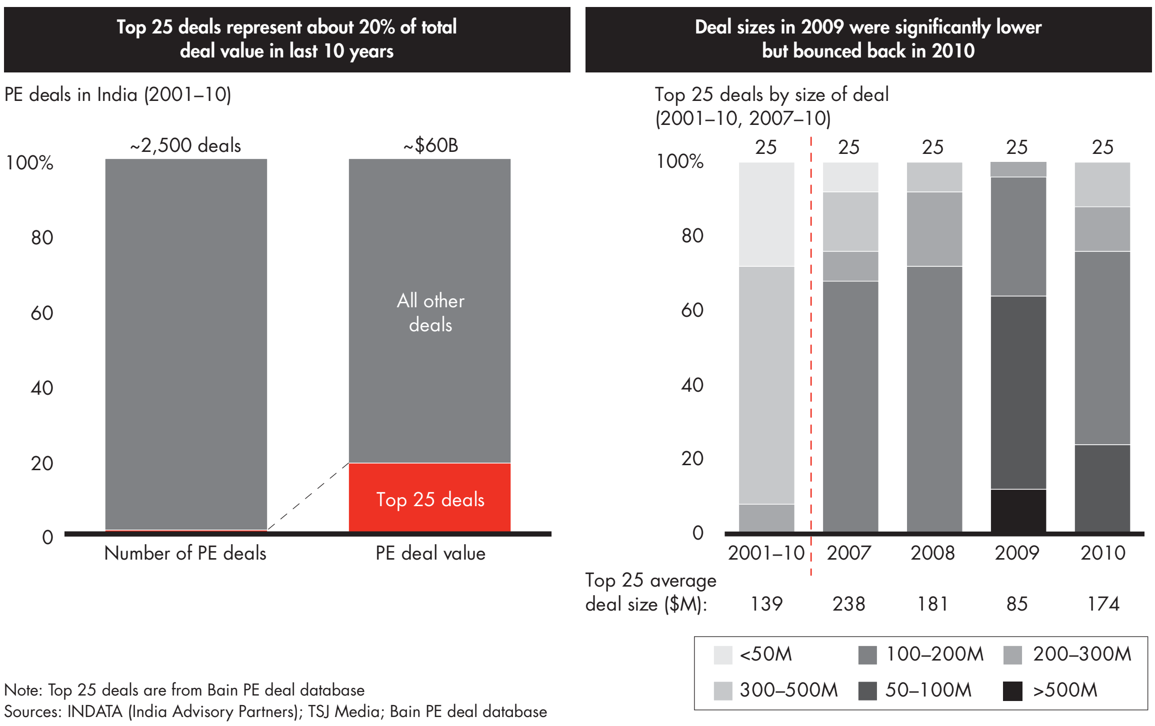
Source: Bain IVCA VC/PE research survey 2011 (n=50)

makers' shift from funding large IT companies to more opportunistic value investments in small to midsize niche companies needing growth capital as the industry matures.

One long-standing trait of Indian PE that has not changed much is the relatively small size of the deals completed. Average deal size in 2010 did increase slightly to US$24 million compared with some US$21 million in 2009, but it remained well below the US$35 million average value of deals concluded in 2007 at the peak of the PE cycle. Among the largest deals in 2010 was the US$425 million acquisition of a 44 per cent stake in Asian Genco, a developer of power generation systems, by a group of PE funds that included General Atlantic, Goldman Sachs, Morgan Stanley Infrastructure Partners, Everstone Capital and Norwest Venture Partners.

Small deals have characterised Indian PE from its early years, but even the biggest deals have been smaller in recent years. The average deal size for the 25 largest PE investments made in 2007, for example, was US$238 million. In 2009 and 2010, by contrast, the average value of the 25 biggest deals dropped to just US$85 million and US$174 million, respectively (see Figure 3.3). As in previous years, the rebound in deal value in 2010 partly mirrored the higher valuations available in the capital markets as public equities bounced back along with promoters' willingness to sell ownership stakes.

Figure 3.3: The share of larger deals is increasing but remains below peak levels



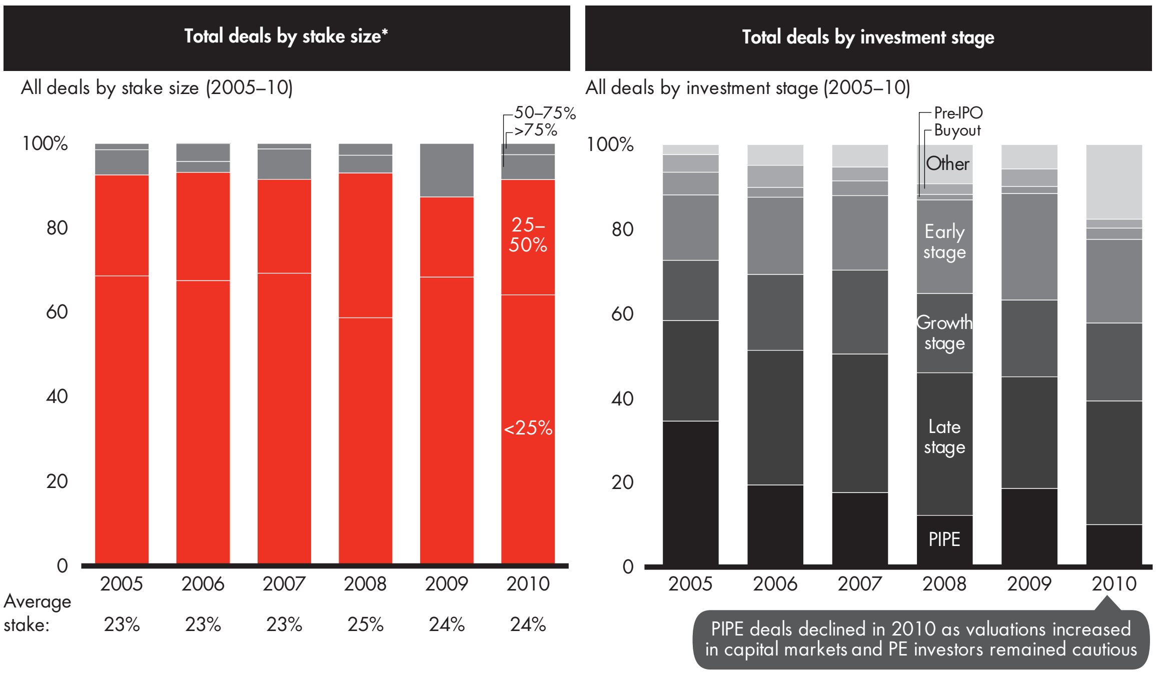
Note: Top 25 deals are from Bain PE deal database
Sources: INDATA (India Advisory Partners); TSJ Media; Bain PE deal database

Consistent with the small monetary values of PE deals are the generally small minority ownership stakes promoters are willing to sell. In 2010 as in the previous five years, some 60 per cent of deals involved the purchase of less than a 25 per cent ownership position (see Figure 3.4). Even among the 25 biggest PE deals in 2010, almost 80 per cent were purchases of minority ownership positions ranging up to 50 per cent of the target companies. The cultural attitudes of the Indian promoters coupled with restrictions on the amount of debt PE investors can use to finance purchases have caused the acquisition of minority holdings to be more popular than outright buyouts.

PE and VC investors are active in roughly equal proportion across all phases of Indian companies' life cycles. Some 20 per cent helped early-stage start-up companies get on their feet. Another 20 per cent or so supported companies' efforts to help build scale and scope in their growth phase. Late-stage and pre-IPO investments in companies coming to maturity each accounted for approximately 30 per cent.

One notable trend over the past six years has been a decrease of PE investments in the shares of public companies (PIPE deals) in proportion to the increase in public equity market valuations. During their early years, many PE investors with capital to deploy and trying to break into a market where their relationships with promoters were not well developed had few investment options other than to buy shares in public companies.

Figure 3.4: Most deals continue to involve a minority stake



Note: *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 PE deal database

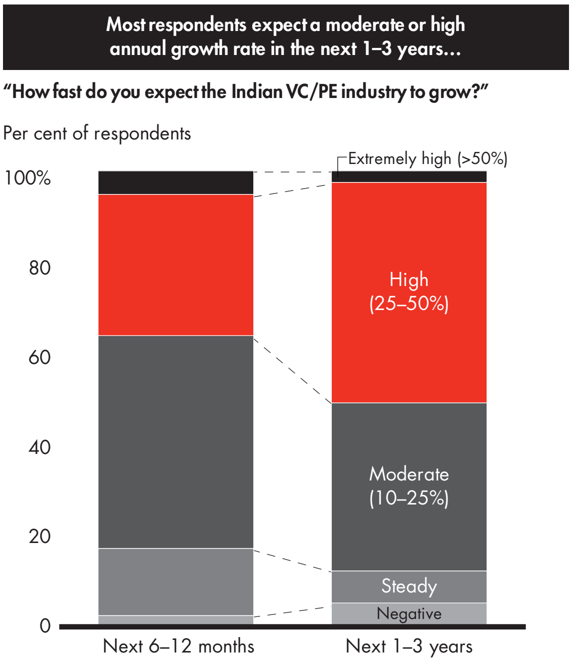
With time, as their networks of relationships have grown stronger and more and more promoters have come to understand the PE value proposition, so too has the range of deals PE funds are able to complete. Comprising some 35 per cent of all deals in 2005, PIPEs comprised less than 10 per cent of the investments made last year. One major reason for the decline in PIPEs has been increasing public market valuations that inflated valuations. There are also regulatory obstacles that dampen PE investors' enthusiasm for PIPEs, most notably disclosure requirements that effectively prohibit potential PE buyers from undertaking due diligence that relies on information that is not available to all other investors. However, as we will see later in this section, general partners we interviewed believe that PIPEs will make a comeback.

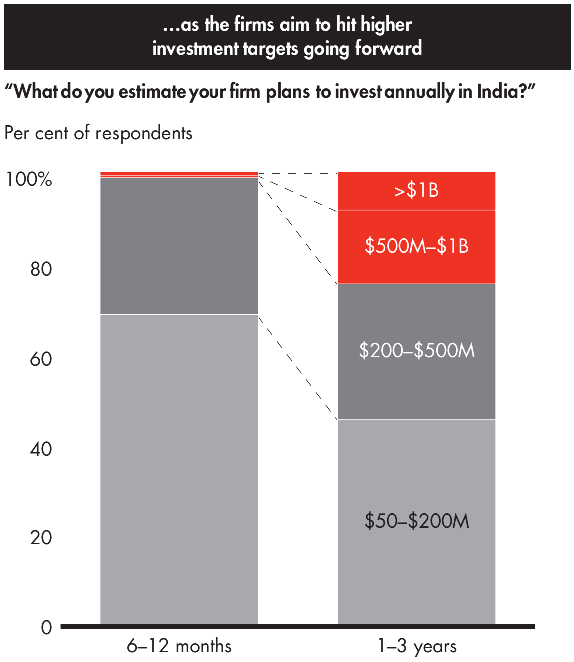
Longer-term prospects for 2011 and beyond: Activity will pick up but competition will be intense. The basic features of India's PE deal-making environment—smaller deals for minority stakes—look to be well entrenched. But PE funds will need to work harder to remain in the deal flow and to convert more of their initial expressions of interest into closing successful deals. International PE firms will face stronger competition from the new breed of experienced domestic rivals. Both domestic and international firms should also expect to continue working within regulatory constraints that will likely remain largely unchanged over the coming year. Staying ahead of the game will require fund managers to deepen relationships with promoters, portfolio company executives and other intermediaries to be the "partner of choice" in the most attractive deals.

How will deal-making dynamics play out in 2011 and beyond? In terms of deal activity, a clear majority of the Bain survey respondents anticipate a continued moderate increase in 2011 from the already improved levels of 2010 (see Figure 3.5). While just 5 per cent of the investors we polled look for the growth in deal activity to be extremely high, soaring by more than 50 per cent over the coming year, nearly one-third of respondents expect it to increase by between 25 per cent and 50 per cent. Almost 35 per cent anticipate more moderate growth in the range of 10 per cent to 25 per cent. Over the next three years, respondents expect slightly higher growth, with approximately one-half foreseeing a 25 per cent to 50 per cent growth rate through 2014. Fewer than 20 per cent think deal activity will hold steady at around 2010 levels or decline somewhat in 2011, versus to just over 12 per cent who expect it to remain flat or fall through 2014.

Survey respondents also look for deal opportunities to appear across the breadth of the Indian economy. Asked to rank the attractiveness of business sectors on a scale of one to five, where five indicates "most attractive", they are most bullish on banking and financial services, healthcare and consumer products. The IT and ITES sector continues to hold promise, but it appears to have slipped slightly from the top spots it occupied over the past two years or longer (see Figure 3.6). Investments in the infra-

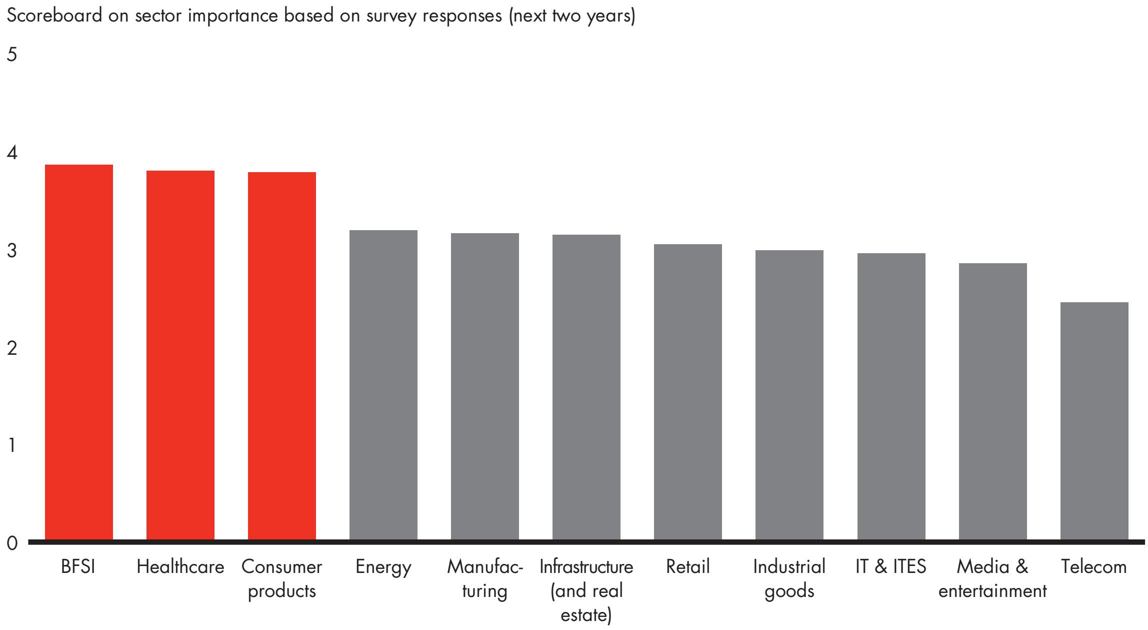
Figure 3.5: Solid growth expected in PE and VC industry growth will spark more investment in India





Source: Bain IVCA VC/PE research survey 2011 (n=50)

Figure 3.6: Financial services, healthcare and consumer products will draw the most PE interest over the next two years



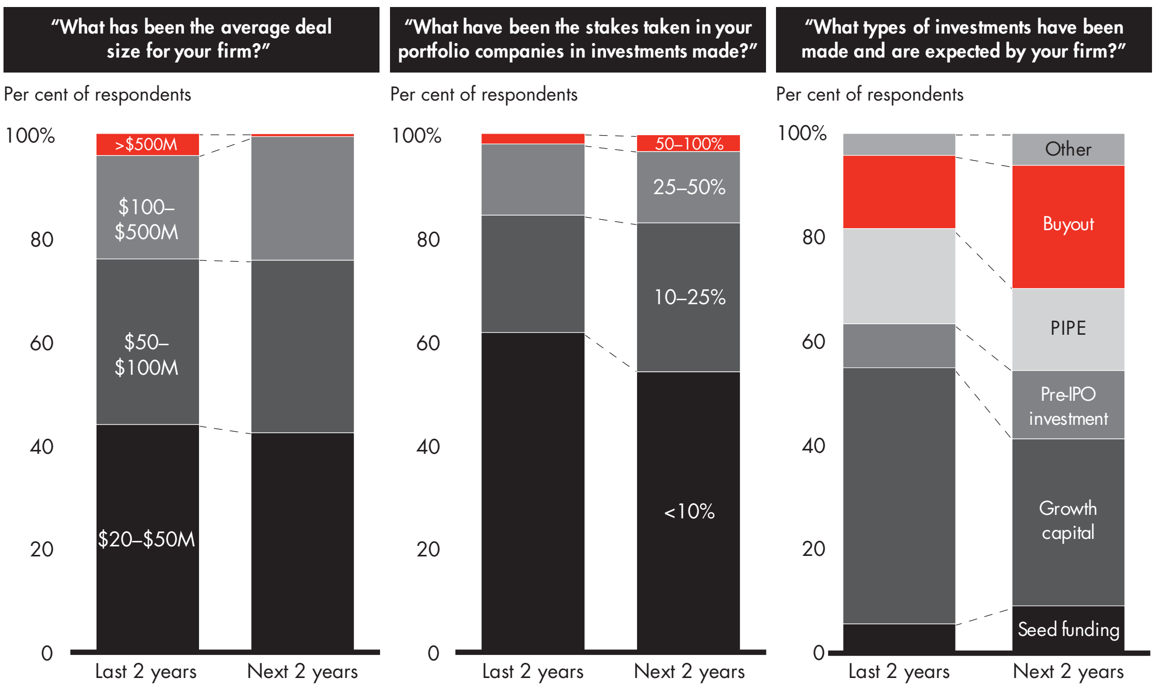
Note: Survey conducted across firms from all sectors; score refers to average of score given to sector by survey respondents; 1 refers to "least important" and 5 refers to "most important"
Source: Bain IVCA VC/PE research survey 2011 (n=50)

structure and energy sectors hold appeal to some PE funds, but their return dynamics do not make them popular investment avenues for all firms. Section 4 of the report analyses the deal activity and investment dynamics in the infrastructure sector further.

When it comes to deal size, the survey participants expect them to decline marginally over the coming two years, with none of the respondent firms expecting to do any deals valued at US$500 million or more. However, respondents do expect to see the number of deals in every other size category to increase, tracking the growth of India's economy and the capital needs of companies that aim to grow with it. The number of deals valued between US$100 million and US$500 million will see the largest rate of increase (see Figure 3.7).

Survey respondents anticipate that they will acquire larger investment stakes, yet average deal size is expected to stay in the current range. Our interviews found a consensus among industry experts (including LPs) that the number and proportion of buyouts will increase only marginally. Minority positions will continue to dominate as promoters' reluctance to cede control changes very slowly. An interesting indicator of this gradual shift is the increasing number of first-generation Indian entrepreneurs selling off their businesses to strategic buyers. Notable transactions include promoters' sale of Anchor Electricals and Paras Pharmaceuticals—two long-standing family businesses—to

Figure 3.7: Average deal size is expected to stay in the current range, but investors are likely to buy larger stakes in portfolio companies



Source: Bain IVCA VC/PE research survey 2011 (n=50)

Panasonic and Reckitt Benckiser, respectively. As sales like these gain increased acceptance, the second and third generations in established businesses are likely to pursue their independent aspirations or simply realise a better financial return through sale of the business.

Investors will increase their activity in PIPE deals, as the choppy capital markets in 2011 are likely to present attractive opportunities for PE funds. For all the regulatory difficulties PE funds encounter trying to assess the "right" price to pay for untapped value-creation opportunities in public companies, PIPEs vastly expand the PE deal universe. "PIPEs are difficult to ignore", said a general partner in a highly regarded PE fund, "and PE firms are developing asset appraisal capabilities and using a wide range of advisers to develop a robust investment thesis".

The relative ease with which they can access capital markets leads even promoters, whose businesses are subscale, not to consider PE investments as a source of capital to help finance their growth. But with public markets currently volatile and shallower than many perceive them to be, the stock prices of their companies do not often match their aspirations because trading volumes are thin due to limited and sporadic investor interest. This is leading several public promoters to look at PE to raise their next rounds of capital. The recent departure of four managing directors from Sequoia Capital, reportedly to form an independent fund that will focus on PIPE deals, is a telling sign that PIPEs in India are here to stay.

Options for deal structuring will likely remain much as they are today—relying on straight infusions of equity and limited use of debt. Convertible debt issues may increase their share as PE investors seek to combine the benefits of providing portfolio company managers with performance incentives while protecting themselves against downside risks. However, regulation mandates that require foreign funds to be explicit on pricing from the outset will continue to limit their creativity in structuring deals. Domestic funds have a clear advantage here, since they can use flexible pricing mechanisms linked to the portfolio company management hitting performance benchmarks.

In one critical way, deal making will change materially from what it has been; competition will intensify even further from its already high levels. The competition among PE bidders is exacerbated by the fact that the promoters we interviewed said that they intended to continue to circulate IMs to several funds to improve their chances of getting the best deal. Beyond their eagerness to benefit financially from a higher valuation, promoters do not appear to appreciate fully the variety of PE options available to them or the opportunities for value creation that different PE and VC firms can offer.

As competition among more funds looking to invest larger volumes of dry powder in good deals ratchets up, experts say, PE firms are feeling pressure to differentiate themselves with the promoters. Although not yet a trend because the Indian market is still too shallow to make it worthwhile for PE funds to develop true specialisation, more firms are organising their hunt for attractive deals around specific industry sectors or investment themes.

In parallel, PE funds are recalibrating their sights in search of more proprietary deals. They are scouting out opportunities in parts of the market where competition is less ferocious and they have more bargaining room. That tactic has been only modestly successful to date, as Indian promoters are quick to include an intermediary in the equation in order to secure better valuations. Thus, it is not surprising that while PE funds work hard to source proprietary deals, most of the fund executives we interviewed said that they expect the role of intermediaries—including that of their own limited partners—to increase. One PE executive told us that his fund has paid premiums of between 10 per cent and 20 per cent on deals after an intermediary got involved—a surcharge that can weigh heavily on an investment's ultimate return. Hoping to offset this disadvantage, PE funds will continue to engage early with promoters in order to assess the investment opportunity better and establish a good rapport with the promoters for more favourable outcomes when the time comes to negotiate the term sheet.

What, then, do promoters look for in a PE firm? The short answer: the foundation of a strong working relationship with a partner that understands their business, brings a solid reputation to the table and has a track record of success. The most important investment general partners will make is in the time and energy it takes to establish good rapport with promoters before the term sheet is drafted. One successful promoter who has raised multiple rounds of funding from VC and PE funds told Bain that failure to put in sufficient effort to understand his business and credibility of his team in the first round of funding was one of the major reasons negotiations with some PE funds ended with no transaction coming to fruition.

Promoters we interviewed also confirmed that prior experience in similar businesses or an established network in their industry does make the PE fund more attractive than others. Finally, the brand that a PE fund creates with promoters and projects to the market, in general, goes a long way towards making it the preferred choice. One promoter told us that he passed up going with the fund that offered the highest valuation and has not regretted the decision. He selected a leading VC fund sponsored by a respected technology company, expecting that the positive reputation it established in that relationship would rub off on customers and business partners of his own technology-driven business. He says that the partnership has been much more successful than he had envisaged.

Portfolio management

Today's baseline: Inching towards a more activist role and deeper partnerships. Perhaps preoccupied by their energetic pursuit of capital to fund their companies' growth over the past decade, Indian promoters have come a long way from seeing private equity as simply another source of funding. Many still fail to place a value on PE investors' value-creation skills—the very capabilities that underpin the PE ownership model in developed markets.

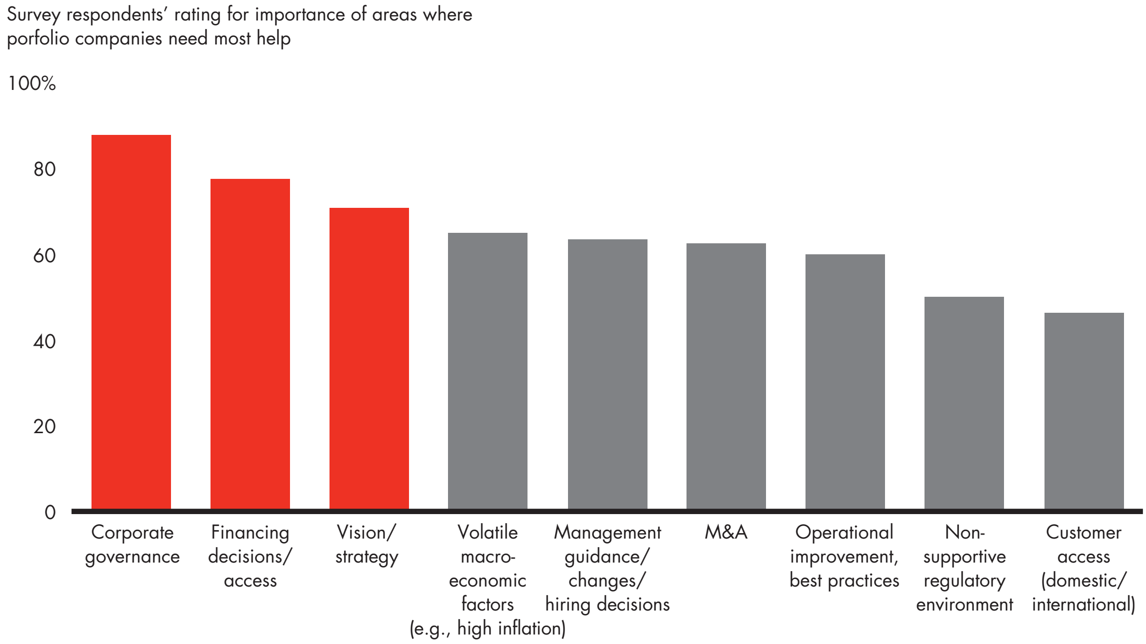
The fact that promoters have been reluctant to allow PE investors to become more actively involved in the operations of their businesses fails to take full advantage of their talents. In most instances, PE owners still play an advisory role and monitor their investments periodically through management reports, meetings with management and sometimes a seat on the company board. Beyond that mostly consultative role, more active PE participation continues on an as-needed basis as called for by the promoter.

When Indian companies have other financing options they can tap but do accept PE, they usually have a specific objective in mind. Most often they turn to PE owners to help strengthen their company's corporate governance or for the financial savvy PE partners can bring as they ready their companies for an initial public offering.

Our survey reveals that promoters and PE investors agree that there are clear areas where portfolio companies value support and guidance from the VC or PE investor. Specifically, corporate governance, financing decisions and access to capital, and defining the company's vision and strategy top the list. The ability to provide these is likely to become an increasingly important criterion for differentiating leading PE funds from their rivals. However, while a majority of respondents cited operational improvements and support gaining access to domestic and international customers as areas where PE could add value, these more hands-on activities were seen as less important (see Figure 3.8).

Determined to play a more activist role, some PE firms are beginning to build operating teams they can put to work at portfolio companies. But so far, these have been limited primarily to firms that focus on buyouts or specialise in very high-value deals, both of which are still uncommon in India. For most firms, increasing their value-creation capabilities is premature because India's deal market is still too shallow to warrant investment in specific industries. Still, it can make sense to invest in certain capability areas. Eventually, PE firms that can bring operational expertise to the table will likely enjoy a competitive edge that could lead promoters to favour them over other potential PE buyers, even when they do not offer the highest bid. But to date, value-addition skills have not resulted in valuation discounts exceeding 3 per cent to 5 per cent. When

Figure 3.8: Promoters need PE help with corporate governance, financial decisions and strategic vision



Note: Per cent refers to the proportion of respondents who considered area as very important (score of 4 or 5); 1 refers to "least important challenge" and 5 refers to "most important challenge"
Source: Bain IVCA VC/PE research survey 2011 (n=50)

asked, GPs of several leading PE funds concede that the VC and PE industry has not done enough to educate promoters and prospective investee companies about the PE value proposition.

The higher level of attention PE funds have devoted to their portfolio companies until recently appears mainly to protect investments during the lean deal-making period and to develop a unique positioning with the LPs for future rounds of fund-raising. Industry observers note that even those rare PE firms that have built operating teams as an integral part of their fund philosophy have enjoyed some success in adding value to their investments, but not as much success as investors in buyout deals have had in developed markets. That is because most investments are of such small scale that the time and energy the operating team professionals commit ends up being fragmented across several portfolio companies.

Longer-term prospects for 2011 and beyond: Finding ways to make PE true business partners, not just finance providers. For private equity to deliver its full potential, it is clear that both promoters and PE investors need to recognise that their interests are aligned. For promoters, that means being willing to see PE as more than just a last-resort source of capital or opportunistic pre-IPO funding for the short term but as a partner in helping the company outperform its growth goals. PE owners are recognising that they need to do more to build their brand with promoters, working to win the confidence of promoters as a step in making the investment that is every bit as critical to the deal as coming to terms over the financials.

There is much riding on developing that deeper collaboration. In our survey results, 70 per cent of respondents estimate that profit growth will be the key driver of future returns, and not share price-to-earnings multiple expansion or other conventional market-related drivers of investment returns. Premium returns will go to promoters and PE investors that are best able to drive value creation in the investee enterprise.

With habits of behaviour on both sides fairly well fixed by the experience of the past several years, major changes in PE portfolio management approaches are not likely any time soon. The basic interactions that characterised relations between promoters and PE investors over the past two years via occasional meetings with senior executives, board participation and periodic discussions of performance reports will remain essentially the same even two years from now. One significant development survey respondents anticipate is that there will be somewhat closer involvement of PE fund representatives in the day-to-day workings of their portfolio companies, including the assignment of PE fund employees to work with company management. That does not mean that promoters will become more amenable to operational interference, however. As a general partner in one leading PE firm pointed out, "PE funds mistake value creation for driving operational improvements. In India, it is really about being able to become a 'trusted adviser' for the promoter and having a truly transparent business partnership".

Nevertheless, evidence is beginning to appear that attitudes towards PE activism are gradually starting to shift. In our survey, some 40 per cent of respondents said they believe promoters have a good understanding of the PE value proposition, and nearly 80 per cent are convinced that appreciation on the part of promoters for what PE can add will deepen in the future. In interviews, several promoters said that they valued the experiences PE investors could share from their involvement with previous businesses that are similar to their own. Elaborating on the point, a successful entrepreneur told Bain that promoters would do well to recognise the help PE can offer in terms of access to their domestic and global business networks and advice they can offer in critical areas like cash management. But he emphasised that PE investors need to understand better how long it takes for investments to mature in India and become more realistic about returns.

When PE investors are more actively involved in the operations of their portfolio companies there are five principal areas where they have a major impact. The first is to strengthen corporate governance, often the most difficult role for PE to perform yet the one that promoters told Bain is most appreciated once it has been accomplished.

The second valued role for PE owners is the help they can offer to position the portfolio company to raise new rounds of capital. Their financial expertise adds much needed experience and sophistication. In fact, a promoter in the industrials space told us that his organisation benefitted immensely from the guidance its PE partner provided and asked the fund's board representative to stay on even after the fund had exited the investment.

The third area where PE investors can help is by bringing rigour and discipline to inefficient business systems and processes, clearly mapping the company's growth trajectory and prioritising critical business initiatives.

The fourth key support PE firms can provide is valuable access to business networks that can help a portfolio company to expand—an advantage that many PE insiders say promoters do not yet fully exploit. That can have a bigger impact on smaller companies promoted by inexperienced or first-generation entrepreneurs. Finally, PE owners can help to strengthen the team by identifying management talent to fill critical roles in portfolio companies. A partner with a PE fund who is helping to hire a COO-level executive for an education company in which his firm has invested explained what his firm derives from this kind of indirect engagement. Even without the hands-on involvement from the firm's investment professionals or operating teams, he told us, he has found that this kind of engagement presents an interesting opportunity to achieve operational excellence.

One entrepreneur we interviewed pointed out that as PE fund managers begin to assume a more active role in the management of their portfolio companies, they would do well to discuss the needs of the investee company very explicitly with the promoter upfront. In his experience, PE funds sometimes look at all investee companies through the same lens and end up expecting a company in its juvenile stage to demonstrate success too soon or provide too much handholding to more mature companies. Understanding the promoter's needs and aspirations, aligning the incentives to its own objectives and tailoring the support and day-to-day involvement with investee companies' needs facilitates superior collaboration and ultimately higher returns.

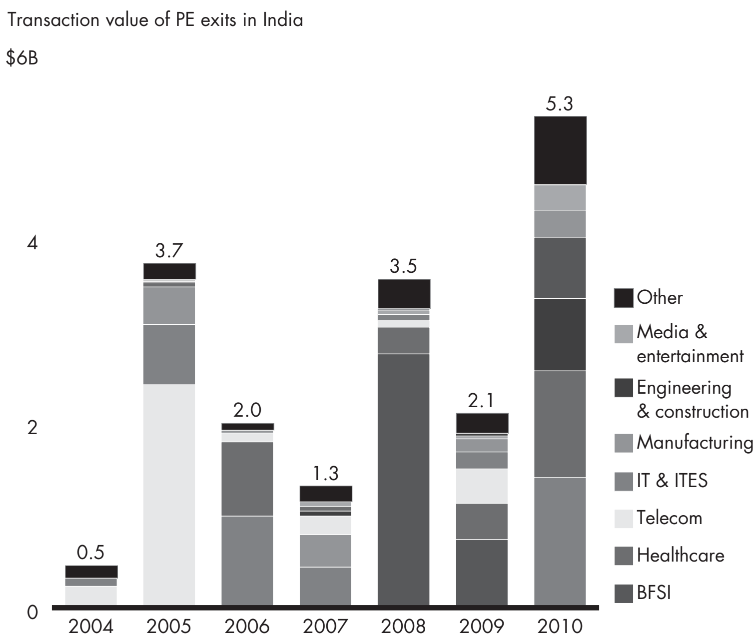
Exits

Today's baseline: Building upon a record year in 2010. The soundness of Indian PE's exit routes and the internal rates of return (IRR) PE investors reap from the sale of their portfolio holdings is the acid test of health of the PE industry. Because PE in India is still a relatively new and rapidly evolving industry, the story of whether PE firms will be able to sell off their investments successfully at the end of their typical three- to five-year holding period was yet to be written conclusively. However, 2010 marked a year of testing, and India passed with flying colours.

Following several years when exit volumes were low relative to the number of new deals being done, PE funds unwound positions in 120 companies last year, taking in US$5.3 billion. With the number of PE sales more than doubling the previous peak of 56 in 2007, it was a record year. In terms of total value realised, 2010 far surpassed the previous peaks of 2005 (exit volume: US$3.7 billion), when a handful of very large transactions skewed the totals, and 2008 (exit volume: US$3.5 billion), when the public equity markets soared at the peak of the business cycle (see Figure 3.9).

Cyclical factors partly explain why exit activity was so strong. Many PE firms that acquired assets earlier in the decade postponed sales when the markets softened following the 2008 global credit crisis. Solid economic fundamentals and revived public equity markets in 2010 presented PE sellers with favourable conditions to clear the backlog. Equally notable was the depth and breadth of the exit markets. PE funds sold holdings in companies representing in roughly equal proportion every major sector of India's economy. Among the healthy crop of big divestitures included sales of Paras Pharmaceuticals, a healthcare company for US$726 million by Actis and Sequoia Capital; Infosys Technologies, a business-process and IT enterprises company, for US$400 million by ChrysCapital; SKS Microfinance, a financial services firm, for US$359 million by a group that included Sequoia Capital and Kismet Capital; and Orient Green Power,

Figure 3.9: Exit values hit a record high in 2010, with activity strong across all sectors



Top 10 exits in 2010

Target	Value ($M)
Paras Pharmaceuticals	$726M
DLF Assets	$694M
Infosys Technologies	$400M
SKS Microfinance	$359M
Intelligroup	$199M
Aamby Valley	$323M
Pipavav Shipyard	$187M
L&T Infrastructure Development	$165M
SpiceJet	$127M
RFCL Ltd.	$112M

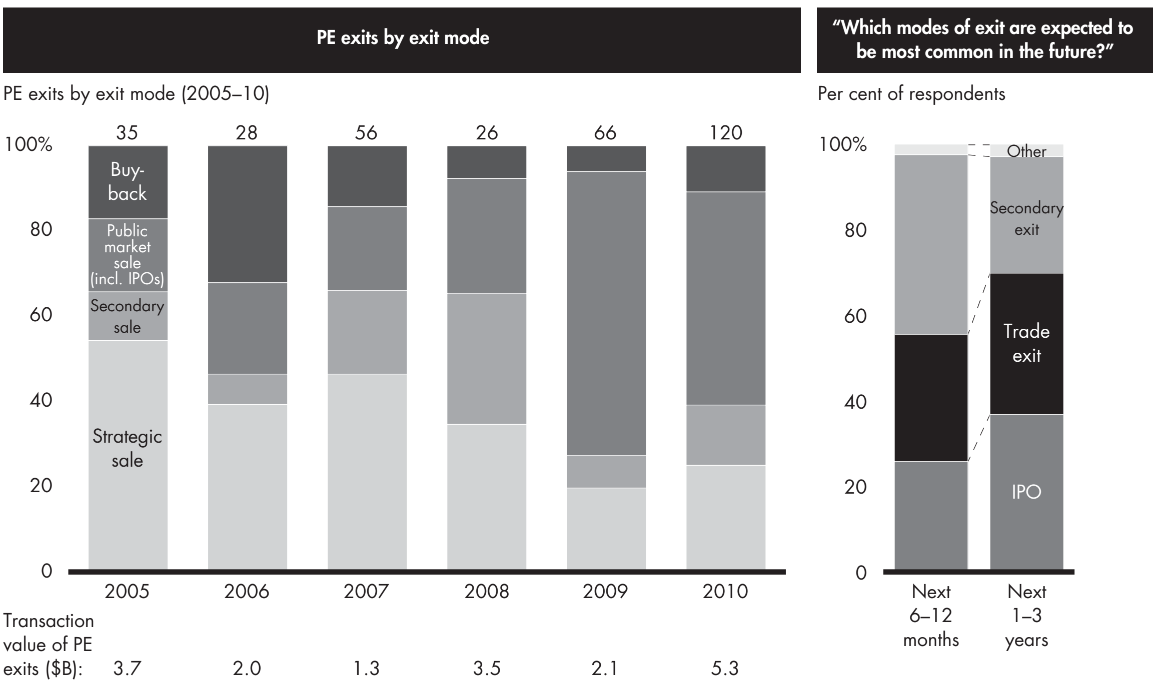
Note: "Other" includes consumer products, hotels & resorts, retail, shipping & logistics, textiles, education and other services; peak in 2005 due to large exits by Warburg Pincus and CVC
Sources: Venture Intelligence; Bain PE exits database

an alternative energy company, for US$200 million by Olympus Capital and Bessemer Venture Partners.

PE funds looking to sell last year were able to choose from among several healthy exit-route options. By far the most popular was public market sales, including a buoyant IPO market, which accommodated 60 new listings, which corresponds to nearly half of all exits (see Figure 3.10). Strategic buyers were also back in the market during 2010, accounting for a record 25 per cent of sales through mergers and acquisitions. Secondary sales to other PE firms like that of Metropolis Healthcare by ICICI Ventures (US$85 million) and buybacks by promoters such as that of L&T Infrastructure Development Projects Limited by JPMorgan and IDFC PE (US$165 million) accounted for the balance.

Longer-term prospects for 2011 and beyond: Favourable exit conditions will continue but timing will be important. Survey respondents remain bullish about exit prospects through 2011—and are even more optimistic about conditions over the next one to three years. The nearly 800 deals made through 2007 that remain in PE fund portfolios are the likeliest prospects for exit in 2011. Together, they represent an investment value of some US$15 billion. In the near term, about one-half of the industry participants surveyed said they expect the number of exits to "increase somewhat",

Figure 3.10: IPOs and public market sales will remain an increasingly important route to exit



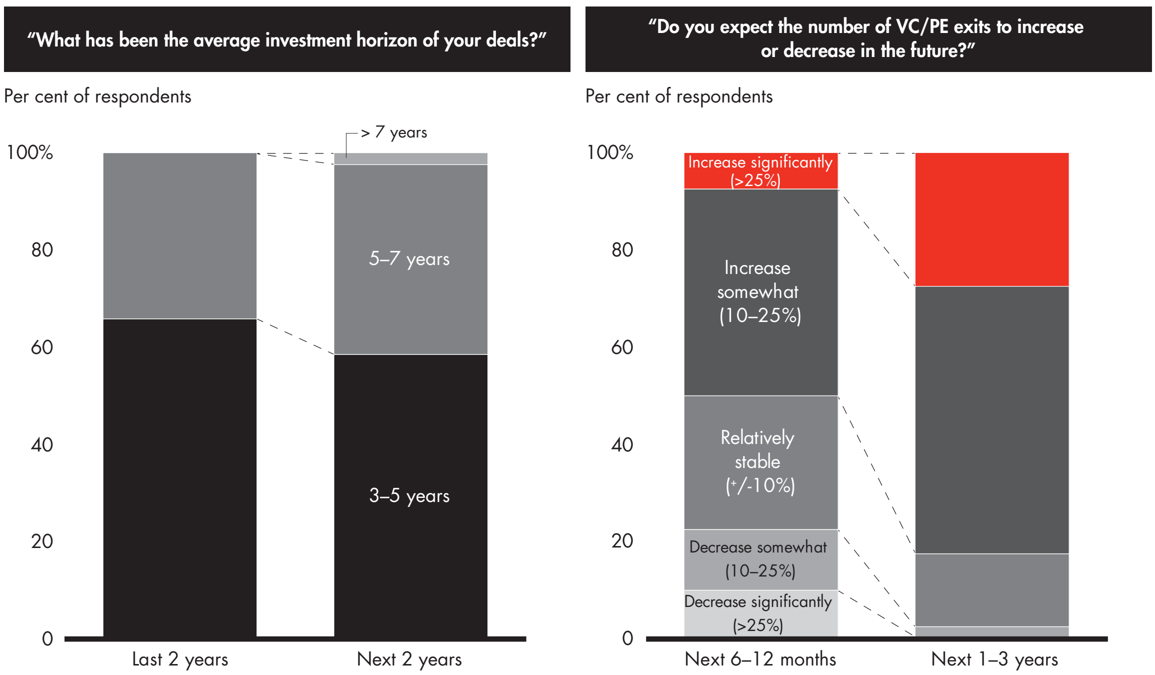
Source: Bain IVCA VC/PE research survey 2011 (n=50)

rising between 10 per cent and 25 per cent, or "increase significantly" (jumping by more than 25 per cent). But looking ahead to 2013, pessimism all but vanishes; just 2 per cent of respondents expect exit activity to "decrease somewhat" with the balance anticipating that it will remain stable or continue to increase off the expanding base (see Figure 3.11).

The medium-term attractiveness of exit conditions leads our survey respondents to think that more PE funds will be inclined to stretch out their investment horizons. Over the past two years, the average investment-holding period for about 65 per cent of funds in our survey sample ran between three and five years; the balance held on to their PE assets for between five and seven years. Looking ahead to the next two years, however, about 35 per cent expect to have an investment horizon of between five and seven years, and some 5 per cent more estimate their investment horizon will stretch longer than seven years, indicating a slight drop in funds expecting holding periods to hold steady at between three and five years.

There is certainly a deep inventory of potential exits already in the PE pipeline. Approximately 60 per cent of PE funds invested through 2007 remain in PE funds' portfolios and around 10 per cent of investments in the exit universe are more than or equal to five years old. Now reaching the upper end of their investment holding periods, many of these holdings should soon be coming up for sale.

Figure 3.11: Even as PE funds increase their investment holding periods, most look for exit activity to increase



Source: Bain IVCA VC/PE research survey 2011 (n=50)

Of course, how individual PE firms navigate exit markets in the coming year will depend critically on the kinds of assets they are trying to sell, the exit route they are able to take and their timing horizon. Industry experts forecast that public equity markets will be choppy through the summer, making pricing conditions uncertain. For PE funds holding infrastructure or financial services assets, which are generally liquidated only through initial public offerings, market volatility could complicate exit timing. These funds may be able to tap the IPO market opportunistically to bring in cash, and hence, the likelihood is low that they will not be able to dispose of their holdings fully. Thirty-seven per cent of survey respondents do look for the IPO market to be more inviting in the second half of 2011 and beyond, and some PE firms appear to be deferring their exit plans until conditions are more conducive.

Many general partners who are eager to book some "wins" and return cash to their limited partners are moving ahead with their exit plans now, even if that means selling at slightly lower valuations. Most experts Bain spoke to believe that is the right approach. Waiting in the hope of capturing a higher valuation multiple might not improve the investment's IRR especially where entry valuations were relatively high or holding periods have exceeded the norm. A PE executive told us that most PE firms have re-rated exit-multiple expectations downwards following the 2008–2009 meltdown, which demonstrates the maturity on the part of the GPs and the LPs backing them.

For PE funds with portfolio holdings in specific sectors like consumer goods, which are less dependent on the public equity markets as their primary exit route, the near-term options look even more flexible. Disposal of these assets through sales to strategic acquirers and a strong market for secondary sales to other private investors should provide a good cushion against public market choppiness.

Given the generally attractive current conditions and even better ones expected over the intermediate term, PE sellers are well positioned to benefit from favourable exit trends. And if this positive outlook does come to fruition, it will go a long way towards re-affirming the confidence of limited partners in the Indian PE market.

4. Sector deep-dive: The outlook for PE in infrastructure

Infrastructure development is India's single biggest economic challenge and one of private equity investors' biggest opportunities. Investment in infrastructure averaged between 3 per cent to 5 per cent of GDP during the period from 1980 to 2007, and the government has targeted it to grow to 9 per cent of GDP by 2012. Yet, infrastructure development has lagged India's spectacular economic expansion and is now a constraint on the nation's ability to sustain or increase growth.

The current infrastructure deficit is stark. For instance, 40 per cent of all traffic is carried on just 2 per cent of India's total road network. In agriculture, which employs more than half of India's population, 54 per cent of land is arable yet just over one-third of that is irrigated. In merchandise trade, India's ports can accommodate some 10 million TEU of containerised traffic, less than 10 per cent of the capacity of China's ports.

Roads, irrigation, power and railways are integral to the economy and need to scale up as the economy grows. The need to increase their capacity correlates with rising domestic consumption, which in turn supports the overall long-term growth of the Indian economy. For instance, the demand for power in India increases in proportion with the GDP growth rate. With peak power deficit estimates ranging from 10 per cent to 15 per cent, no slowdown in investment is expected. Furthermore, utilisation of critical infrastructure assets, such as railways, is straining to keep up with demand, making additions imperative across virtually all infrastructure subsectors. India's need to steadily expand infrastructure development offers a very attractive opportunity for value creation even in the face of fluctuations in the global economy.

Public policymakers' appreciation of the central importance of infrastructure development has increased considerably in recent years. Infrastructure emerged as a sector of focus for the first time only when the government of India's Planning Commission

The Planning Commission of India defines infrastructure as consisting of the following subsectors: electricity, roads and bridges, telecom, railways (including mass rapid transit), irrigation (including watershed development), water supply and sanitation, ports, airports, storage, and oil and gas pipelines. The construction sector is included in this report as a part of infrastructure, as it is implicit in the spending for each of the other major subsectors.

drafted the Xth Five-Year Plan (2002–07). The XIth Five-Year Plan (2007–12) brought it into even sharper relief, with targets outlined for subsector investments as well as projected sources of capital. Significant private investment through public-private partnerships became a core element of the planned expenditures, as policymakers adopted the principle that users of utilities such as transport and power would pay differential rates. The strategy to attract private sector investment into infrastructure proved successful. The mid-term assessment of the XIth Plan published in June 2010 revealed that private investors accounted for nearly 35 per cent of total infrastructure investment in the period 2007 to 2009.

The role of the private sector

The private sector is poised to seize the opportunity presented by infrastructure development. Private investors are already participating in a variety of ways and establishing a strong track record of wealth creation. Successful private sector companies are typically quick to spot opportunities in specific sectors and geographies, bring strong project and programme management capabilities to their investments and use capital efficiently.

Regulatory changes have further encouraged private sector participation in infrastructure. For example, the Electricity Act (2003) and its subsequent amendments have made it much easier for private investors to invest in the power generation sector. Pricing has become more transparent as the number of public corporations and other private players now competing for project assets has increased. Open bidding for large-scale power installations like the ambitious Ultra Mega Power Projects attracted large industrial houses, such as Tata Power, Larsen & Toubro, Reliance Energy and the Adani Group, among others. As of January 2011, the private sector has accounted for more than one-third of incremental installed thermal and hydro capacity under the XIth Five-Year Plan.

Reforms in coal mining and gas exploration and production sectors have enabled private participants to secure the fuel supply through vertical integration. The opening up of power trading, allocation of captive coal mines and open bidding for power projects have created different types of companies active across the value chain, which has also sparked increased investor interest. The Electricity Act, along with the policy changes during the past three to five years, has triggered significant capacity addition. Other sectors, including airports, roads and telecom, have benefitted from similar regulatory and policy changes, which have significantly increased private sector interest and accelerated investment activity.

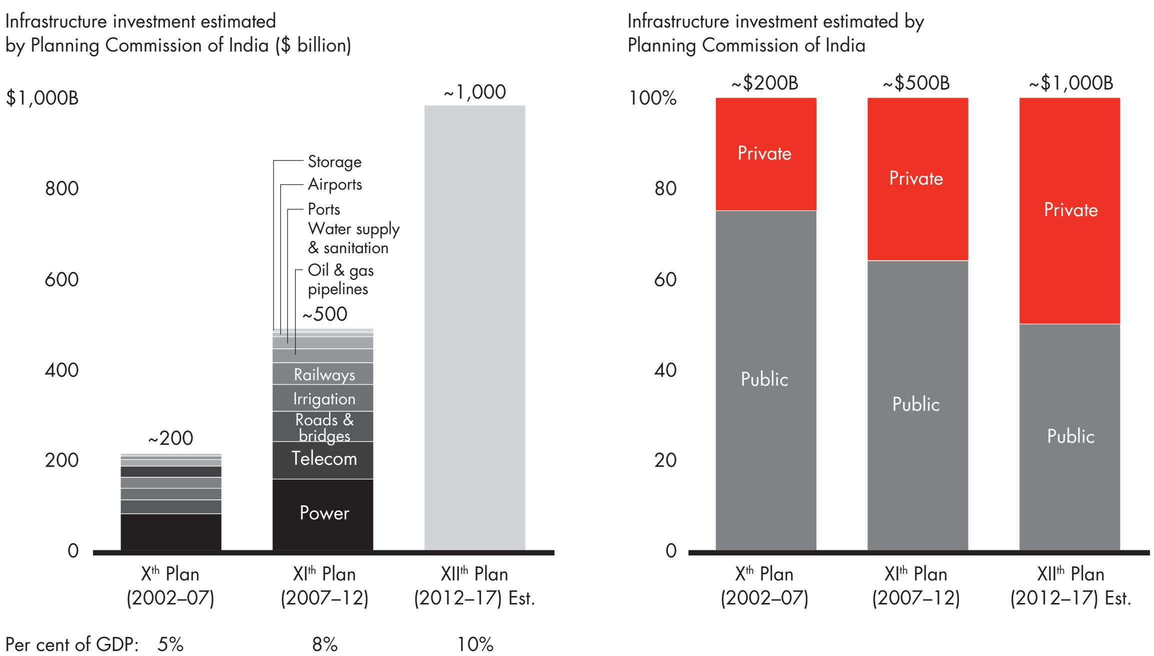
The government now expects that private participation in the creation and operation of infrastructure assets will see further major increases. The XIIth Five-Year Plan (2012–17) forecasts that infrastructure outlays will double to some US$1 trillion, with the private sector accounting for between 40 per cent and 50 per cent of the total (see Figure 4.1). Apart from providing capital, the private sector also has an important role to play in optimising capital expenditures and managing projects efficiently, both of which are critical for enhancing returns.

Private equity's financing role in infrastructure development

Historically, the government has not always met all of its investment targets. But even assuming that it were to reach between 70 per cent and 75 per cent of its US$1 trillion goal, spending in the range of US$700 billion to US$750 billion is highly plausible under the XIIth Five-Year Plan period. Thus, assuming a debt-to-equity ratio of approximately 2.5:1, the private sector will be required to invest some US$80 billion of equity and borrow an additional US$220 billion to US$295 billion to meet its anticipated financial commitment. Beyond that amount, the construction industry will need between US$150 billion and US$200 billion over the next five years to augment its capital assets and fund working capital. (That estimate assumes an investment commitment of about 20 per cent of total project construction costs.)

An ability to mobilise sufficient funding will be critical. Historically, Indian promoters have preferred to raise capital using a combination of debt and IPOs, but these modes

Figure 4.1: Government infrastructure investment will nearly double; private investors will play a bigger role



Notes: Investment includes public and private contribution; subsector allocations for XIIth Plan not yet disclosed; "roads & bridges" includes MRTS (mass transit)
Source: Mid-term Assessment of the XIth 5–Year Plan (Planning Commission of India)

have their limitations. While an IPO has its own set of challenges, including multiple regulatory filings, approvals from different authorities and most importantly, public equity market volatility, commercial banks face constraints on how much exposure they can assume. Under current rules, total lending by a bank or financial institution cannot exceed 20 per cent of a single borrower's net worth or 40 per cent of that of borrowers belonging to a consortium. They can increase that total by another 5 per cent with board approval, but those ceilings limit their funding of infrastructure investments. Moreover, regulatory restrictions, underdeveloped bond markets and the absence of efficient credit risk transfer mechanisms further limit banks' ability to back infrastructure projects.

To break through the financing barriers, a report issued by the blue-ribbon Committee on Infrastructure Financing headed by Mr. Deepak Parekh, the chairman of HDFC, India's leading housing finance company, recommended harmonising the definition of "infrastructure", liberalising investment guidelines for debt and equity instruments and rationalising the dividend distribution tax (DDT), among other measures. The report also strongly urged regulators to reassess the treatment of holding companies in order to ease equity and foreign investment flows. Many in the private equity community also cite some of these issues as barriers to their investments in the sector.

Because infrastructure projects typically have an investment term spanning more than 15 years, commercial banks that issue short-term loans face an asset liability mismatch, another constraint that limits lending. Likewise, insurance companies have not yet shown an appetite for financing private sector sponsors and continue to favour the public sector. To create a better match between long-enduring assets and short-term liabilities, the government set up the Indian Infrastructure Financing Company Limited (IIFCL) in 2006. Last year, the IIFCL introduced a take-out finance scheme to align the duration of concession periods to loan terms, which are typically half as long, and signed agreements with five commercial banks. Helpful as this step has been, efforts by IIFCL alone will not be enough, as its capacity does not cover the requirements of the infrastructure sector.

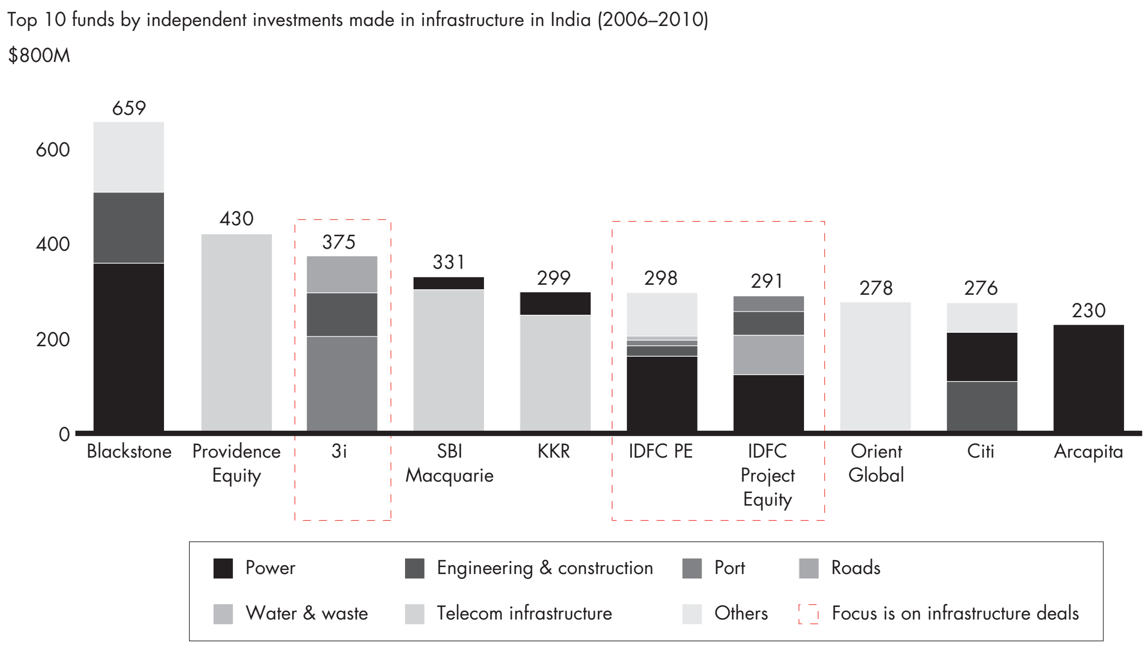
The handicaps on conventional financing magnify the important role PE can fill among other private investors. In addition to being a source of patient capital, PE firms can offer promoters and entrepreneurs their distinctive value-creation skills through their guidance and practical support in operational areas, corporate governance and business networking. As discussed in Section 3, these skills have already helped scores of companies across several industry sectors and have transformed many into some of India's most successful enterprises.

PE investors are taking a strong interest in infrastructure. Macroeconomic fundamentals, consumer demand, capital needs and the government's active role in promoting this sector are attracting PE funds and LPs alike. Although the prospects of returns in infrastructure investments are in the mid to high teens and thus somewhat lower than the returns realised on many of the private sector investments they make, PE firms are attracted by its growth prospects and the relatively low level of uncertainty they face once the construction and initial operations phases are complete. Long gestation periods and stable cash flows attract investors looking to diversify their portfolios and spread risk. Over the last two to three years, yield investors like endowments and pension funds have begun to look seriously at infrastructure as this opportunity is well suited to their specific investment and return needs. Several prominent PE funds have already started to focus on infrastructure as an important asset class and have deployed capital successfully (see Figure 4.2).

PE activity in the sector: Trends and challenges

Over the last five years, PE funds have invested approximately US$13 billion, equivalent to one-fourth of the total capital flows to India, into the infrastructure sector. Since 2006, annual PE investment in infrastructure has grown fourfold, from about US$1 billion to US$4 billion in 2010, when it rebounded to 2007 levels. Apart from a brief slow-down in 2009, average deal size has also increased—yet another indicator of growing PE interest in the sector. While three-quarters of the deals were for investments of less

Figure 4.2: While many PE funds have been active in the sector, a few have made infrastructure their focus



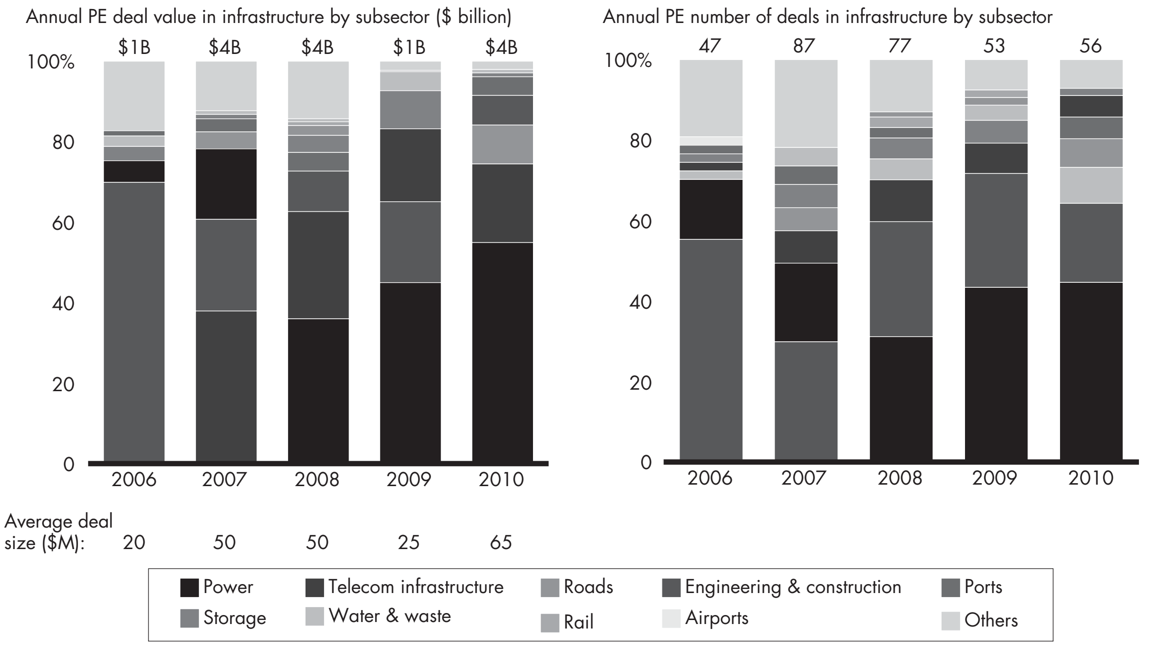
Notes: Independent investments means investments without other investors or consortiums; "roads" includes bridges and MRTS (mass transit); "others" includes shipping & logistics (excluding ports) and oil & gas; "telecom infrastructure" excludes services
Source: Bain PE deal database

than US$50 million, the share of equity investments greater than US$100 million has also increased. Notable among these were investments of US$425 million in Asian Genco, a developer and operator of power-generation assets, and US$300 million in GMR Energy, which is engaged in the business of power generation, transmission and distribution.

The range of subsectors attracting PE interest is also broadening and evolving (see Figure 4.3). In 2006, PE interest was largely concentrated in the engineering and construction space. Over the past three years, the power sector has attracted the most interest from PE investors, increasing to 45 per cent of total PE infrastructure investment between 2008 and 2010. Telecom infrastructure has become the next biggest target for PE investment, attracting US$1.9 billion over the same period. Opportunities in road construction are drawing investor interest due to changes by the National Highways Authority of India (NHAI) in model concession agreements that have speeded up the awards process. However, the total number of deals has barely increased over 2009, primarily owing to the lack of a strong project pipeline. Subsectors like water and waste management and storage have also seen a few small deals.

PE investments in infrastructure share some characteristics with those in other sectors. For one thing, most purchases are for small positions in the target company or project.

Figure 4.3: PE investment in infrastructure has rebounded to 2007 levels, but deal volumes still lag



Note: ~10% of deal values were undisclosed; average deal size calculated using deals with disclosed values from Bain PE deal database; "telecom infrastructure" excludes services; "roads" includes Bridges and MRTS; "others" includes oil & gas, mining & minerals and other shipping & logistics
Source: Bain PE deal database

More than 82 per cent of PE-backed deals in the last five years have involved stakes under 25 per cent, and only 5 per cent have involved stakes greater than 50 per cent. Apart from reluctance on the part of Indian promoters to sell a majority position, managing the complexities of running an infrastructure project or company is not a part of the skill set of most PE firms. A senior GP of a leading PE firm Bain interviewed also suggested that regulatory restrictions, such as one limiting leveraged-funding instruments, have also contributed to this trend.

PE investors have used a variety of relationship formats in this sector. While most have made several standalone investments across a few companies and developers, some PE firms have partnered to form a joint venture at a sector level. An example of this approach is the 2010 agreement between Actis and Tata Realty and Infrastructure Ltd. to form a joint venture to invest US$2 billion in road projects. They will jointly invest US$200 million, with the balance to be funded by Atlantia, Italy's largest toll road operator, and financial institutions. Others, like IDFC Project Equity, for example, have preferred blended models, such as investments in multiple special-purpose vehicles (SPVs). The investors can potentially consolidate earnings, giving them the option to exit their investment through an IPO.

One question that many PE funds face is whether to invest in construction companies or in individual infrastructure projects. Each type of investment has unique risk-return characteristics and has consequently appealed to PE investors with different profiles. For one thing, PE funds have investment horizons of between five and seven years, and infrastructure projects usually have a gestation period of between 15 and 25 years. Further, investing in construction companies is easier than acquiring stakes in project-holding companies because they have more certain short-term margins and cash flows. Once an order book is generated, projects are completed within a two- to five-year period, depending on the subsector in most cases. Moreover, a construction company's performance is generally more predictable, easier to measure and returns can compare favourably with those in other potential investments. For example, ChrysCapital's investments in IVRCL, a diversified infrastructure development company, and in Simplex and Gammon, both engineering and construction firms, have generated returns equal to between four and five times the equity they committed. Investments in construction companies are more liquid, as these companies are more commonly traded in the capital markets. Their greater liquidity has attracted a much broader set of PE firms to evaluate investments in infrastructure. In contrast with investments in construction companies, those made in infrastructure projects are stable and predictable once the construction period is complete and operating revenues begin to flow. The project-level returns have normally been in the mid to high teens, making infrastructure attractive to a different set of PE funds.

Promoters in the infrastructure space appear to recognise the significant role PE investors can play in facilitating their growth. In an interview, one promoter said PE firms can help companies—especially start-ups and smaller companies—become market savvy as well as provide introductions to other PE players and investee companies that can help the portfolio company build a more robust revenue pipeline.

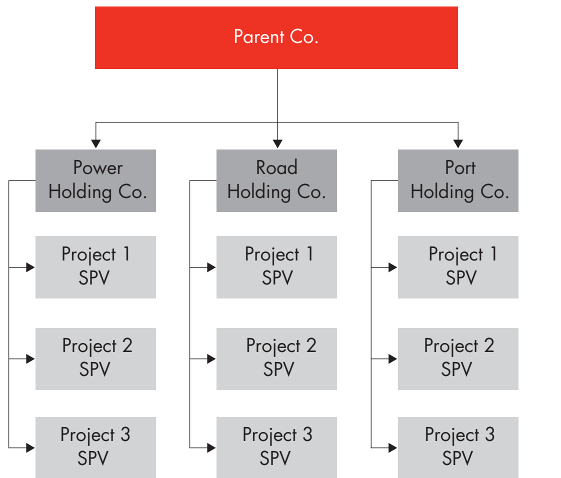
For infrastructure promoters and PE investors to make the most of the mutually beneficial relationship ahead of them, however, five key challenges need to be addressed.

Tiered structure of holding companies: Because most infrastructure projects are developed by construction companies, they are typically structured as multi-tiered entities, each organised as a unique SPV. The SPVs are typically owned by a sector-level holding company, which, in turn, is owned by the primary developer (see Figure 4.4). The SPV structure, which is also mandated by regulation in most sectors, ensures better risk management, as well as greater control for the project sponsor.

However, there are important tax consequences that seriously affect after-tax returns for the SPV investor. As project investments are typically in the holding (or primary) company, a dividend distribution tax (DDT) is deducted twice, first, at the SPV level and, again, at the holding company level, before investors see any returns. Easing or

Figure 4.4: India's largest construction companies have made infrastructure an important part of their business

Typical SPV holding structure



Five largest construction companies and their infrastructure development activities

Company	Roads	Power	Ports	Metro rail	Water
Larsen & Toubro	●	●	●	●	●
HCC	●				
Gammon India	●	●	●		
IVRCL	●				●
Nagarjuna Construction Co.	●	●			

● Holds assets in indicated subsector

Sources: Analyst and investor presentations, Bain analysis eliminating this double-taxation problem would not only make asset side investments more attractive; the financing community would also welcome more clarity around the DDT from the government's side.

Restrictions leading to range-bound returns: Standalone SPVs have limited investor appeal because they are self-liquidating at the end of the public-private partnership concession period and, thus, offer no economies of scale or scope. When asked in our survey of PE investors whether they would be inclined to make infrastructure investments using asset SPVs alone, most respondents answered no. The range-bound nature of returns is a deterrent to both PE funds as well as to LPs that are not focused predominantly on infrastructure and are not backed by long-term yield investors like pension funds. Their lack of appeal is further aggravated by the fact that Indian regulations do not permit the use of leverage in private equity investments, further suppressing potential returns. It comes as little surprise, then, that none of the Bain survey respondents would prefer to invest in an asset SPV alone. Twenty-five per cent of respondents said they would prefer to invest in a construction company, with another 20 per cent saying they would favour a multiple-asset holding company investment. Indeed, some 40 per cent of respondents indicated they would prefer investing in a blend of the above. The remaining 15 per cent said they would not discriminate against any of the various vehicles.

Limited protection against financing risks: Under conventional banking rules, all major equity shareholders are required to offer equal obligations of payment (*pari passu*) for the bank's loan. When a concession is terminated prematurely for reasons not due to the government or sponsor, investors are not compensated but are still liable to pay the banks, putting them at significant risk. Even when a concession ends through *force majeure* or government-imposed conditions, stipulations in the agreement may still result in investors receiving less than full compensation—further increasing their risk exposure.

Payment risk is another concern. One investor we interviewed pointed out that some annuity-based projects in India may not have inflation protection built into them and also lack an independent backup account to ensure that project sponsors pay out the annuities owed. In the developed markets, by contrast, the annuity payment is linked to separate guaranteed revenue streams to give investors greater assurance that they will receive income through the years and will be protected against inflation.

Social and political barriers: Most infrastructure projects are land intensive, making property acquisition difficulties another important concern voiced by many investors. India's agrarian economy and polity make land acquisition a contentious and emotional issue. The environmental impacts of land use and the political need to balance development and conservation further impose problems in land acquisition. Infrastructure sponsors like the NHAI have tried to partner with state governments to bring about changes in this area, and Parliament is weighing amendments to the Land Acquisition Act 1894. But the land issue is likely to remain a challenge for the foreseeable future.

Regulatory complexity: Perhaps the most unavoidable challenge facing investors in India's infrastructure sector is regulatory complexity. The tiered governance structure most projects use requires investors to obtain approvals from central, state and urban authorities, whose jurisdictions are often evolving and can frequently overlap. For instance, developing a power plant project requires approvals from more than a dozen authorities, spanning agencies from the local to the national level. To improve investment flows, the government needs to streamline the project bid and award process.

Even in wake of the severe challenges that impede the realisation of full potential in infrastructure PE, most investors and LPs we interviewed view infrastructure as a critical part of their investment portfolio going forward. They believe that the various stakeholders, including the Indian government, should take steps to remove these roadblocks.

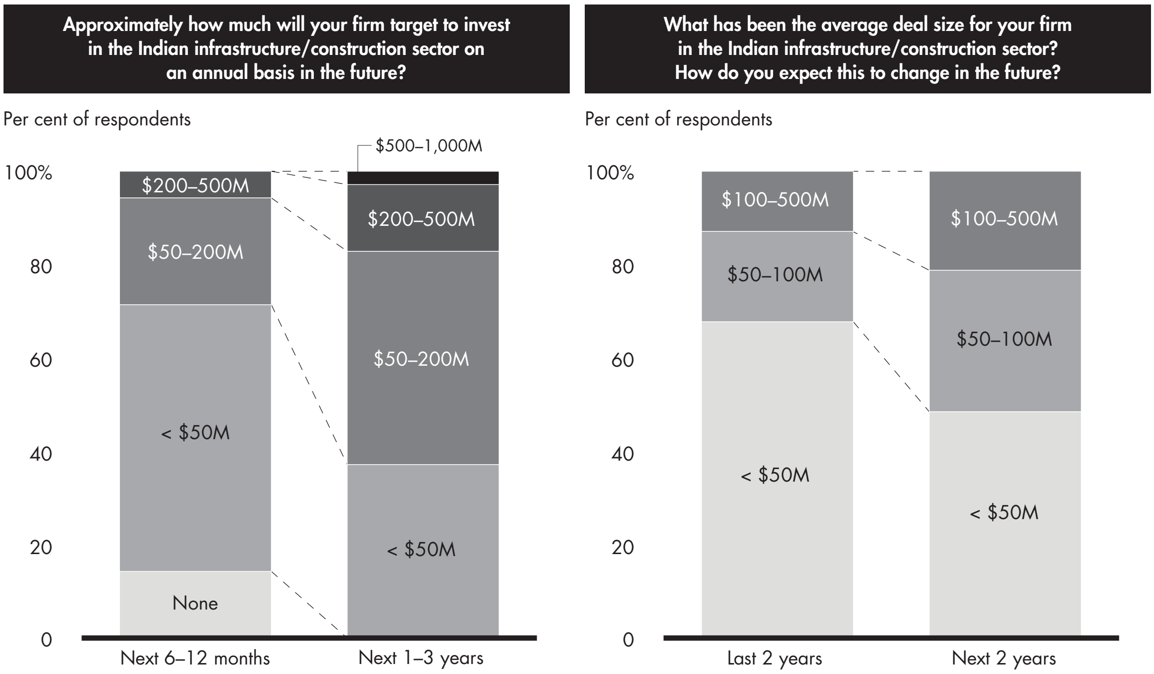
Future outlook for PE in infrastructure

Given the overall size of the infrastructure opportunity, the need to mobilise private capital and the acceptance and early success that PE investors have enjoyed in the sector, the future for PE in Indian infrastructure is bright. Its positive prospects have come in spite of the sector's growing pains and the clear need for reforms to make the process work better. Survey respondents are bullish that deal activity will increase in 2011 and beyond. Approximately one-half of the respondents believe that VC and PE activity in the infrastructure sector will grow at rates of 25 per cent to 50 per cent over the next six to 12 months; the other half forecast growth will be in the range of 10 per cent to 25 per cent. Looking ahead, survey respondents believe growth will intensify, expanding by 25 per cent to 50 per cent annually over the next three years.

Along with more deal activity, survey respondents also expect deal size to increase significantly. Fifty per cent expect average deal size to be in a range exceeding US$50 million (see Figure 4.5). Major reasons for expanding deal size include industry consolidation, the growing size and complexity of projects, larger fund sizes and investors' plans to participate in more deals that result in their gaining majority control.

Low levels of deal activity in the past had less to do with a lack of willingness to invest than with bottlenecks in the project pipeline and the need for a smoother government process for approving deals. Those barriers are now beginning to fall. For example, the NHAI has allowed concessionaires more leeway on some highway construction projects

Figure 4.5: Annual investment into infrastructure by PE firms as well as deal sizes are set to increase



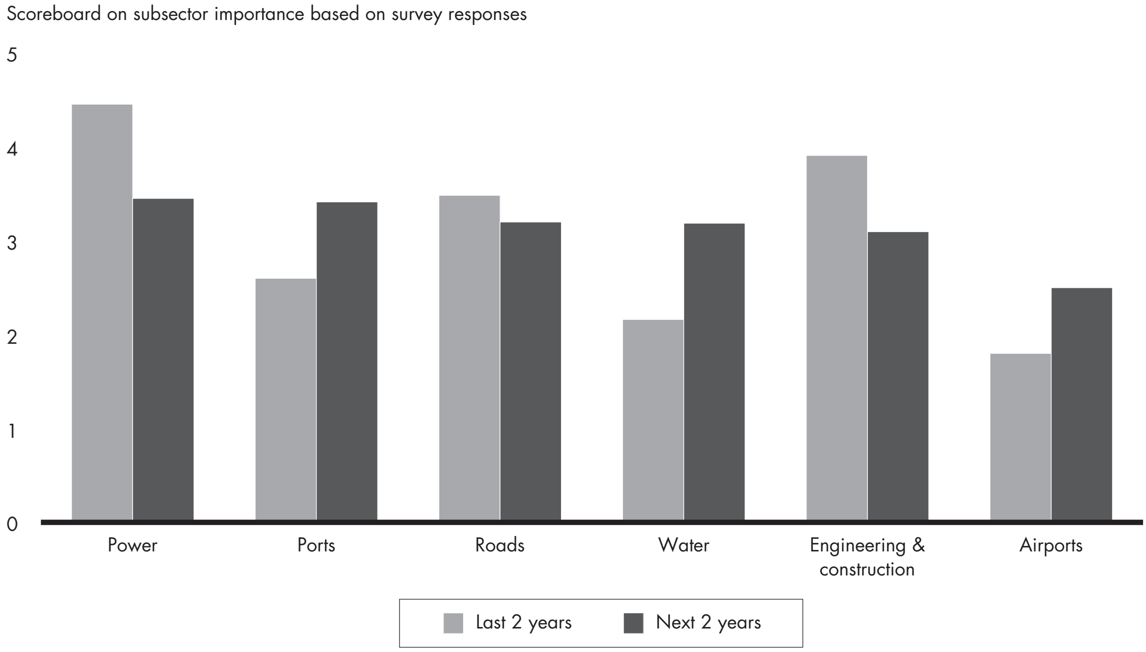
Source: Bain IVCA VC/PE research survey 2011 (n=35)

organised as public-private partnerships by shifting from restrictive "build-operate-transfer" structures to more flexible "design-build-finance-operate" ones. Likewise, in the power subsector, bids on "ultra mega power projects" now shift back to the government much of the burden for lining up approvals and undertaking project development.

The government's renewed focus on the sector is also apparent in the Union Budget of India for the financial year 2011–12. The FY2011–12 Union Budget has allocated US$55 billion for infrastructure, an increase of 23 per cent over FY2010–11, accounting for approximately half of the total plan allocation for the year. The budget has also set a target for IIFCL disbursements to reach US$6 billion by the end of the financial year.

Investors' expectations for infrastructure deal activity are also rising rapidly (see Figure 4.6). PE survey respondents see attractive opportunities in the power and roads sub-sectors where the demand and supply imbalance is especially large, government encouragement for investment is strong and exit opportunities through IPOs look promising. Although survey respondents expect the power, engineering and construction, and roads subsectors to remain attractive, they also look for the ports and water subsectors to strengthen in the next two years.

Figure 4.6: Some shift expected in the attractiveness of infrastructure subsectors

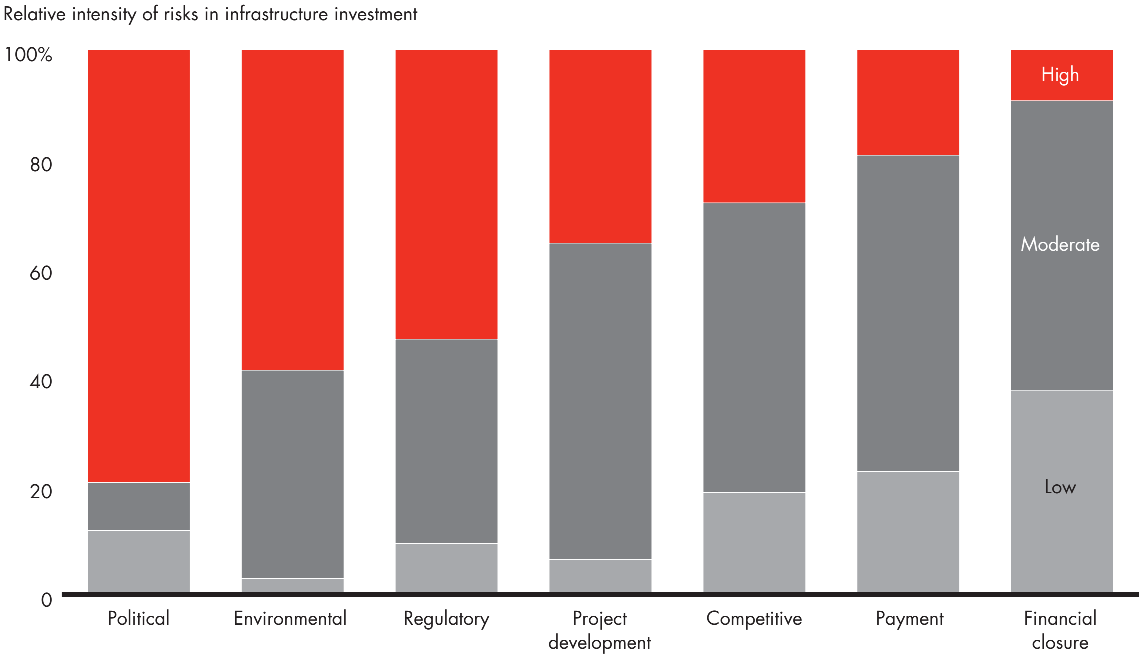


Note: Score refers to average score given to subsector by survey respondents; 1 refers to "least important" and 5 refers to "most important"
Source: Bain IVCA VC/PE research survey 2011 (n=35)

Investors' expectations for the infrastructure sector and the opportunities it offers are becoming increasingly realistic. Three-quarters of survey respondents recognise that the returns will remain lower than they are in other sectors, with 45 per cent estimating that the differential will be 5 percentage points or more. In an interview, a GP at a London-based PE firm said that the supply of overseas funds available for investment in Indian infrastructure is set to grow. That is due to the fact that the sector has gained global recognition as a separate asset class with distinct investment, risk and return characteristics, and those characteristics in India resemble the opportunities in other economies. Representatives from some firms we interviewed believe that funds with investment professionals based in India will be best positioned to assess the risks and returns this attractive market opportunity presents (see Figure 4.7).

As deal activity heats up, more funds will focus on developing infrastructure-specific expertise in areas of risk assessment and project management. PE's contribution will continue to be purely financial in SPV investments. However, as attitudes evolve over the next two to three years, promoters of asset holding companies and broad-based construction firms will begin to expect more than just funding. PE firms specialising in infrastructure will be able to provide operational support in areas such as project planning and execution and corporate governance. Even though these value-added skills

Figure 4.7: Political, environmental and regulatory risks rated highest for infrastructure investment

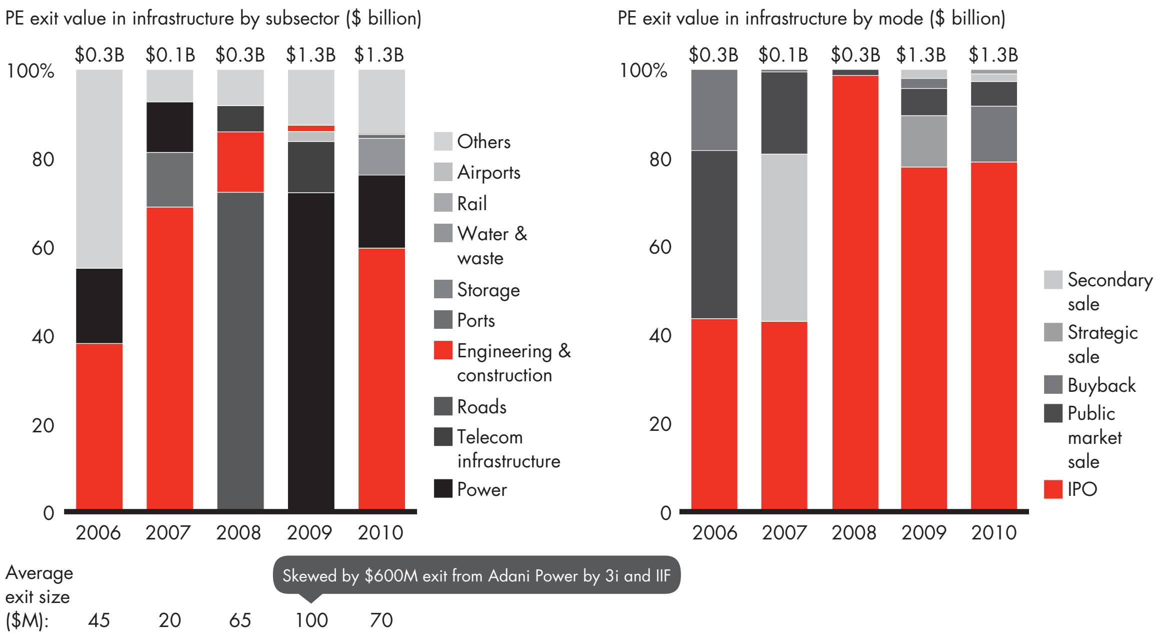


Note: Per cent refers to number of respondents who rated a particular type of risk "high", "moderate" or "low"
Source: Bain IVCA VC/PE research survey 2011 (n=35)

may not yield an immediate material advantage, they do provide PE firms a platform to demonstrate their relevance to the deal's success and give them increased leverage in deal sourcing. In interviews, partners with several infrastructure-focused PE funds agreed that their fund's expertise improved the likelihood that investments will actually come to fruition.

PE investment in India's infrastructure sector is a fairly recent phenomenon and is also characterised by holding periods that are longer than PE deals overall. Exits from infrastructure investments in 2010 totalled approximately US$1.3 billion spread over some 21 holdings, the most in the last five years (see Figure 4.8). There are plenty of more exits in the PE pipeline. More than one-third of the 28 deals made in 2004 and 2005 have not yet seen exits. In fact, about 100 deals made between 2004 and 2007 remain in PE portfolios. When exits do occur, however, buybacks are the principal mode for smaller deals. For larger holdings, an IPO is a preferred route; and with India's public equity markets expected to be buoyant, that is not expected to change. Another possible exit for PE funds that have stakes in projects that have completed construction and stabilised their revenue streams is to line up longer-term financing. Stable infrastructure investments that provide annuity-like returns are an ideal asset class for insurance companies and pension funds.

Figure 4.8: Engineering and construction dominated exits in 2010



Note: Average exit size calculated using exits with disclosed values from Bain PE deal database; approximately 15% of exit values were undisclosed; "others" includes oil & gas, mining & minerals and shipping & logistics; "telecom infrastructure" excludes services
Source: Bain PE deal database

Private equity is well positioned to contribute to, and benefit from, the rapid growth of the infrastructure sector in India. Given the focus of the XIth and XIIth Five-Year Plans on the sector and the increasing role for private enterprise in infrastructure development, PE can be both an important source of capital as well as a potent provider of capabilities and expertise. In summary, the future for PE in infrastructure looks bright, and this business cycle should see a solid upsurge in PE deal making and exit activity in infrastructure as investors direct their interest to this attractive white space.

5. Implications: With the future bright, it's time to reassess PE's new realities

With its solid performance in 2010, Indian PE has re-emerged in good shape from the testing times of the global credit meltdown and subsequent economic retrenchment. Deal activity has rebounded more quickly than in other Asia-Pacific markets, the exit markets are healthier than ever and capital continues to pour into an expanding number of domestic and international PE funds.

While the period ahead looks bright, it remains to be seen whether current conditions will prove to be a sturdy platform for sustained growth. Certainly, the Indian growth story remains on track and continues to attract PE interest. New opportunities in several under-penetrated sectors like infrastructure, financial services, healthcare and manufacturing are waiting to be tapped and appear to be generating an increased level of PE engagement. The PE industry itself is demonstrating interesting signs of growth and evolution. The number of domestic funds continues to expand, GPs with experience gained in the global PE funds are spinning out new breakout funds and promoters are warming up to the idea that PE partners are more than just another source of capital and can help them achieve exceptional growth, way beyond what the promoters can achieve alone.

But for all of the change and novelty the industry has witnessed, some characteristics specific to India PE appear to remain firmly fixed and continue to challenge PE investors, promoters and policymakers. For example, PE deal making will continue to expand, but for the foreseeable future deal size will remain small—mostly in the US$20 million to US$30 million range—and acquisitions will be limited to minority stakes. As competition to purchase high-quality assets intensifies, PE firms need to continue to find ways to demonstrate what makes them distinctive and superior to other providers of capital. Likewise, today's exit markets are vibrant and showing signs of depth and greater maturity, as PE funds, promoters and LPs become more realistic and aligned in their expectations for returns. Finally, even as the government begins to recognise PE's value, much remains to be done. The regulatory environment continues to impose obstacles that hamper the development of PE as a distinct and fully functional asset class that can accelerate capital formation and fuel entrepreneurship and the continued vitality of the Indian economy.

All stakeholders in India's PE and VC space have an important role to play in helping alternative capital investments achieve their full potential. Given the characteristics of the Indian PE and VC industry and the evolution path it is on, here are some implications and imperatives for each participant in 2011 and over the next few years:

General partners in PE and VC funds: In the period ahead, minority investments will continue to dominate deal making, and PE general partners will need to find ways to work with and influence promoters after they conclude their deal. To be able to do that effectively, PE investors will want to work hard to nurture their relationship with promoters and align their interests with theirs during the pre-investment phase. Beyond that, successful PE firms will stay ahead of the competition by digging deep into their investment themes and building strong networks. They will need to build comprehensive due-diligence capabilities as well as an up-to-date understanding of the evolving regulatory regimes that govern the industries in which they are looking to invest. To win financial commitments from increasingly discriminating limited partners, general partners need to present a consistent track record of value creation.

Beyond strengthening their investment teams, more firms will build operating bench strength by hiring specialists who can help them realise their investment theses and add value to their portfolio company investments. Others can achieve the same objectives by expanding their set of advisers or by helping deploy the right talent in their portfolio companies. While few promoters welcome what they regard as operational interference, many do look to PE investors to bring industry experience, financial savvy and the strength of their network to bear and help the companies generate better returns than what management teams can do on their own. They are also seeking to benefit from the synergies that come from selling or sharing products and services across the PE investor's other portfolio companies. Most importantly, they are looking for PE firms to become a trusted adviser and true business partner.

It will be important for the PE funds to reach agreement with promoters about the business's top priorities and provide the right amount and type of support their investee companies most need. As one promoter told Bain in an interview, "Promoters expect PE firms to nurture their companies like a parent takes care of a child. Just as a parent knows that a child needs knowledge, a teen looks for guidance and an adult requires his space, PE investors would do well to understand the needs of the portfolio company and tailor their involvement accordingly. No one size fits all".

Beyond what individual firms do to help promoters better understand what role PE can play in their success, the PE and VC industry needs to become more active in educating a larger set of Indian companies and policymakers on what PE can contribute to their investee companies and the overall growth of India's economy.

Indian entrepreneurs: Indian entrepreneurs have underutilised the PE asset class and need to take a fresh look at it as a means to create value and not just as a source of capital.

Businesses that are already working with PE: Promoters need to understand that the PE investor's interests are congruent with their own. They need to ensure that this alignment of interests is in place at the outset, during the deal-making stage, by ascertaining that the PE firm they ultimately commit to brings value-creation skills to the deal. Even before the transaction is complete, it is important to define the terms of the operating partnership clearly, and promoters should take the lead in defining the blueprint for this with the PE fund.

PE investors value openness. Over the course of the relationship, promoters need to focus on governance and transparency. By demonstrating that they are willing to share information, promoters can greatly reduce investors' anxieties and build trust. Even as they work together to implement their operational blueprint, it is important that both partners have a clear sense of what the PE partner's exit strategy will be. PE investors will be looking to liquidate their stake at some point, and the business will need to ready itself financially and culturally for that eventuality. But the relationship need not end there. Promoters can continue to benefit from the wisdom and experience the PE fund can impart by seeking out creative ways to sustain the relationship and continuing to have access to a credible partner that can help fund future growth opportunities.

Businesses new to PE: Newcomers to PE need to recognise how private equity is distinct from other financing options they may be weighing. Unlike lenders that get paid whether the company prospers or languishes, PE shares in its risks. And in contrast with selling public shares to stock market investors who can freely move in and out of their holdings, PE investor commitment is more stable over a longer time horizon.

Promoters with serious growth aspirations and a long-term vision should remain mindful of the fact that only a very small proportion of listed stocks reflect fair valuations and provide the required liquidity. Because PE funds differ in their ability to add value to a particular business, assigning the right value to the PE firm best suited for a company's given situation is apt to result in the most mutually beneficial partnership.

As with companies that have experience working with PE, companies contemplating accepting their first PE investment should focus relentlessly on governance and transparency to ensure a fairer valuation and improve the prospects of the investment being a win-win deal.

Limited partners: For the better part of the past two decades, investments in private equity have been the best-performing assets in the portfolios of the globe's biggest institutional investors. So, when the top US and European PE firms began to turn their attention to the growth opportunities in India over the past decade, the investors, along with the domestic LPs, eagerly signed on as limited partners to provide the capital that fuelled the growth of the Indian PE industry.

Now, as those early investments have begun to mature and the Indian PE and VC industry has gone through one full major cycle of growth, limited partners have learnt to come to terms with Indian PE's unique characteristics. Looking ahead, LPs should accept the realities of longer holding periods (especially in early-stage investments), small deal sizes, sceptical promoter attitudes and the risk-return trade-offs that characterise Indian PE. LPs need to be patient and recognise that GPs may be slow to invest in a market where valuations are high and promoters can be resistant to change. As more PE firms take to the road trying to raise new funds, LPs will have to become more discerning when selecting the ones with which they will work. Now, with the wide variety of India-focused PE funds and investment philosophies to choose from, LPs should closely examine not only the performance track record of the GPs across the full investment cycle but also the capabilities and networks they have built in the Indian market.

Finally, LPs can take confidence in the fact that the basic contours of India's strong growth story remain intact. While opportunities are attractive across many sectors, from financial services to technology and telecom, it will be wise to stick to basics. For example, the Confederation of Indian Industry (CII) forecasts that the consumer goods sector will grow by 13 per cent in the current fiscal year, some 50 per cent faster than the expansion in overall GDP. As more and more exits occur and Indian markets deliver on their growth promise and generate commensurate returns, LPs will discover that the original reasons that drew them to India continue to look attractive.

Public policymakers: Despite its rapid growth, PE and VC still represent a minuscule share of the total funding India's economy needs to sustain its robust growth rate. They also constitute a very small percentage of total foreign investment inflows to India. But the outsized role PE plays in the nation's economic development and business growth makes its continued healthy growth an urgent public priority. As a sizeable source of patient capital managed by sophisticated investment professionals, PE will be indispensable to sustaining India's expanding wealth and prosperity. According to estimates by the CII, India will require capital infusions totalling approximately US$1.25 trillion over the next three years in order to sustain a GDP growth rate of 7 per cent annually—moderate in comparison to India's recent experience and future aspirations.

Private equity and venture capital will be an indispensable part of that mix. Many of the small and midsize corporations for which Indian policymakers are looking to spur innovation and cultivate employment growth are undercapitalised by the public equity markets, thinly traded and not well tracked by equity analysts. As such, they will be hard pressed to look to the stock exchanges to raise the funds they will need to finance their growth. As deep-pocketed and patient investors, PE and VC funds can fill that gap. Bain estimates that PE and VC investments could potentially provide as much as between

US$40 billion and US$50 billion in funding through 2014—four to five times their current levels by reaching 3 per cent of GDP, about the level that exists in the US.

Clearly, public officials cannot fail to recognise that potential investment flows on this scale will be a critical component of India's economic development. To facilitate PE and VC fulfilling their role as growth enablers, a host of regulatory changes will be needed to remove ambiguities about their treatment under Indian securities and tax laws. That requires policymakers to begin by recognising the importance of PE as a distinctive asset class with unique benefits and immense potential to propel growth. A recent white paper on PE and VC published by the Confederation of Indian Industry with contribution from Bain identified many of these and laid out a long-term agenda for addressing them.

Three regulatory changes, in particular, merit immediate attention. First, PE and VC funds should be allowed to purchase at least 25 per cent of the capital of companies they target for investment without triggering an open offer. Under current law the threshold is set at just 15 per cent. Moreover, promoters should be permitted to share financial data about their companies with prospective qualified PE bidders, enabling the PE investors to conduct a thorough, well-informed due-diligence process and more accurately identify value-creation opportunities.

A second set of rule changes that would vastly expand the pools of capital available for PE and VC investment would be to ease restrictions that bar deep-pocketed domestic institutional investors, such as pension funds, from investing in PE and VC. Additionally, removing barriers that limit insurance company investments only to funds that focus on infrastructure would draw more capital into PE and VC as an asset class. The Insurance Regulatory and Development Authority has recently circulated a proposal that would allow insurers to increase the proportion of their portfolio holdings they could invest in PE and VC funds, but only for those operating in the infrastructure space. Pension funds are prohibited from PE and VC entirely. Steps that would progressively allow them to participate would not only help mobilise capital but should enable the institutional investors better to diversify their portfolios and increase their returns.

Tax simplification, in particular the broad reinstatement of straight pass-throughs of investment earnings, is a third regulatory reform that would make a significant difference.

Indian private equity stands poised to enter its second major decade and far exceed the remarkable growth and contributions to the development of India's economy it made during its first. For that to happen, attitudinal, behavioural and regulatory barriers will need to be removed that prevent the industry from achieving its promising potential. Promoters, policymakers and PE firms themselves have a major part to play in ensuring that happens.

About Indian Private Equity and Venture Capital Association

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

IVCA members include leading venture capital and private equity firms, institutional investors, banks, corporate advisers, accountants, lawyers 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.

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 one another.

The Association stimulates the promotion, research and analysis of private equity and venture capital in India, and facilitates contact with policymakers, research institutions, universities, trade associations and other relevant organisations. IVCA collects, circulates and disseminates commercial statistics and information related to the venture capital industry.

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Notes

Notes

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