INDIA PRIVATE EQUITY REPORT 2012

BAIN & COMPANY

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Contents

Key takeaways

Overview of current conditions

- Despite declines in other geographies, the value of private equity (PE) investments in the Asia-Pacific region (including Australia) grew at an impressive 32% in 2011, largely due to increased investment volumes in India and China.
- India was the fastest-growing PE market in Asia in 2011. PE investors poured US$14.8 billion into the region, roughly a 55% increase over 2010. They closed 531 deals—40% more than the year before. This was driven by higher cost of debt and choppy capital markets that drove Indian entrepreneurs to consider private equity as the primary source of funds.
- The Indian PE market saw a big surge in early stage deals focused on companies in the formative stages of growth. In 2011, 28% of the deals struck were with companies founded within the last three years, up from a high of 25% in previous years.
- Another notable theme in 2011 was the dramatic decline in the number of exits. Only 88 investments exited PE fund portfolios in 2011, compared with 123 in 2010—a nearly 30% decrease. Given that initial public offerings (IPOs) are the most prevalent way for PE investors to gain liquidity, the depressed stock market contributed significantly to this trend.
- Fund-raising has become increasingly difficult especially as several GPs could not raise funds and others took much longer in 2011. LPs say they have become far more selective, evaluating re-ups and managing their investments more closely than ever to ensure capital protection, better returns and appropriate liquidity.
- There is growing uncertainty around a variety of regulations that affect the attractiveness of certain investments. This would have a significant bearing on the growth trajectory that PE follows in India.
  - Most LPs and GPs are optimistic about India's future and unequivocally agreed that even in the long term, India's economic growth would remain firm. However, challenges in exiting current investments, mismatch in valuation expectations and poor corporate governance creates confusion.

Fund-raising

- While none of the GPs interviewed see LPs shifting their fund allocations away from India, the paucity of exits has caused LPs to be more cautious.
- According to Preqin, about 680 funds throughout the world raised around $270 billion in capital in 2011. Of that total, however, only $12 billion came with the mandate to invest in India, down from $18 billion in 2010—a clear sign that LPs are becoming more selective about where they park their money.
- Key to successful fund-raising is differentiation. The need to differentiate arises from the track record of the GP and the exit record, which in turn is determined through sector expertise, a through deep deal-sourcing network or by virtue of having strong operating teams that help improve performance in portfolio companies.
- In 2012, we foresee capital being plentiful, but harder to acquire. PE funds are entering 2012 with an estimated $17 billion worth of "dry powder" to put to use in India specifically, about 15% less than the $20 billion they had at the start of 2011.
- Foreign funding will continue to be critical. Our survey suggests that more than two-thirds of funds in the next two years will come from Foreign Venture Capital Investors (FVCI) and Foreign Direct Investment (FDI).

Deal making

- The average investment size for the top 25 deals was $236 million, nearly equal to that in 2007. The cumulative investment in the top 25 deals in 2011 was $5.9 billion, about 34% higher than the 2010 value.
- On the other side of the average, smaller deals proliferated, thanks to a growing interest in e-commerce. Deals in this space nearly tripled compared with 2010.
- Real estate was the hottest area of interest for PE investors in India in 2011. Total deal value in this sector more than doubled, to $3.4 billion in 2011, up from $1.5 billion in 2010.
- Other attractive sectors included manufacturing and IT/ITES (helped by e-commerce). Together they garnered about $4 billion, or more than a quarter of the $14.8 billion total that PE investors poured into India. The proportion of late-stage deals in the mix halved, from about 30% in past years to around 20% last year. The weak IPO market was a big factor in this drop, since exit strategies seem elusive in the near term.
- Most of the participating funds that we spoke with felt that there will be more buyout opportunities ahead though the buyouts will continue to constitute a small percentage of deals.
- Another trend marking PE investments in 2011 was the rise of Private Investment in Public Equity (PIPE) deals. Seventy-one of these deals were struck, an increase of 87% over 2010, because of a lackadaisical stock market. As much as $2.4 billion was invested through PIPEs last year, close to the $3 billion PIPE investments in 2007.
- 2012 looks to be a year of solidifying the gains of 2011, although opinions vary. According to our survey about half the respondents feel that deal activity will grow moderately in 2012 while majority of the others believe that the deal activity will remain steady at 2011 levels. However, this could get dampened if clarity on capital gains and taxation regime does not emerge in the first half of 2012.
- Looking ahead, consumer products is likely to evince maximum PE interest, with banking, financial services and insurance (BFSI) and healthcare following.
- Given that Indian entrepreneurs are becoming more savvy, the onus is shifting to the PE funds to demonstrate that they are the right partners for the entrepreneurs. Our conversations with entrepreneurs indicate that more and more entrepreneurs are carefully considering qualities such as a clear investment rationale and transparency when choosing a PE partner.
- Minority stakes will continue to dominate, even though promoters are starting to be more open-minded about greater participation from PE investors.
- Overall, a relatively large number of GPs believe that competitive intensity among PE funds is unlikely to change; some even believe it will decrease, given the challenges in raising capital and inability to find exits from current portfolios

Portfolio management

- A recent analysis of the top 100 Indian public companies (by market capitalisation, for the 2007-2011 period) indicates that PE-backed firms boasted an additional 5% revenue growth and an extra 14% profit before tax (PBT) growth compared with firms that had no PE backing. Value addition by the PE funds in India has happened in five different ways: setting up corporate governance, networking, global expansion, recruitment of talent and operational efficiency improvements.
- 2011 saw the dissonance between promoters and their PE investors becoming a key roadblock in value creation. Many GPs we spoke with believe that it has become important to acknowledge and address these disagreements early on.

- There are several reasons for misalignment between the PE fund and the promoters: lack of common vision, lack of strategic alignment and lack of transparency post-investment.

- There are several ways the funds can address some of the challenges in establishing a smooth and collaborative relationship with the entrepreneur for value creation:
  - Conduct a detailed and comprehensive diligence before the deal to identify all possible issues
  - Get the management team's buy-in on the value creation blueprints
  - Invest in building a strong and collaborative relationship with the promoters and their team
  - Build an operations team with relevant expertise to support the company

Exits

- In 2011, the number of exits dropped precipitously—by about 30% compared with 2010. Based on the exits reported in the public domain, only $4.1 billion of funds were returned to the LPs by the PE funds last year, which is $2.5 billion lower than total returns in 2010.

- The exit market in India has been lackluster for a number of reasons beyond weak public markets. For one, many of deals struck between 2006 and 2008 carry premium valuations that make attractive exit IRRs (internal rate of return) difficult to achieve, exacerbating the problem of these high purchase prices. The inability of PE funds and promoters to agree to and pursue a value creation plan has, in many cases adding to the problem of high purchase prices. Finally, given the minority nature of most PE stakes, funds are heavily dependent on promoters agreeing to the timing and the terms of an exit.

- As we enter 2012, a large portion of the funds that were invested between 2003 and 2007 are still being held in PE funds' portfolios. According to Bain research, 71% of the capital deployed on the largest deals in India during those years has yet to be returned to LPs.

- Most GPs agree that exits are a high priority for LPs right now, regardless of the target valuation. According to our survey, 61% of investors continue to expect exits after holding periods of three to five years for most deals, while 33% expect a horizon of five to seven years. In the next two years, we expect the same trend to hold.

- The majority of respondents—about 60%—agree that the number of exits will increase by at least 10% in 2012 because of the growing pressure from 2003 to 2007 vintage deals.

Wide angle: Investing in e-commerce

- E-commerce as a transaction medium is relatively small and nascent in India with the Internet retailing market, estimated at about $900 million. Industry observers estimate that online retailing in India will expand at a CAGR of 25% over the next five years, to reach $2.8 billion by 2016. There are five key reasons why this expansion is likely to happen, namely, increase in broadband access, increasing penetration of smartphones and similar devices, growth in enabling infrastructure and services, widespread consumer acceptance and benefits from the demographic dividend.

- Investments in e-commerce accounted for 40% of the volume of early-stage deals in 2011 and 16% of the total deal volume. Moreover, e-commerce was the single largest sector contributing to the 37% increase in the number of PE deals compared with 2010.

- The growth in India's e-commerce sector has been breathtakingly swift. In 2011, investors signed 86 deals in the space—about 46% more than the totals deals signed in the previous two years combined. Deal value in 2011 was also up, more than the cumulative deal value over the last four years and close to seven times the deal value in 2010.

- Overall, e-commerce deals in India still lack an established track record of exits and value creation. Only three of the largest 25 e-commerce deals in the past five years have exited, although their combined returns—$630 million—are impressive, making up 80% of the $770 million total invested in the deals.

- Looking ahead, PE investors continue to be optimistic about investing in e-commerce. As per our survey, both the number of deals as well as the volume of funds to be invested in e-commerce is set to grow.
- Clearly, e-commerce presents an attractive investment opportunity in India, but it is not without its attendant risks and challenges. Besides a lack of sufficient talent to hire, one of the greatest difficulties in the market is to scale businesses enough to achieve a critical mass. Even on a global basis, e-commerce has had few winners in each vertical, be it online marketplaces or social networking.
- Beyond these issues, the infrastructure of e-commerce needs to be improved for the sector to blossom. The most critical areas of infrastructure development include more secure payments gateways, more efficient delivery systems and better broadband access.

Implications

- Funds from LPs are still abundantly available to Indian PE and VC firms, even though they have yet to establish a robust track record on returns. Meanwhile, LPs carefully evaluate how various funds engineered their exits and helped book capital gains. They have become more selective in committing incremental capital and are getting more involved in the fund's operations.
- The deal-making environment has promise as valuations have become modestly reasonable compared with the past.
- Increasingly, regulators are starting to pay attention to alternative investments, including PE and VC, as an asset class distinct from other sources of capital. The evolution of the regulatory landscape in the direction of tax regime clarity pushes towards reform in certain sectors, and protecting rights of PE investors would go a long way in furthering the growth of PE industry in India. Another area where regulatory changes would significantly enhance the environment for PEs is in deepening the domestic capital pool.
- The events of 2011 have reemphasised the need to conduct diligence in much greater detail, mapping all the potential opportunities and risks that an investment poses. Not only would this enable them to understand the risks in the investment comprehensively, but also allow them to collaborate better with the management after the deal.
- Indian entrepreneurs who seek PE funding should make the most of the expertise, network and fiscal discipline that PE capital brings to the table. In accepting the PE funding, entrepreneurs should agree on an operating model with the PE fund and also agree on the level of involvement that the fund will have in the business. It is important for the management team to align with the PE fund on the value creation blueprint upfront.
- LPs that understand the nuances of the Indian business landscape will find themselves at an advantage in placing their capital. It is important to understand the investment philosophy and exit approach of the fund before committing capital to ensure the desired returns and liquidity.
- LPs could consider taking greater interest in fund operations through the commitment periods, as GPs can benefit from their networks, experience and advisory support.
- Policy makers need to appreciate that PE funding is a unique source of capital in several ways. It is what is considered "involved capital," because the interests of the fund and the business it gives money to are much the same.

1. Introduction: PE climate in India thrives, even as exits slow

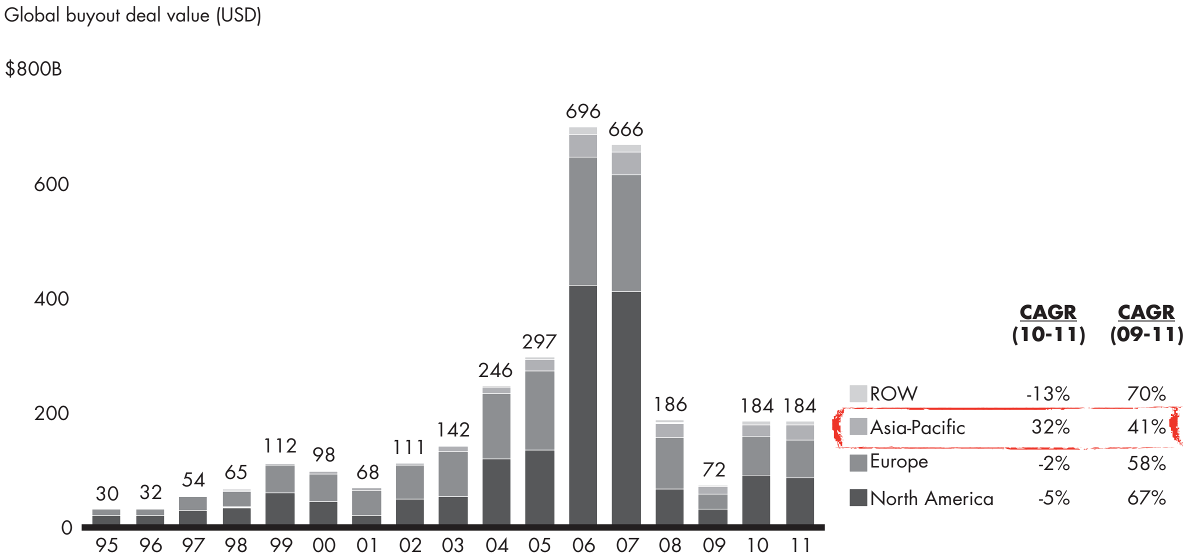
In all parts of the globe, volatility was the main theme for 2011. The continuing economic uncertainties in eurozone countries and a slower-than-expected recovery in the US created major challenges for governments and left investors unnerved. The trouble in the largest economies also rippled out to emerging markets, the new engines of growth. Thanks in part to lower demand for exports, both India and China revised their 2012 GDP growth rate targets down to 7.3% and 7.5%, respectively, far below their historical paces of 9% and 10%. Their waning confidence in growth was reflected in the weak performance of the regions' equity markets. In 2011, China's Hang Seng stock index slipped nearly 20% while India's Sensex dipped about 25%.

Amid the global economic gloom, growth in private equity (PE) investments stalled worldwide in 2011 (*see Figure 1.1*). North America, one of the key markets for PE investments, saw deal value decline by 5%, while deal value in Europe slid 2%, as shown in Bain's Global Private Equity Report 2012.

India was not insulated from the events of the global economy. Key macroeconomic indicators, such as production output, stock indexes, trade balance and currency exchange rates, fluctuated throughout 2011. The Central Bank of India gradually raised the repo rate by 350 basis points in the 20 months following March 2010, making borrowing much more expensive, although there are indications that the trend might be reversing.

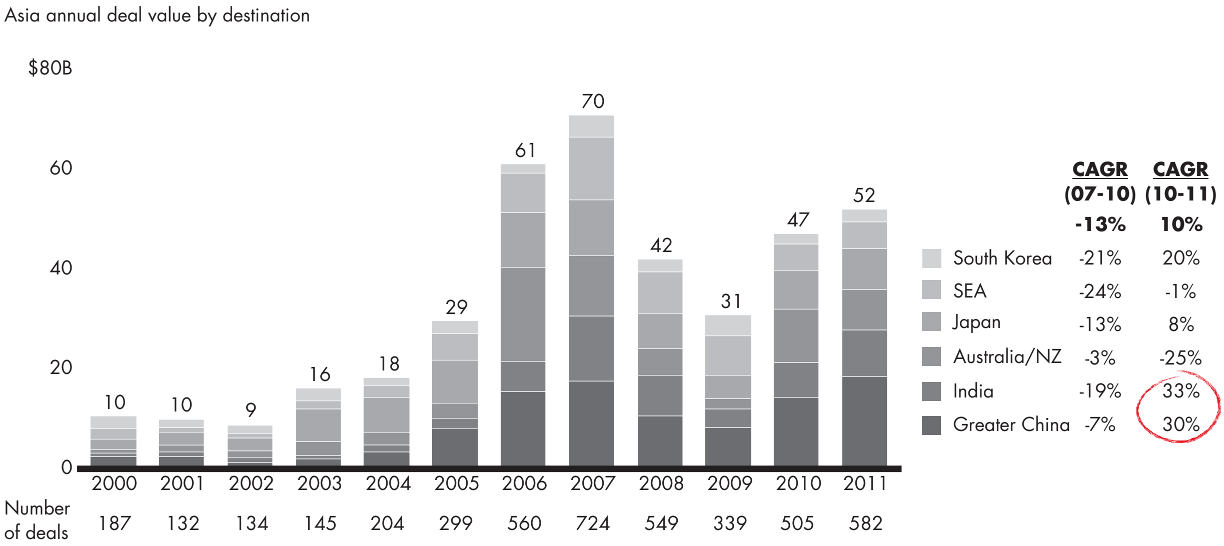
For PE investors in India, however, the combination of choppy equity markets and high debt costs had an unexpected upside: PE became a more attractive source of funds. Despite declines in other geographies, PE investments in the Asia-Pacific region (including Australia) grew an impressive 32% in value in 2011, largely driven by increased investment volumes in India and China (*see Figure 1.2*). In 2011, PE funds in India closed 531 deals—40% more than in 2010. Those deals came with relatively favourable terms as well, as promoters had tempered their expectations about the valuation of their firms and exhibited greater openness to having PE partners contribute ideas and expertise.

Figure 1.1: Global investment activity in 2011 matched that of 2010



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: Bain Global PE Report 2012

Figure 1.2: Growth in Asia PE was led by Greater China and India in 2011



Notes: Investments with announced deal value only; excludes deals of value <$10M; does not include bridge loans, franchise funding, concept and seed/R&D deals; excludes infrastructure project finance deals, real estate, real estate investment trust, and hotels and lodging property deals; excludes investments in China's banking sector in 2009 and 2010 (Agricultural Bank of China, Bank of China and China Construction Bank); Greater China includes China (PRC), Taiwan, Hong Kong and Macau; SEA (Southeast Asia) includes Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam
Source: Bain Asia PE Report 2012

These changes bode well for the Indian PE industry. With one full investment cycle behind them, PE firms now have an established track record of value creation. As the second cycle of investments that began in 2006 comes to maturity, the task of getting good returns on that capital will be paramount over the next year. At the same time, PE funds are applying new discipline and getting more involved in new investments. It would be fair to conclude that PE, which is now firmly established as a credible source of patient capital in India, is setting off on a new journey of prudence in investing and sophistication in creating value out of its assets.

About this report

Over the last decade, Bain & Company has closely followed and participated in the growth of PE in India. We strive to create value for the different stakeholders in the Indian PE ecosystem by engaging substantially with general partners (GPs) at PE funds, limited partners (LPs), entrepreneurs and regulators. For the past three years, we have mapped the evolution of the PE industry in the annual editions of our report.

In this third edition, we highlight the key trends that shaped the PE industry in 2011 and closely examine industry expectations for 2012 and beyond. We have also included a special feature on the e-commerce investment arena, as both PE and venture capital (VC) firms took an active interest in this space in 2011. Our analysis in this report is based on Bain's proprietary deal and exit databases, perspectives gained from an extensive survey of GPs at various PE funds and in-depth interviews with more than 50 industry practitioners, GPs, LPs and entrepreneurs in India. Our views have also been enriched by the perspectives of several members of the Indian Private Equity and Venture Capital Association (IVCA).

In our next section, Section 2, we take a comprehensive look at the current state of the Indian PE industry. We summarise key trends, track changing attitudes toward PE funding and highlight several challenges faced by the industry.

Section 3 moves on to an in-depth analysis of the key aspects of PE and VC investing, encompassing fund-raising, deal making, portfolio management and exits. Not only do we analyse the key trends in 2011, but we also discuss the expectations for 2012 and beyond.

In Section 4, we emphasise the role of PE and, to a large extent, VC funds in fostering the e-commerce sector. We highlight the ongoing investment opportunity in e-commerce and analyse the trends that have shaped and accelerated investment activity in this space.

In Section 5, we use the report's findings to draw implications for each of the industry's participants and stakeholders. We also outline the steps they could take to foster growth in the industry while creating value in the process.

Bain and IVCA have a deep commitment to cementing the success of PE in India. We continue to help PE firms and Indian entrepreneurs build a greater appreciation of one another's capabilities, needs and expectations. We hope you will enjoy our latest edition of the Bain-IVCA India Private Equity Report.

2. Overview of the Indian PE landscape

2011: Bumper crop in uncertain times

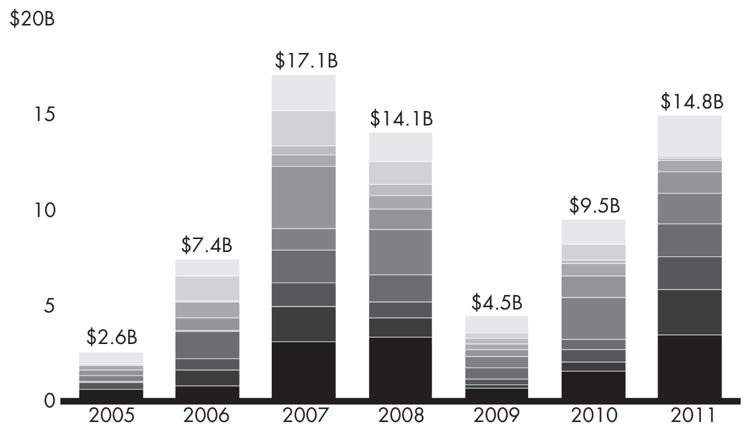
2011 began as a tough year, with economic growth remaining elusive and fears of a double-dip recession continuing to spook investors. While the global economy took tentative steps toward recovery during the year, uncertainty prevailed. The world's largest economy, the US, struggled to reduce unemployment and reignite growth. Europe continued to battle fears of a meltdown, with investors reassessing portfolio risks as sovereign debt crises multiplied across the continent. The brightest note of the year was the last quarter, when annualised US GDP growth inched up to 2.8%, stoking optimism that had previously remained damped.

Amid this turbulence in developed countries, growth in the large emerging economies took a breather as well. The Indian economy slowed particularly abruptly, with GDP growth dropping from around 9% in recent years to an estimated 7% for the financial year ending in March 2012. This slowdown occurred for a variety of reasons, including some that are not directly connected to the global turbulence. For one, inflation remained high—close to 10% for most of 2011 (though a reversal was seen in December)—despite India's central bank tightening monetary policy. As a result of high inflation and high borrowing costs, industrial production plummeted to negative 4.7% in October 2011. At the same time, the Indian rupee hit a record low and hovered around INR 50 to the US dollar in the last quarter of the year. A weakened rupee will adversely affect several key sectors, such as petroleum, gold and electronics, which are heavily reliant on imports.

On the face of it, the events in India read like a recipe for discouraging fresh investments, particularly from a relatively new class of investors. Yet, the surprising reality is that PE investing in India took off in 2011. In fact, our research shows that India was the fastest-growing market for PE in Asia during the year. PE investors poured $14.8 billion into the region (including deals less than $10 million in size), about a 55% increase over 2010, and closed 531 deals, 40% more than they did the year before (*see Figure 2.1*).

Figure 2.1: Deal making increased across all major sectors in 2011; volume surpassed 2007 peak

Annual VC/PE investments in India by sector



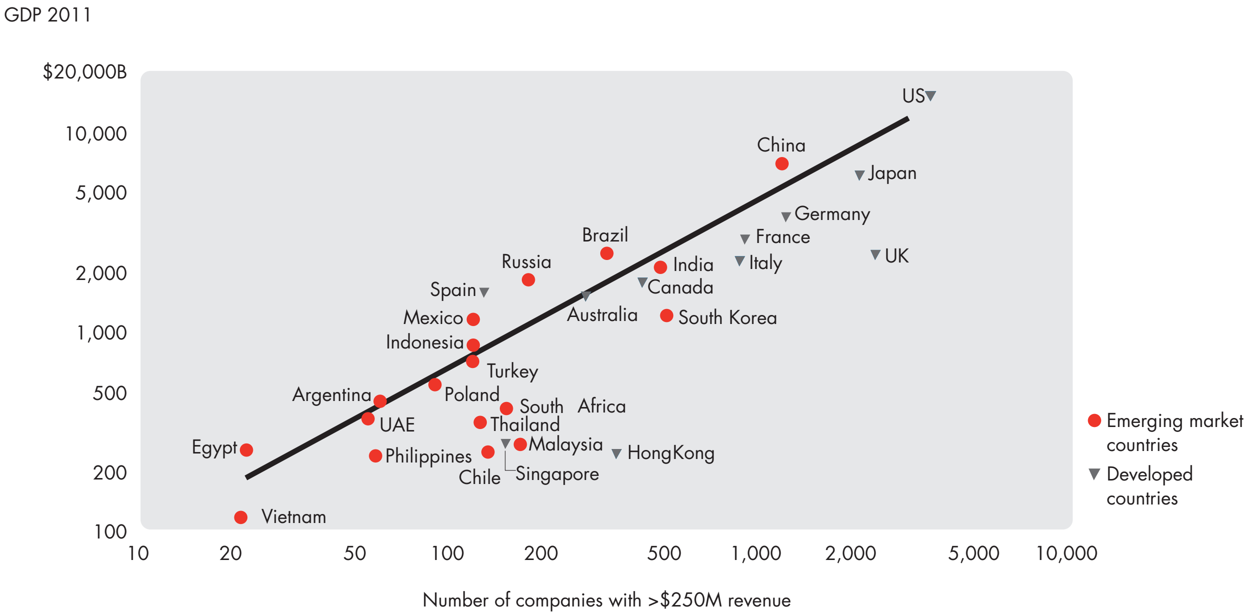
	2005	2006	2007	2008	2009	2010	2011
Number of deals	185	296	494	448	216	380	531
Number of active funds			244	256	181	202	238

Breakup of deals (2011)

Sector	Deals	Growth (10-11)
Other	105	60%
Telecom	5	-89%
Media & entertainment	9	-6%
Healthcare	31	-4%
BFSI	48	-6%
Energy	35	-25%
IT & ITES	135	191%
Eng & construction	28	160%
Manufacturing	72	456%
Real estate	63	136%
Total	**531**	**56%**

Notes: "Other" includes consumer products, hotels and resorts, retail, shipping and logistics, textiles, education and other services; BFSI refers to banking, financial services and insurance; active funds are funds that have done at least one deal in the mentioned year
Source: Bain PE deal database

Figure 2.2: As GDP grows, the number of large companies is likely to follow, helping India catch up to China and the US



Note: GDP reflects nominal GDP
Source: Bain Global Private Equity Report 2012

This value approached the peak levels seen in 2007, while the volume actually surpassed it. More players helped fuel the fire, as the number of funds closing at least one deal in the market jumped from 202 in 2010 to 238 in 2011.

The surge in total deal value in 2011 is quite a significant achievement, particularly considering the scope of investment opportunities in India. For the most part, Indian companies are in the mid-market range, or in earlier growth stages, and the number of large-ticket deals is limited. This means driving growth in India is a greater challenge than it is in other countries. As Bain's Global Private Equity Report 2012 indicates, the number of larger companies (those with revenues greater than $250 million) is correlated with the nominal GDP of an economy (*see Figure 2.2*). India has only about 500 large investment opportunities, compared with about 1150 in China and 3500 in the US.

What drove this remarkable trend? Three key factors helped make PE investments more attractive in the past year. First, the tough economic environment forced promoters to reexamine the viability of equity offerings. India's stock benchmark Nifty declined as much as 25% in 2011, setting a weak tone for those looking to tap the market. In fact, only 37 companies attempted to raise money in the primary markets, a far cry from 2010, when 67 companies made an initial public offering (IPO). In addition, around 25 IPOs were withdrawn despite a go-ahead from the market regulator because sentiment remained skittish. Moreover, about 28 firms traded below their listed price after debuting in 2011, discouraging other promoters even more.

Second, loans became more expensive in 2011. The cost of funds soared for banks, as repo rates rose and already high cash reserve ratio (CRR) levels added to liquidity pressures (though the trend seems to have reversed in early 2012). As a result, the benchmark prime lending rate (BPLR) increased significantly during 2011. These high interest rates made the debt market unattractive for promoters looking for funds.

Third, the ongoing business challenges that come with persistent volatility, like sagging demand and pricing pressures, have helped Indian enterprises better appreciate the PE proposition. In such an uncertain climate, more and more promoters are beginning to welcome PE investors not just for the funding they can provide, but also for their business acumen, financial savvy and vast global networks. PE therefore stepped into the role of partnering with promoters, leading to an eventful and hectic year for deals.

Key trends for PE in 2012

What made 2011 stand out from the previous years for PE investors in India? Five important trends emerged during the year. The first significant one is that more deals closed at lower valuations, on average. Historically, high valuations have plagued PE investors in India, in part because Indian entrepreneurs looked at PE as funding of last resort and tended to ask for rich valuations. The high degree of competition for deals has pushed up valuations even further in the past. In 2011, however, our analysis suggests that the average EV/EBITDA trailing multiples came down significantly for the largest 15 PE deals (not including real estate), from an average of 14.3 in 2007 to 11.8 last year.

While promoters may have been more willing to acquiesce, the decline also indicates a new restraint in investing behaviour. Clearly, the PE industry is maturing, and GPs are becoming more selective. Fund investment committees are scrutinising transactions more carefully, and investment professionals are applying stringent pre-tax earnings multiples as cutoffs in considering prospective deals. When asked how his PE fund has altered its deal screening and sourcing efforts in a certain industry vertical, one of the GPs we spoke to said, "We have a clear ceiling on EV/EBITDA multiples for a particular sector. If a deal is not below that ceiling, we will not consider it, irrespective of how attractive it may sound, or the amount of interest in the deal from other PE investors."

A second trend in Indian PE is the big surge in early-stage deals focused on companies in the formative stages of growth. In 2011, 28% of the deals struck were with new companies founded within the last three years, up from a high of 25% in previous years. E-commerce companies led this trend, cornering about 40% of early-stage capital. There has been widespread euphoria as both PE and VC funds attempt to ride the growth of this nascent sector. Some of the larger deals included a $200 million investment by SoftBank in InMobi, a global mobile advertising network, and a $52 million investment in Snapdeal, an online deal discounts site, by IndoUS Venture Partners, Nexus Venture Partners and Bessemer Venture Partners through multiple rounds. As a special feature, we will discuss the e-commerce investment opportunity and elaborate on the deal trends in this space in Section 4 of this report.

On a related note, the Indian market continued to see overlap in the interests of PE funds with VC investors, which is a departure from the traditional styles of these firms. While VC funds typically invest in small start-ups and in small amounts, several VC funds evaluated larger-ticket investments in India last year. One such example is the $20 million investment in Medi Assist, a third-party administrator of health insurance policies that offers online medical assistance, by Bessemer Venture Partners and a management team led by Dr. Vikram JS Chhatwal. On the other hand, while PE typically seeks bigger businesses, many of them either considered or put their money into small businesses with sound fundamentals. These opportunities arose in several industry subverticals like medical diagnostics, waste processing and e-commerce.

The third notable theme in 2011 was the dramatic decline in the number of exits. Only 88 investments exited PE fund portfolios in 2011, compared with 123 in 2010—a nearly 30% decrease. Given that IPOs are the most prevalent way for PE investors to gain liquidity, the depressed stock market contributed significantly to this trend. Several PE funds tried other exit avenues, either selling their stakes to other funds through secondary transactions or to strategic industry buyers. Overall, though, the pace of exits is provoking high anxiety levels within funds, as the inventory of deals in the exit pipeline swells. "On an absolute basis, there are a lot more investments than exits; stock markets are not strong enough for some of these companies to go out," one GP we spoke to said. The fact that investors are turning to other exit options means "the pressure to exit is evident."

Increasing difficulty in fund-raising was the fourth piece of the new reality in 2011. LPs say they have become far more selective, evaluating re-ups and managing their investments more closely than ever to ensure capital protection and better returns. Industry practitioners are feeling this heat. While some funds have taken more time than expected to close, others have not been able to close at all. This newfound caution was captured well by one LP who invests in various Asian markets. "Though we are confident of India's long-term potential, we have not seen our capital return as yet," he said. "Hence, we are scrutinising the management teams of the various funds a lot more rigorously before committing additional capital."

Finally, the fifth force shaping PE in 2011 was the growing uncertainty around a variety of regulations that affect the attractiveness of certain investments and the calculation of net capital gains accruable to foreign investors.

At a general level, India's government is still grappling with how to treat alternative investment classes, including PE. Regulators are increasingly aware of the need for a framework, and recent SEBI Alternate Investment Fund draft regulations seem to be a step in the right direction. However, it's too early to say what form the regulation will eventually take. Industry practitioners are "anxious" about this, as one told us, because "right now too much has been left open to interpretation or discretion."

One of the key ways that further reform could lower roadblocks to PE investment in India is by clarifying and improving tax rules for foreign investors. Under the current regulations, domestic PE firms rely heavily on foreign funds, since Indian insurance companies and pension funds are barred from investing in PE. With this limit on the pool of domestic capital, about 80% of the combined PE and VC funding in India comes from foreign capital. This might change in the future, since the government is considering a proposal of tax free exits for domestic VC and PE investors. This is likely to give a fillip to the domestic PE and VC industry.

The tax obstacles crop up in a number of ways. For one, India has struck Double Taxation Avoidance Agreements with some countries to help mitigate the costs when foreign investors exit an Indian investment, but investors often face opposition when trying to exercise their rights under them.

In other situations, the duality is more obvious. Current rules also explicitly limit investment opportunities for foreign investors in some ways. They are still prohibited from investing in several regulated sectors such as multibrand retail.

Another important concern for investors that could benefit from better legislation is bankruptcy. Unlike the US or UK, India does not have a comprehensive bankruptcy law. Instead, frustrated lenders or vendors in India can refer sick firms to the state-administered Board of Industrial and Financial Reconstruction (BIFR), but typically only after the firm's net worth has been completely eroded. Moreover, it's not easy for creditors to recover their dues when a firm is declared sick. This outmoded process keeps many PE and VC funds on the sidelines, as they often thrive on high-risk companies with untried business models that can fail quickly. Several investors we spoke to demanded a faster and simpler liquidation process for enterprises that need to be shut down, keeping in mind the rights of all shareholders.

India's policy framework, which has been in reform mode for nearly two decades, is still constantly being fine-tuned. If this long-standing regulatory paralysis can be resolved, the PE and VC industry could achieve a much more desirable depth of investment in India.

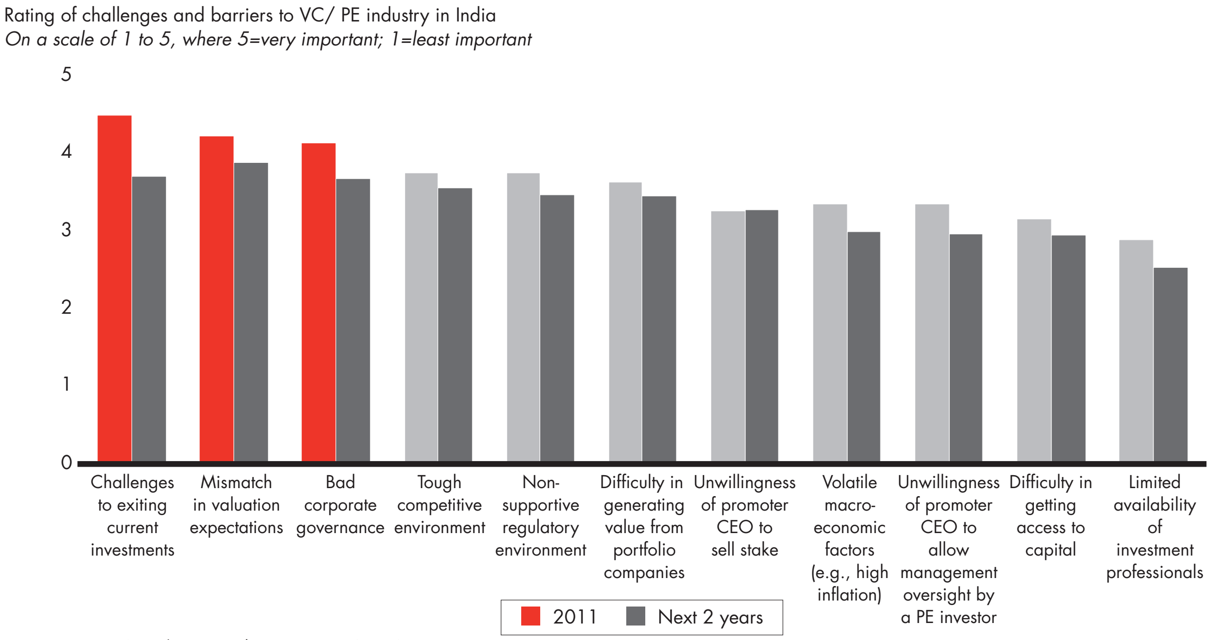
Issues to watch in 2012

Even with the slowdown of the economy in 2011 and flat growth in buyout deal activity globally, India thrived with LPs and GPs, who continue to be optimistic about India's future potential. Most of them unequivocally agreed that even in the long term, India's economic growth would remain firm. Given the vast population and burgeoning middle class, consumption is likely to be robust for several years, creating myriad business opportunities.

While this creates a great backdrop for budding entrepreneurs, and in turn for PE investors, there remain several challenges that could hamper PE's path to becoming a preferred source of capital. The respondents we surveyed underlined three key challenges that the industry faces today and that are likely to have a significant effect on its evolution (*see Figure 2.3*).

Challenges in exiting current investments. The top challenge in the minds of industry practitioners seems to be the increased pressure to exit investments and return capital. It is clear that Indian PE investors are in a tough spot, as many of the investments made in the pre-crisis period of 2006 and 2007 are coming to the end of the standard five-year holding periods. We will analyse these trends in the "Exits" subsection in upcoming Section 3 in greater detail. The weak IPO market can explain part of the slowdown in exits last year, but the

Figure 2.3: Difficulty in exiting and mismatch in valuations remain the biggest challenges and barriers to the VC/PE industry



Source: Bain IVCA VC/PE Research Survey 2012 (n=66)

bigger concern is that the difficult macroeconomic environment may reveal portfolio companies to have overestimated their original performance projections. Several noteworthy investments are now underwater and those with weak fundamentals have little chance of yielding attractive financial returns for their PE investors.

The difficulty in exiting may mean fewer investments going forward. LPs are now adopting a more cautious approach in capital allocation as funds come with requests for re-ups or new rounds of funding.

Mismatch in valuation expectations. Though valuations in 2011 tempered moderately, the high-potential deals—ones with proven, scalable business models in high-growth sectors, led by strong and committed management teams—continued to be pricey. GPs reported that competition for these deals among PE funds in 2011 was equivalent to that in previous years, pushing up valuations.

To cope, PE fund managers have started putting more emphasis on defining the right entry valuation, exit route and liquidity potential of prospective investments. To some extent, they have been helped by the decline in public company valuations, as listed companies typically set the pace for private company transactions. Companies in the BSE Sensex traded at 10 to 12 times, trailing 12-month EBITDA multiples throughout 2011, a marked decrease from a high of about 18 times in the peak PE investment year, 2007. However, as the stock market starts to recover, PE players fear that promoter valuation demands might head north, refuelling some dissonance. Several GPs agreed that first-generation entrepreneurs sometimes demand unfairly high valuations, much before their companies are ready for them. In cases where they are able to raise funds, there is tremendous pressure on both the entrepreneur and the PE fund to scale up the business and make the company ready for the next round of funding at an even higher enterprise value.

Poor corporate governance. Another issue flagged by GPs is the weakness of corporate governance in many of the businesses they assess. While this is not a new phenomenon, several high-profile conflicts between businesses and PE firms have put the spotlight on it and made PE funds cautious. Last year, India's biggest listed microfinance firm, SKS Microfinance, sacked its chief executive officer, raising governance issues that eventually claimed its founder. Around the same time, children's apparel maker Lilliput fell out with its PE partners, allegedly over poor accounting methods.

Experts believe that these public examples are just the tip of the iceberg. Several PE funds continue to face these governance issues in their portfolio companies, with limited ability to take corrective action given their minority positions. "The last five years have been a tremendous learning experience for me and the industry in general," said one of the GPs we spoke to. "As the industry comes close to completing one full investment cycle, we are now starting to understand the Indian entrepreneur and are already incorporating these insights as an important input in our diligence process." Given the recent memory of these disputes, corporate governance will continue to be closely scrutinised by PE funds as they evaluate opportunities.

In addition to the above, survey respondents indicated two more challenges on the horizon that could increase in significance.

On the micro level, PE funds need to start considering how to manage the churn in their investment and portfolio teams. As entrepreneurs and PE investors partner more closely, both sides are realising the importance of building personal relationship. "Having gone through two major rounds of funding, I am certain that relationship with the individuals in the PE fund is critical," an entrepreneur at a mid-sized industrials company commented. Some attrition at senior levels in several PE funds in India over the past two years could reduce the effectiveness of the deal-sourcing network and has the potential to disrupt investment philosophies.

At a macro level, PE firms should keep a close watch on regulatory changes and reform, particularly those related to the tax treatment of foreign entities. LPs are worried about uncertainties in India's tax regime, which directly affect their net capital gains from their committed investments. The recent Vodafone tax dispute has raised fresh concerns around how controlling interests in Indian companies will be taxed when investors exit. And a proposed retrospective taxation on the transfer of shares, including in cases where the transaction is between two overseas entities, could limit the exit options available to PE funds. Since a large number of PE and VC funds in India are incorporated outside the country, the government's current view on taxing gains from cross-border transactions could significantly increase transaction costs for the funds.

In the next section, we will take a closer look at the trends and factors that shaped the PE sector in 2011 and what to expect in 2012.

3. In-depth perspective on Indian PE, now and over the intermediate term

Last year the PE industry went through a significant transition, with transactions now starting to display the characteristics of a maturing industry. We have already delved into the factors that shaped this transformation, and how some investors are looking to exit their current holdings.

Entrepreneurs and investors have learned valuable lessons over the last few years in all four aspects of the business—fund-raising, deal making, portfolio management and exits. We will now take you through some of these lessons in detail, while also attempting to forecast how they will develop in 2012.

Our insights are drawn from a survey of more than 66 PE and VC respondents and refined by interviewing more than 50 industry participants that include entrepreneurs, LPs and GPs during 2011 and during the preparation of this report.

Fund-raising

Today's baseline: Fund-raising gets tougher

The good news for the Indian PE industry is that LPs continue to believe in the India growth story, based on the country's economic potential, demographics and growing consumer base. While none of the GPs interviewed see LPs shifting their fund allocations away from India, the paucity of exits has certainly made LPs more cautious. The shift in sentiment is palpable in a series of interviews conducted by UK-based research firm Preqin. In December 2010, 35% of LP respondents believed that India presented "attractive opportunities"; that number dropped to 12% in the most recent poll, conducted in December 2011.

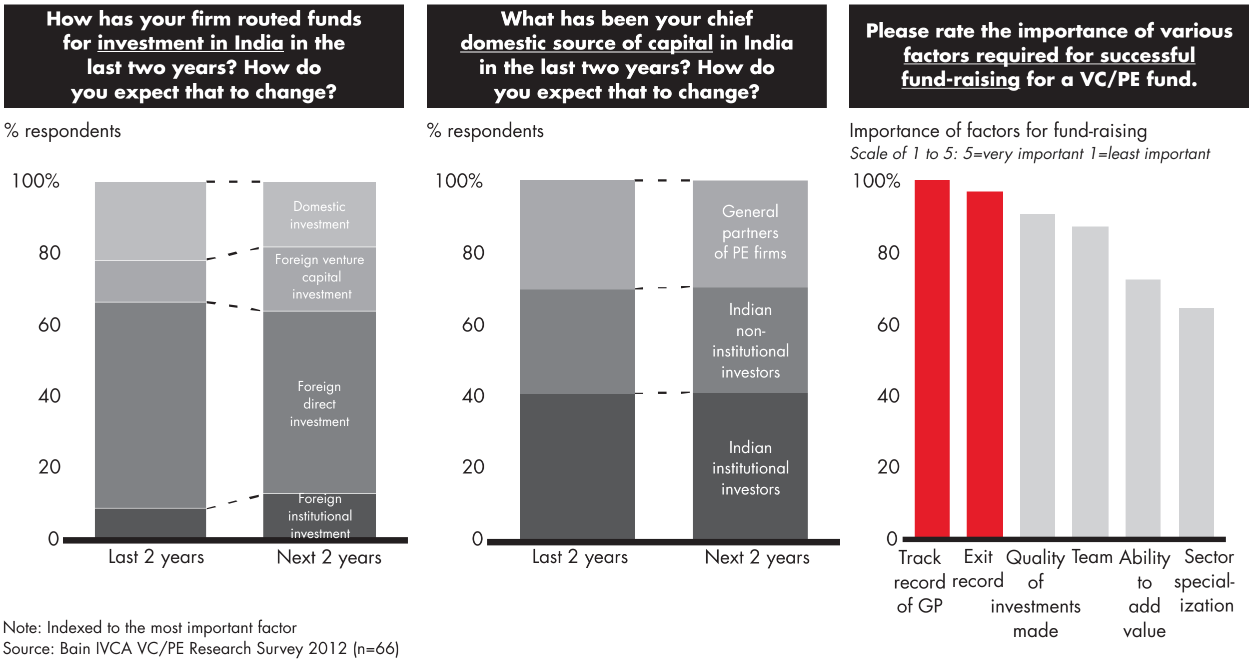
According to Preqin, about 680 funds raised around $270 billion in capital globally in 2011. Of that total, however, only $12 billion came with the mandate to invest in India, down from $18 billion in 2010. This is a clear sign that LPs are becoming more selective in where they park their money.

Bain research shows that more than 78% of the funds raised in the last two years have been from foreign sources (*see Figure 3.1*). The domestic capital pool remains limited, mostly to high-net-worth individuals (HNWIs) or corporate institutions, since current regulations bar domestic insurance and pension funds from committing money to alternative asset classes such as PE. Fund preferences have also created the high level of overseas funding; many investors want to stay outside of India's jurisdiction to avoid disputes over taxation and redemption, especially as the local legal system is already overwhelmed by a large backlog of pending cases.

In line with their increased caution in the region, LPs are putting fund managers under the microscope before extending any money. One LP we interviewed summed up the trend in the following way: "As we have gone through the learning curve of investing in India, we have become more rigorous in evaluating investment teams, deal sourcing and screening processes, and the approach the fund would take to create value and ensure sufficient liquidity of the investment." The results of this approach are already apparent, with some fund managers failing to close their fund raises in 2011 and others having to wait an exceptionally long time. Moreover, some LPs are now visiting the country to develop a first-hand understanding of India and its potential. "Our LPs have become more hands-on," said one GP we spoke with. "Though we retain the flexibility in investments, they are discussing deal themes a lot more and are constantly pushing us for a more rigorous diligence." LPs are willing to remain invested in India, but it is clear that they want to get more involved with the local teams.

The key to successful fund-raising is differentiation, suggested some of the GPs we spoke to (*see Figure 3.1*). This differentiation arises from GPs' track records and exit histories, which are determined through their sector expertise, wide deal-sourcing network or by virtue of having strong operating teams that help improve performance in portfolio companies. One GP who recently finished a successful capital raise remarked that

Figure 3.1: Funding from FIIs is expected to grow; GP performance would be the key driver in fund-raising success



Note: Indexed to the most important factor
Source: Bain IVCA VC/PE Research Survey 2012 (n=66)

LPs "are increasingly asking questions around differentiation in deal sourcing, investment philosophy and value creation. The discussions have moved from choice of sectors to clearly defining hurdle rates, aligning on the risk appetite and ascertaining how the path to liquidity will be made." The good news? "There is no paucity of funds or aversion to India," the GP reported.

Longer-term prospects: 2012 and beyond

In 2012, we foresee that capital will be plentiful but harder to attain. PE funds are entering 2012 with an estimated $17 billion worth of "dry powder" to put to use in India specifically. That is approximately the same amount that they deployed in 2011, but about 15% less than the $20 billion they had at the start of 2011. Even if the market soaks up the dry powder quickly, though, there is little reason to sweat over possible shortfalls in funds, since GPs can always draw more capital from larger global or regional funds. New funds for India are also likely to be raised in 2012.

Foreign funding will continue to be critical. Our survey suggests that more than two-thirds of funds in the next two years will come from foreign venture capital investors (FVCI) and FDI (*see Figure 3.1*). Only 18% of funds are expected to come from domestic sources, including a large portion from GPs in PE firms. Indian institutional investors are expected to continue to contribute about 40% of total domestic funds raised.

Given this environment, the GPs we interviewed ranked "difficulty in raising capital" low on their list of concerns—a distant 10 of the 11 challenges mentioned (*see Figure 2.3*). However, GPs will have to deal with a subtle but steady increase in scepticism among the LPs from whom they draw funding. Our research indicates that LPs will be scrutinising GPs closely before signing on the dotted line for more funds. Successful track records and exit history are the two most important factors in getting funding, our survey indicates. This means that fund managers who are seeking to raise funds for the first time will find the job even more difficult than their peers.

Deal making

Today's baseline: Surge in deal flow

The good news is that the volume of deals in India grew by 40% in 2011, hitting a record 531 by the end of the year. The deals were mostly small in size, but collectively they pushed the value of funded deals up to $14.8 billion over the year, a 56% increase compared with $9.5 billion in 2010 (*see Figure 2.1*).

The average deal size grew slightly, from $24 million in 2010 to $28 million in 2011 (*see Figure 3.2*). Though this average is still 20% below the peak value seen in 2007, the largest deals show promising momentum. The average investment size for the top 25 deals was $236 million, nearly equal to 2007. The cumulative investment in the top 25 deals in 2011 was $5.9 billion, about 34% higher than the 2010 value. Two megadeals—the investment into Hero Investments Private Limited by Bain Capital and Singapore's sovereign fund GIC, and the Patni acquisition by iGate and Apax—constituted a significant portion of that capital.

On the other side of the average, smaller deals proliferated thanks to a growing interest in e-commerce. Deals in this space nearly tripled as compared with 2010, a trend we will analyse in greater detail in Section 4. With an average deal size of $10 million, these deals constituted about 40% of early-stage capital invested.

Taking a broader look at the leading investment sectors, real estate was by far the hottest area of interest for PE investors in India. Total deal value in this sector more than doubled to $3.4 billion in 2011, up from $1.5 billion in 2010. Several factors helped propel this trend. One, the higher borrowing costs in India forced real estate developers to look for alternatives in addressing their unwieldy debt burdens. Two, the property market boom has been petering out as the economy has slowed, leading to lower sales volume and cash inflows. With funding scarce and balance sheets strained, developers turned to PE investors as a source of steady, interest-free capital. In the process, real estate valuations became more realistic, and hence, more attractive for PE funds. All these factors resulted in many more deals being struck in real estate.

Figure 3.2: Deal size for larger deals in 2011 increased to peak 2007 levels

Source: Bain PE deal database

Other attractive sectors included manufacturing and IT/ITES (helped by e-commerce). Together they garnered about $4 billion, or more than a quarter of the $14.8 billion total that PE investors poured into India. E-commerce, meanwhile, constituted almost two-thirds of the deal volume in the IT/ITES sector.

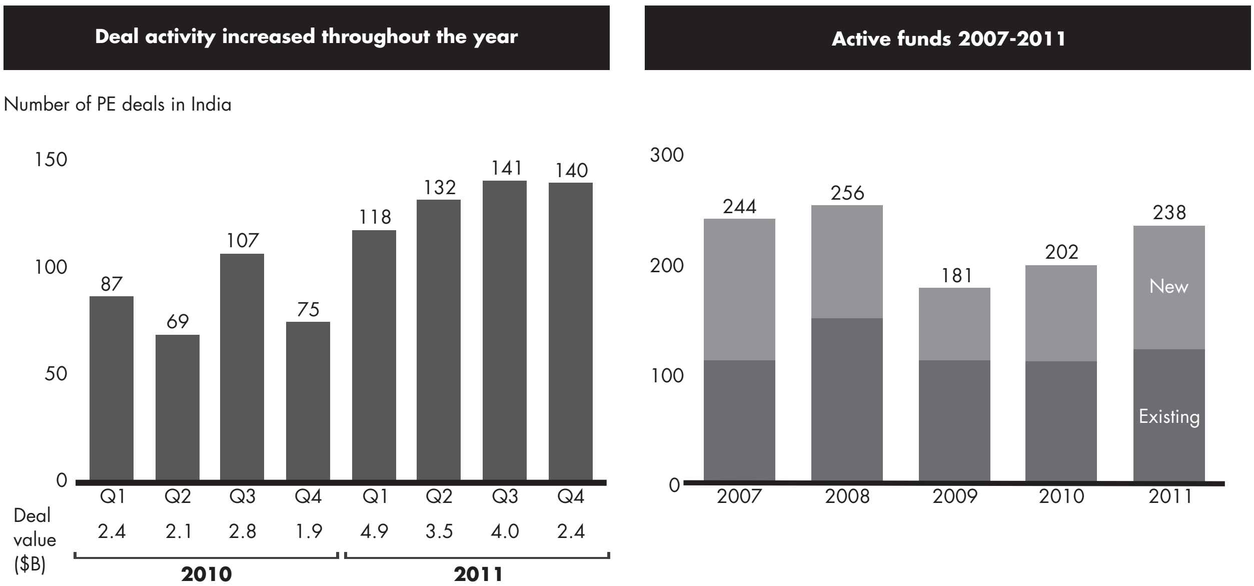
Manufacturing saw 72 deals with a total deal value of $2.4 billion in 2011. Of this, 21 deals totalling about $500 million were in the industrial equipment space, while seven deals totaling $1.1 billion were in the automotive and automotive component sectors. This is significant as manufacturing had been ignored by PE for a long time in India.

Two sectors appear to have lost some lustre since 2010. The first, banking, financial services and insurance (BFSI), saw many deals stall because PE players found promoters' valuations to be excessive. The second category, infrastructure-related investments, has remained almost flat at about $4 billion, in large part due to government contract and policy delays. There was some deal growth in engineering and construction to offset the decline in subsectors such as energy and roads. Deals in telecom infrastructure nearly disappeared in 2011, largely due to the uncertainties around spectrum allocation and delayed network rollouts from several new entrants.

The profile of investors in the region is starting to include some new entrants. Last year, the number of "active" funds, defined as funds that did at least one deal in the year, increased from 202 to 238 (*see Figure 3.3*). Nearly half of those, 113, had not done a deal in the previous year, suggesting that new funds are getting active in the Indian PE market. Of the funds which were active in 2010, about 60% returned to the market in 2011.

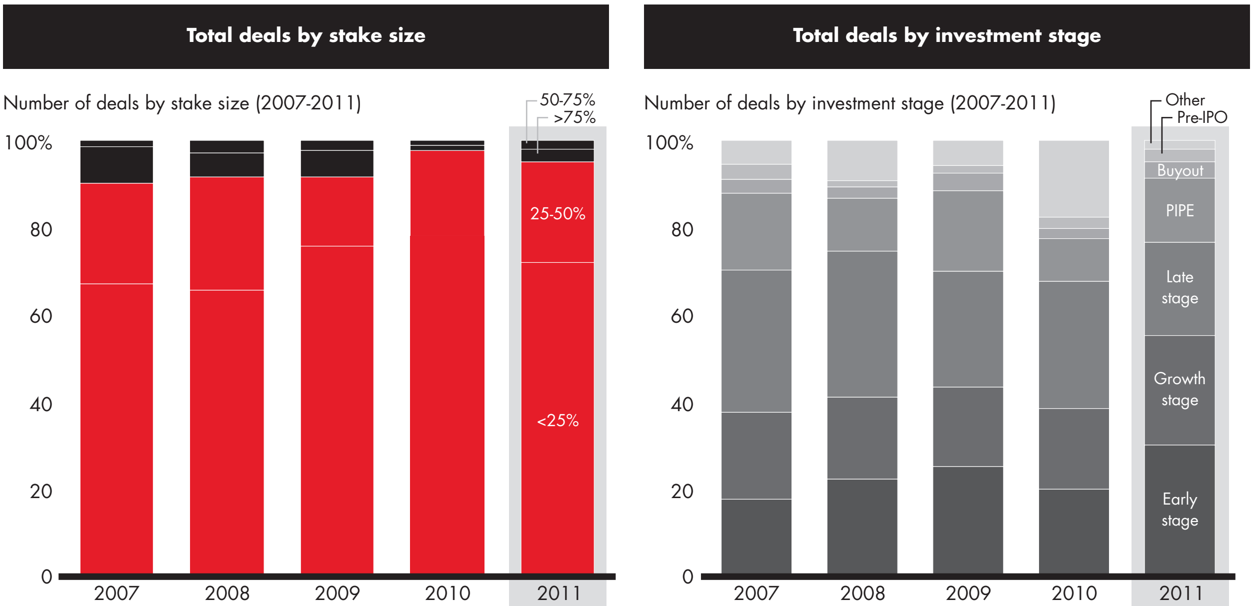
For the most part, those PE investors are still taking minority stakes, with more than 90% of deals involving a sub-50% share of a company (*see Figure 3.4*). That trend is in part the result of growing excitement about early-stage companies, where promoters would typically stay involved in the company. Early- and growth-stage deals make up around 40% of total deal volume in recent years, and that level surged to more than 50% in 2011 thanks to a large cluster of e-commerce deals.

Figure 3.3: Number of active funds increased in 2011



Notes: Only deals with disclosed sizes shown in the quarter-wise deal activity; a fund is classified as new if it has not done a deal in the preceding year; new funds include funds that did a deal in the current year but were inactive last year
Source: Bain PE deal database

Figure 3.4: Most deals continue to be for minority stakes; PIPE and early-stage deals have become more popular



Note: Includes only those deals where stake size is known; real estate deals excluded in the above analysis
Source: Bain PE deal database

An interesting trend in 2011 was the blurring of the line between PE and VC investments. Several PE players evaluated early- and growth-stage deals that traditionally would have been the sole preserve of VCs. In fact, the two types of funds ended up competing for some deals. This crossover has happened in part because some PE funds are looking for more attractive, but riskier, internal rate of returns (IRRs) than they may be able to capture from their traditional hunting grounds. “Due to competition for the few high-quality deals that are available, PE funds are forced to consider certain type of assets that would bear higher risk,” one GP from a growth PE fund told us.

The proportion of late-stage deals in the mix halved, from about 30% in past years to around 20% last year. The weak IPO market was a big factor in this drop, since exit strategies seem elusive in the near term. One notable development, however, was the dramatic spike in the number of buyouts, from 10 in 2010 to 25 in 2011.

Buyouts generally revolve around late-stage firms, and most of the participating funds that we spoke to feel that there will be even more such opportunities ahead. They are evaluating a growing number of mature businesses that are looking to become more professionally managed. In some cases where the enterprise is family-owned, the younger generation is keen to create greater value in the business though PE partnerships. Others want to exit the business altogether, believing that “it is best for them to cash out with a good valuation if they do not have the expertise and means to take the business to the next level,” according to one investor. Some PE funds are preparing themselves for this future, moving to a strategy of taking one or two deals in which they have full control, rather than spreading themselves thin by holding minority stakes in multiple companies.

Another trend marking PE investments in 2011 was the rise of private investment in public equity (PIPE) deals. Seventy-one of these deals were struck, an increase of 87% over 2010, because of a lackadaisical stock market. As much as $2.4 billion was invested last year through PIPEs, close to the $3 billion PIPE investments in 2007. The largest PIPE deal was J.P. Morgan’s $400 million purchase of a 20% stake in SKIL Infrastructure. Industry observers suggest that PIPE deals are here to stay, as many attractive assets in India are listed on the stock markets. Moreover, an investment in listed stocks ensures liquidity and creates a mechanism for the PE fund to make partial exits when the stock price reaches the desired levels.

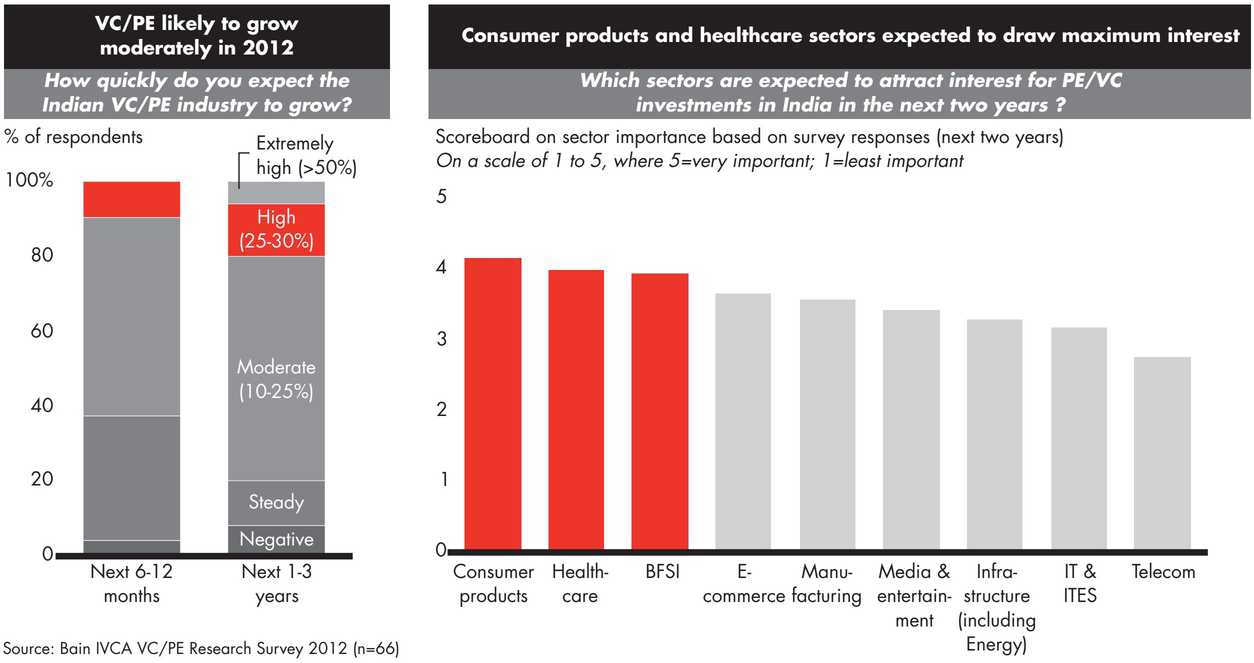
Longer-term prospects: 2012 and beyond

2012 looks to be a year of solidifying the gains of 2011, although opinions vary widely. According to our survey, about 10% of respondents believed that the PE industry could grow substantially, climbing 25% to 50% beyond 2011's levels, while about a third of respondents expect it to remain steady. The most popular theory held by about half of the respondents is that deal activity will grow moderately in 2012 (*see Figure 3.5*). Optimism, however, is subdued by challenges hindering growth. For one, lackadaisical government policymaking may stymie reforms. PE firms are also apprehensive of taxation changes: The proposed General Anti-Avoidance Rules might require them to pay tax on profits if they fail to demonstrate "substantial presence" in an offshore haven such as Mauritius—a stipulation that is unclear to most.

Given India's long-term growth story, more PE capital is likely to flow in to the region in coming years. In 2012, 50% of respondents to our survey expect to invest between $50 million and $200 million in the country, while only 36% plan to invest less than $50 million. Looking over the next three years, more firms plan to migrate toward larger investments, with some eyeing $1 billion-plus allocations to India (*see Figure 3.6*). In a reversal of current trends, industry practitioners expect the volume of PIPEs and buyouts to increase and the share of growth capital deals to decrease over the next two years. As one fund we interviewed said, "It is difficult to ignore public companies in India, as the pool of listed companies is huge."

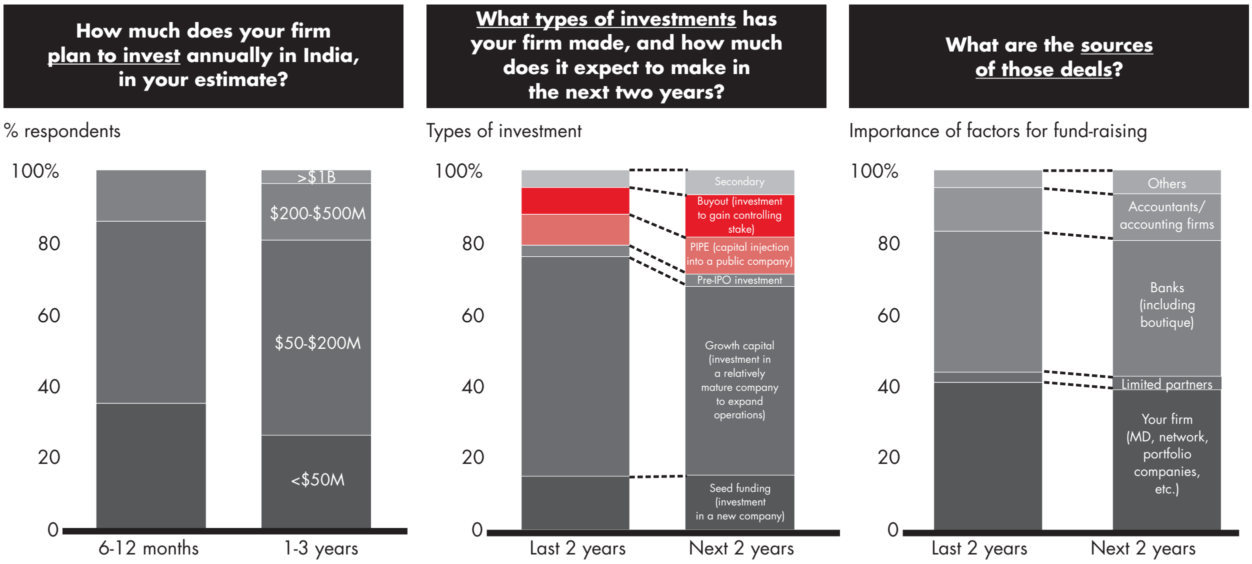
In terms of industries, consumer products is the top-ranked investment category among survey respondents, with healthcare and BFSI following. All of these sectors are dependent on the increasingly large and wealthy Indian population for success. Moreover, the GPs suggested that many subsectors in these areas remain underpenetrated, leaving room for strong growth. Private healthcare in India, for example, is still a nascent market, with per capita healthcare spending at only $132, versus around $7,400 in the US, according to the World Health Organization. India has just 0.9 hospital beds per 1,000 people, compared with 3.1 beds in the US.

Figure 3.5: VC/PE is expected to grow moderately in 2012, driven by investor interest in consumer products, healthcare and BFSI



Source: Bain IVCA VC/PE Research Survey 2012 (n=66)

Figure 3.6: PE funds are planning to increase investments in India; the market will remain intermediated



Source: Bain IVCA VC/PE Research Survey 2012 (n=66)

One of the biggest challenges for PE firms ahead may be shifts in the deal-sourcing process. Without question, investment bankers and accountants, who now grease the wheels, are likely to remain a fixture in the Indian PE market (*Figure 3.6*). Anecdotally, however, PE funds agree that they will have to work harder to gain a proprietary edge on prospective deals. Getting an edge in this area is likely to mean establishing close and cordial relationships with entrepreneurs and engaging with them as early as possible—sometimes long before they start thinking about raising outside capital. With increasing competition for good deals, a few PE firms are already going the extra mile. The founder of a large e-commerce portal remarked that funds were approaching him much before his firm required additional capital. He was appreciative of the fact that these funds were being proactive in highlighting their capabilities and were setting him up with people in their network to demonstrate their ability to add value.

Given the savviness of the Indian entrepreneurs, the onus is shifting to the PE funds to demonstrate that they are the right partners for the entrepreneurs. Our conversations with entrepreneurs indicate that they carefully consider qualities such as a clear investment rationale and transparency when choosing a PE partner. "VC and PE funds need to understand what they are getting into and need to be clear on whether this investment will match their investment ideology and exit requirements," one e-commerce firm founder remarked.

One of the difficulties in creating partnerships is the lack of deep sector specialisation among PE firms, particularly in early-stage deals. While there has been some concentration in industries like infrastructure and real estate, some LPs we spoke to recognised that deal flow is too sporadic for specialisation in many other industries.

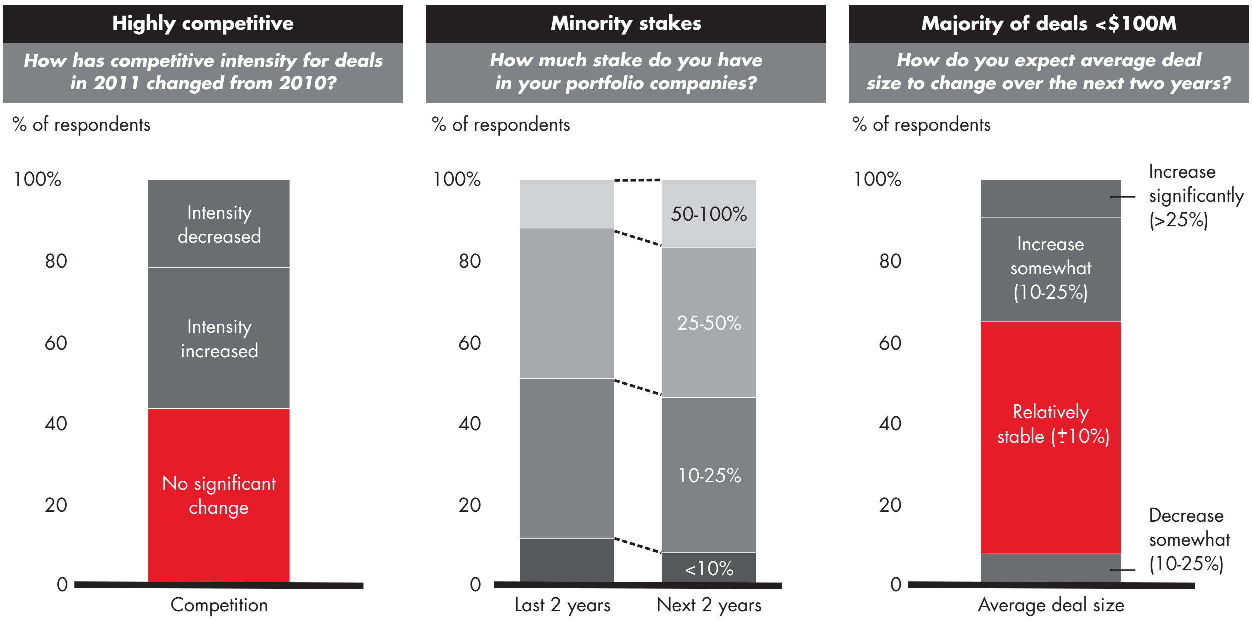
On the other side of the transaction, funds should expect to spend more time on the deal-closing process. In 2011, on average, investors reported that about half their deals took between three and six months to close out, while 35% took between six and 12 months. Anecdotally, we have seen an extension in deal-closure time due to PE funds spending more time in the diligence phase. The scope of the commercial diligence has become more comprehensive; apart from the usual projections for revenues and profits, funds are looking to get comfort around the quality of the management team, any looming regulatory risks and the firm's corporate governance structure. This trend is expected to continue over the next two years, although the number of deals that take an exceptionally long time to close out—more than a year—is expected to decrease from 11% to 4%.

Looking out over the next several years, respondents to the Bain survey expect few changes to deal terms and deal structures. Minority stakes will continue to dominate, even though promoters are starting to be more open-minded about greater participation from PE investors. In the next two years, GPs expect 46% of deals to involve stakes of less than 25% in investee companies (see *Figure 3.7*). Interestingly, 17% of deals could involve majority holdings in the 50% to 100% range, portending a slight increase in that category. As a result, there appears to be some optimism that deal sizes will increase marginally. While the majority of respondents believe that deal sizes will be stable in the next two years, a solid quarter expect them to grow by 10% to 25% in the same period (see *Figure 3.7*).

Deal structures also seem to have stabilised, with most funds combining equity with convertible instruments. Hybrid products, such as mezzanine debt, have started to pick up as more deals now have a debt component. This is an area where domestic funds have a clear advantage over foreign ones. Current regulations require foreign funds to define the pricing upfront. This restricts their flexibility in structuring deals. Domestic funds, on the other hand, can use flexible instruments, such as subordinated debt and structured loans that are linked to the firm achieving specific milestones.

Overall, a relatively large number of GPs believe that competitive intensity among PE funds is unlikely to change; some even believe it will decrease. More than 20% indicate they've already seen a tempering of competition in the past two years (see *Figure 3.7*). How and why those trends come to bear is still a point of contention, however. Several PE funds we spoke to maintained that the industry will see capital concentrating in fewer hands as LPs become more selective about who they extend money to. Meanwhile, well-performing GPs feel that the main competition for deals is likely to shift from other funds to the equity and debt markets, as the economic uncertainty lifts and the capital markets regain health.

Figure 3.7: Unique characteristics of the Indian PE market are likely to stay



Source: Bain IVCA VC/PE Research Survey 2012 (n=66)

Portfolio management

Today's baseline: Move from funding to partnering

Portfolio management practices in India have traditionally been different from those in more developed markets. This is because most PE funds in India hold minority investments in their portfolio companies. As such, the funds have mostly played an advisory role through board membership and been focused on monitoring investments. Beyond the monitoring role, the participation of funds in the business has depended entirely on how much the promoter has been willing to allow the fund to engage. In developed markets, portfolio management involves working more closely with management, with both sides agreeing to a clear strategy for creating value. In India, slowly but surely, the tide seems to be changing toward this higher level of participation.

Dissonance between promoters and their PE investors is one of the roadblocks to a closer working relationship. Many GPs we spoke with believe disagreements are common, though often unreported. In the past, however, several spiralled out of the boardroom and into more public forums, including the cases of Lilliput Kidswear, Subhiksha and Transafe.

There are several reasons for misalignment between PE funds and promoters:

Lack of common vision. In many cases, there is a lack of an agreement between the PE fund and the entrepreneur on the blueprint for value creation at the very start of the relationship. It is important for both sides to align on their aspirations for the company and where they realistically can take it. To overcome this problem, PE funds should invest more time in understanding how the entrepreneur makes trade-offs in his business and what the effects may be on product strategy, pricing approach and cost management.

Lack of strategic alignment. Very often, PE funds and the management teams do not discuss detailed milestones for value creation or the nitty-gritty details of how to achieve these milestones. Sometimes, this leads to ideological differences between the PE fund and the senior management, which then makes it difficult for them to have a smooth relationship. Leaving the dissonance unresolved often makes it impossible for the partners to work together. In a recent case where the relationship between the promoters and the investors broke down, the PE investors decided to exit the business, leaving the company laden with debt.

Lack of transparency, post-investment. Another common reason for fallout between PE funds and promoters is a lack of transparency in day-to-day operations and accounts. The owner of an organic farming venture, which has PE backing, remarked, "Communicating transparently and being upfront is the first thing I would advise promoters to focus upon. Whether the news is good or bad, your fund partner needs to know. If the trust factor is tarnished, then the consequences may be irreversible."

Irrespective of why some PE fund relationships with promoters have gone sour, the consequences have been grave. The most obvious impact is that the PE fund becomes unable to meet the set investment return goals. The entrepreneur also loses, as few such firms have been able to raise funds easily later.

One of the ways PE funds may find future success in these relationships is to highlight their past success. The story of value creation by PE funds has often been underappreciated by entrepreneurs and the general public. However, a recent analysis of the top 100 Indian public companies (by market capitalisation, for the 2007 to 2011 period) indicates that PE-backed firms boasted an additional 5% revenue growth and an extra 14% profit before tax (PBT) growth compared with firms that had no PE backing.

This value addition by the PE funds in India has happened in five different ways. First and foremost, investors have added value by setting up strong corporate governance structures. In fact, the CFO of a PE-backed pharmaceutical company has publicly acknowledged the fund's role in improving corporate governance norms.

Second, entrepreneurs generally find great advantages in a fund's ability to connect them to suitable business partners, customers or topic experts. An entrepreneur in the e-commerce space remarked, "Significant benefits have accrued to us from the doors that our PE partner has opened. In one of the cases, the PE fund set up meetings for us from which we have been able to generate huge business with a large Indian conglomerate. We got direct access to the highest levels, and this helped us in closing our proposal quicker than our competitors." Another promoter was relieved and grateful to be able to meet several prominent US companies during sales visits to the US, all arranged for and set up by the PE fund. A third and related point is that companies looking to scale up or establish a significant presence globally can benefit immensely from the experience and network of the PE funds. Moreover, the financial acumen and deal-making capabilities available from the PE funds can help Indian companies approach M&A far more confidently than they might on their own.

A fourth way in which PE funds can aid their portfolio companies is by attracting and retaining top-quality talent that the entrepreneur might not otherwise have been able to hire. This is a tremendous bonus for new ventures and early-stage growth companies, as they often are expanding rapidly, but lack a strong brand in the talent market.

The fifth form of adding value is in the specific operational improvements that PE funds have been able to support at portfolio companies—projects like working capital optimisation, mitigating project execution risks and even driving cost reductions.

Though still not common, several entrepreneurs we spoke to mentioned they put the relationship first and did not necessarily choose the PE partner with highest valuation on the term sheets. "Valuations are secondary," said a promoter in the entertainment space. "Once I evaluated the various PE funds that would best suit the value creation needs of my company, the valuations automatically fell in place, as the chosen fund aligned its valuation to match the other financial offers available to me."

Longer-term prospects: 2012 and beyond

When asked why some PE portfolio companies suffer, the managing director of a reputed PE fund remarked that there are four key reasons why deals underperform: high initial valuations, poor financial performance, regulatory discontinuities and corporate governance issues.

So far, the ability of PE funds to add value to investee companies has been limited because their holdings tend to be minority stakes, with no explicit control provisions attached. Encouragingly, funds we spoke to said that promoters were changing their attitudes and were becoming open to ideas and business plans that would add value to their firms. However, even when the PE fund is a minority investor and the management is not very open to active management, there are several ways in which the funds can address some of the challenges listed above.

1) **Conduct a detailed and comprehensive diligence before the deal to identify all possible issues.** PE funds should then use their diligence findings to map out a value creation blueprint. An increasing number of funds see their diligence reports as strategic pieces of information that can be used to improve the business practices well after the deal has been signed.

2) **Get the buy-in of the management team on the value creation blueprints.** These joint blueprints could include strategic and tactical initiatives that the company could implement immediately after the deal. Very often, the commercial diligence reports elicit findings from consumer interviews, vendor feedback and other competitive insights. We have started to see examples where the PE fund shared the scope of their commercial diligence with the target and created a win-win situation. The PE fund got full support and customer access from the target, while the target company management received critical insights from the diligence findings that were useful for running their business.

3) **Invest in building a strong and collaborative relationship with the promoter and his team.** Several funds are already extending these relationships beyond attending periodic review meetings, investing time with the management team in achieving desired outcomes. This sometimes involves being on the ground with the management team in a critical product launch, kick-starting an important growth initiative or participating in a negotiation with a banking partner. Entrepreneurs are increasingly looking at quality and the team's attitude when choosing the right PE fund so that the journey of value creation is not slowed down by discord with the PE fund.

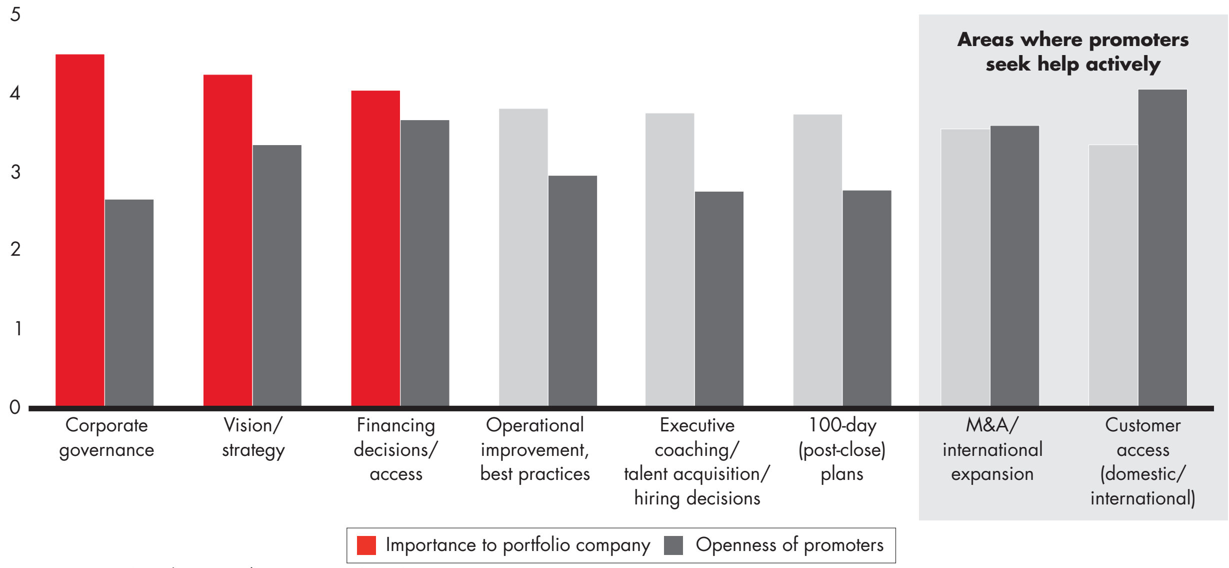
4) **Build an operations team with relevant expertise to support the company.** Some funds have built a network of advisers, dedicated staff and consultants who provide operational support to investee companies. To get closer to their portfolios, more funds are building in-house operating teams and adding managers to monitor and mentor the investee firms to improve growth and profit. In fact, this has become a necessity in some cases because of the growing backlog of companies that have been stalled in exiting the portfolios of many PE firms.

According to our survey, only 33% of PE firms agreed that Indian promoters are currently conversant with the PE value proposition, while an overwhelming 75% agreed that Indian entrepreneurs will become more conversant with the funding proposition over the next two years. Moreover, there are significant disconnects about expectations, especially about what GPs think their portfolio companies need support with versus what promoters and management teams seek help with (*see Figure 3.8*). Customer access and M&A guidance are the only two areas in which entrepreneurs have been more proactive than PE funds in seeking support, while in all other areas PE funds seem to be the ones driving change.

However, promoters' expectations of PE are changing rapidly. In India, it is becoming increasingly clear that to make such partnerships work, promoter interests and PE interests have to be aligned upfront and promoters need to be forthright and transparent about their businesses post-transaction.

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

Rating by PE funds on the most important areas that they feel portfolio companies need help with
On a scale of 1 to 5, where 5=very important; 1=least important



Source: Bain IVCA VC/PE Research Survey 2012 (n=66)

Exits

Today's baseline: Significant drop in exits as public market sales dried up

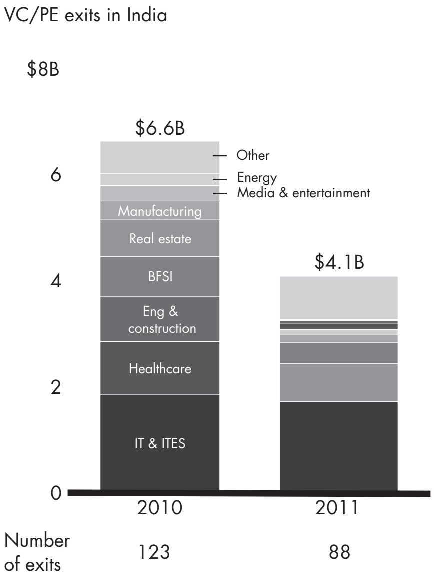
In 2011, the number of exits dropped precipitously—by about 30%, compared with exits in 2010 (*see Figure 3.9*). Based on the exits reported in the public domain, only $4.1 billion of funds were returned to the LPs by the PE funds last year, which is $2.5 billion lower than total returns in 2010. The drop in exit volume and value can be pegged to a bearish equity market. Public market sales (including IPOs) have been the most popular exit route for PE in India over the past two years, but as the benchmark stock indexes slid, public offering sales slumped.

Still, 2011 was a peculiar year with only two such exits, totaling a mere $200 million. One of those PE-backed IPOs was PTC India Financial Services, backed by Goldman Sachs and Macquarie India. The other was Sequans Communications, backed by Reliance Ventures. Numerous IPOs of PE-backed companies that were slated for 2011 were deferred, and instead promoter buybacks and secondary sales to other funds assumed greater importance as exit routes than they had in 2010 (*see Figure 3.10*).

The exit market in India has been lacklustre for a number of reasons beyond weak public markets. For one, many of deals struck between 2006 and 2008 carry premium valuations that make attractive exit IRRs difficult to achieve. Exacerbating the problem of these high purchase prices has been the inability of PE funds and promoters to agree to and pursue a value creation plan in many cases. Finally, given the minority nature of most PE stakes, funds are heavily dependent on promoters to agree to the timing and the terms of an exit. As a result, the slow pace and low numbers of exits from investments in India kept several LPs on their toes, their anxiety levels rising over liquidity of their investments.

As public exits reduced in 2011, the share of secondary sales and buybacks increased. Notable exits in the non-IPO category include Intelenet, which was sold by Blackstone to UK's Serco, and Patni Computers, which was

Figure 3.9: Exits declined by about 30% in 2011

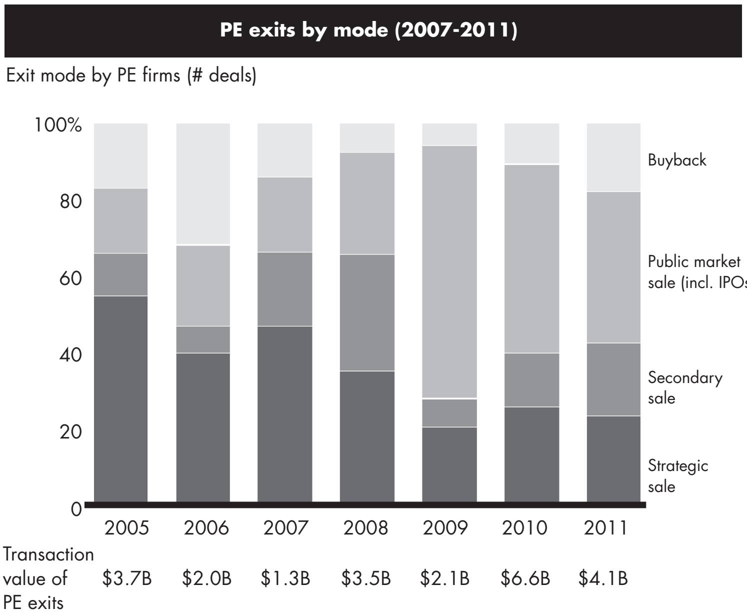


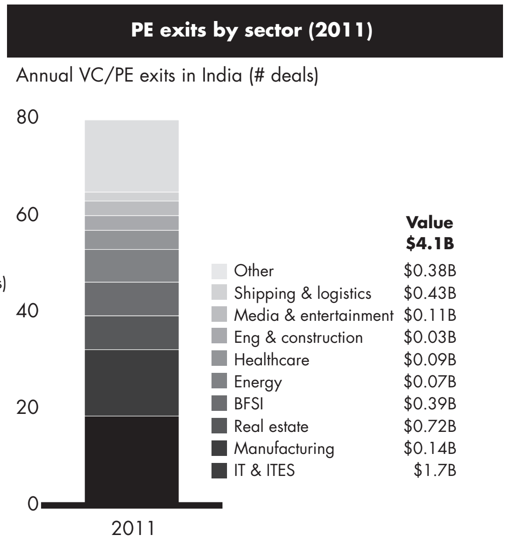
Top exits in 2011

Target	Firm exiting	Value ($M)	Route
Intelenet Global Services	Blackstone	418	Strategic
Patni Computer Systems	General Atlantic	254	Strategic
AppLabs	Westbridge Ventures I Investment Holdings	230	Strategic
Cloud.com	Nexus Venture Partners	225	Strategic
Idea Cellular	TA Associates	180	Public market
Idea Cellular	ChrysCapital	171	Public market
Kotak Mahindra Bank	Warburg Pincus	144	Public market
Geepee Agri	Rabo Equity Advisors	142	Strategic
Gluster	Nexus India Capital Advisors, Index Ventures	136	Strategic
TutorVista	Sequoia Capital India, Lightspeed Venture Partners	127	Strategic

Note: "Other" includes consumer products, hotels and resorts, retail, shipping and logistics, textiles, education and other services
Source: Bain PE exits database

Figure 3.10: Preference for buybacks and secondary sales increased in 2011; IPO exits reduced significantly





Note: Only exits where transaction values are known are shown here
Source: Bain PE exits database

sold by General Atlantic to iGate and Apax Partners (*see Figure 3.10*). These types of exits were vital in establishing the depth of the India PE market.

Beyond these larger deals, the real estate and IT/ITES sectors led exits in 2011, together accounting for 32 of 80 exits, or about 40% of the total (*see Figure 3.10*). Investments in the energy and engineering and construction sectors saw very few exits, despite 10% of all deals in the 2005 to 2008 period being struck in these sectors. There is emerging consensus that investment holding periods are growing for these industries, as projects have ended up taking longer than expected to execute.

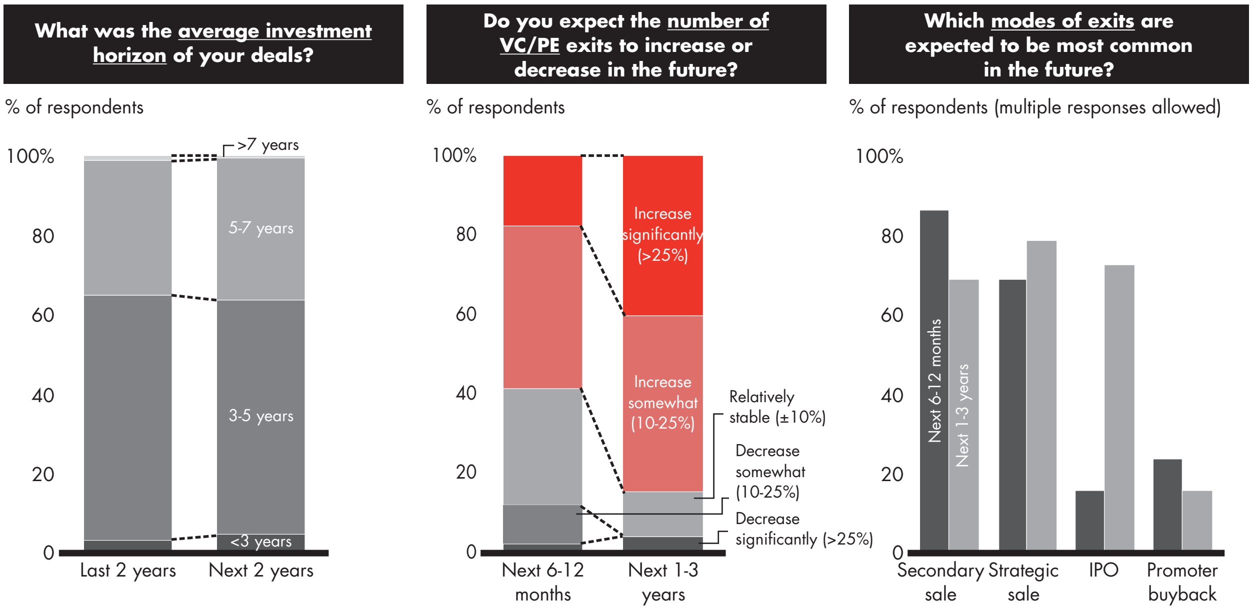
Longer-term prospects: 2012 and beyond

As we enter 2012, a large portion of the funds that were invested between 2003 and 2007 are still being held in PE funds' portfolios. According to Bain research, 71% of the capital deployed on the largest deals in India during those years has yet to be returned to LPs.

Until now, GPs have been able to justify the slower pace of exits because of a general understanding that the Indian market dynamics are different than others and lead to holding periods that are longer than in other countries. In the past, several GPs have been able to raise their second round of funds without much difficulty, despite their lack of robust exit history. However, as GPs go to raise funds today, the fund's track record on creating liquidity is of utmost concern to LPs. In fact, one GP we interviewed said that the concern is not about what level of return exits will generate, but largely about whether exits will happen at all.

Most GPs agree that making the exits is a high priority for LPs right now, irrespective of the target valuation. This puts GPs in a tricky situation. On one hand, failing to exit in a timely manner is likely to significantly weaken their position with LPs. On the other hand, if they make hasty deals that yield IRRs below the target rate, it will be similarly difficult to justify their investment philosophy for the next round of fund-raising.

Figure 3.11: Most PE funds expect exit activity to increase in 2012



Source: Bain IVCA VC/PE Research Survey 2012 (n=66)

In our survey, 61% of investors continue to expect exits after holding periods of three to five years for most deals, while 33% expect a horizon of five to seven years. In the next two years, the same trend is expected to hold. However, whether or not those horizons will be sustainable will only become apparent once the deals in the pipeline begin to show successful exits (*see Figure 3.11*).

On a hopeful note, the majority of respondents, about 60%, agree that the number of exits will increase in 2012 by at least 10% (and often more) because of the growing pressure from 2003 to 2007 vintage deals. For 2012, more than 90% of respondents believe exits will come through secondary sales, with strategic transactions becoming more common, as well. The secondary market is becoming the most credible way for GPs to exit in the absence of a strong stock market. We saw some examples of this at the start of this year: the secondary sale of Endurance Technologies to Actis for $71 million and the stake sale in Max India by Warburg Pincus to Goldman Sachs for about $60 million. Over the next one to three years, however, a significant number of respondents expect the IPO route to rebound.

A stronger IPO market, even with some delay, would be a boon to Indian PE. Many feel that the real rush to exit will happen in about two years as the 2007 vintage deals hit their seven-year mark. The peak of recent PE investments was in 2007, and experts believe that the frothy entry valuations may prove tough to justify. However, if the capital markets bounce back from their lows, there may be good opportunities for PE investors to gain some ground on returns (*see Figure 3.11*).

4. Wide angle: Investing in e-commerce

Rapid growth in early-stage deals

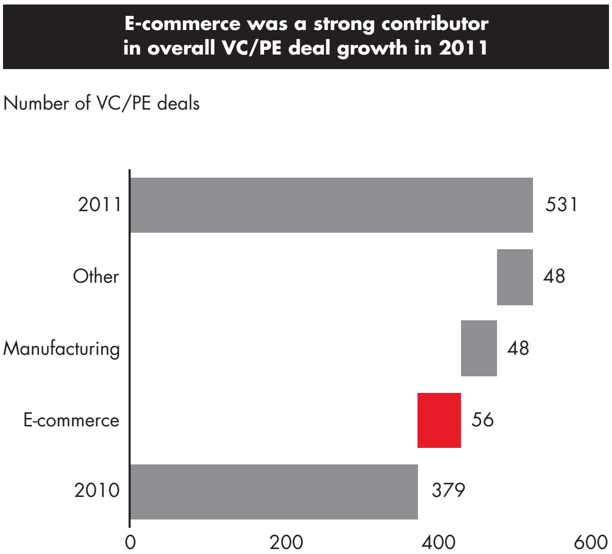
Without a doubt, the most significant driver of the 2011 expansion of both PE and VC funding in India was the boom in e-commerce deals. While the aggregate value of such deals was relatively small—about 6% of total PE and VC investments during the year—the volume changed the entire complexion of the market. Investments in e-commerce accounted for 40% of the volume of early-stage deals in 2011 and 16% of the total deal volume. Moreover, e-commerce was the single largest sector, contributing to the 37% increase in the number of PE deals from 2010 (*see Figure 4.1*). Our interviews with GPs confirmed that most of the funds active in India considered investing in e-commerce companies at one point or another in 2011.

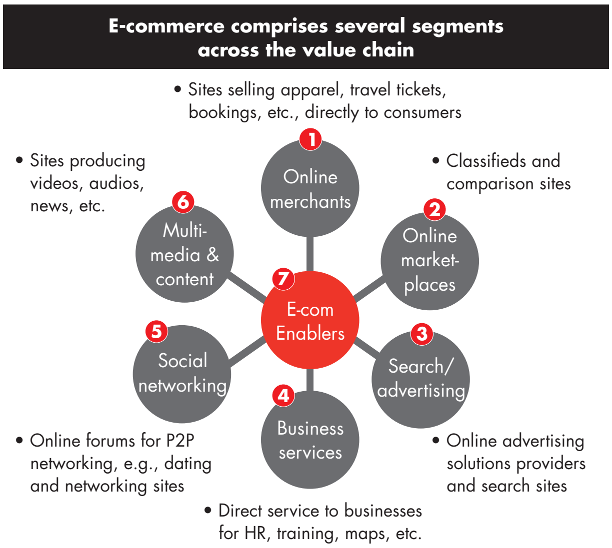
The frenetic deal-making in the e-commerce space reflects the blossoming of the online and mobile commerce ecosystem in India and an unprecedented demand for early-stage money. These e-commerce businesses included a wide range of business models—from online and mobile retailers of movie tickets and fashion to business services, such as job placement platforms, to online content, such as multimedia gaming.

The growth in India's e-commerce sector has been breathtakingly swift. In 2011, investors signed 86 deals in the space, about 46% more than the total deals signed in the previous two years combined. Deal value in 2011 was also up—more than the cumulative deal value over the last four years and close to seven times the deal value in 2010 (*see Figure 4.2*).

VC funds, which typically tend to invest in early-stage growth companies, were clearly the leaders in this space. In 2011, however, PE players also began to participate in e-commerce deals, and more PE shops have expressed a keen interest in the sector. In addition to making early-stage investments, both VC and PE funds invested in slightly more mature online ventures during their growth-capital stage. As a result, as many as 23 deals out of 86 were in excess of $10 million.

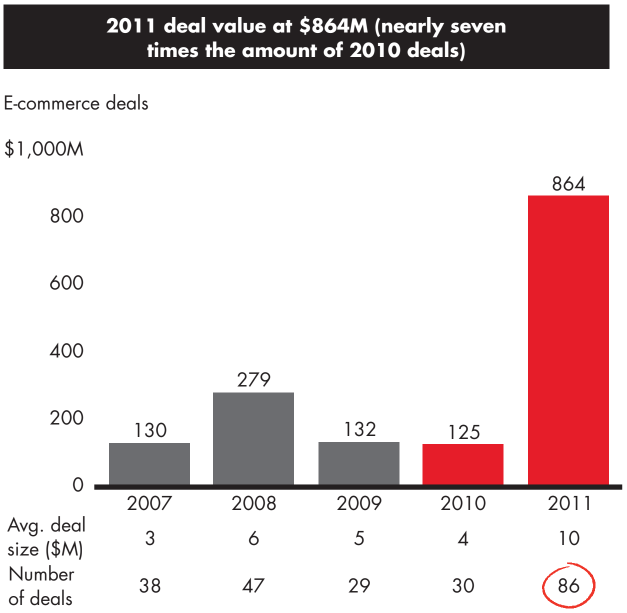
Figure 4.1: E-commerce was a significant driver of PE deal growth in 2011

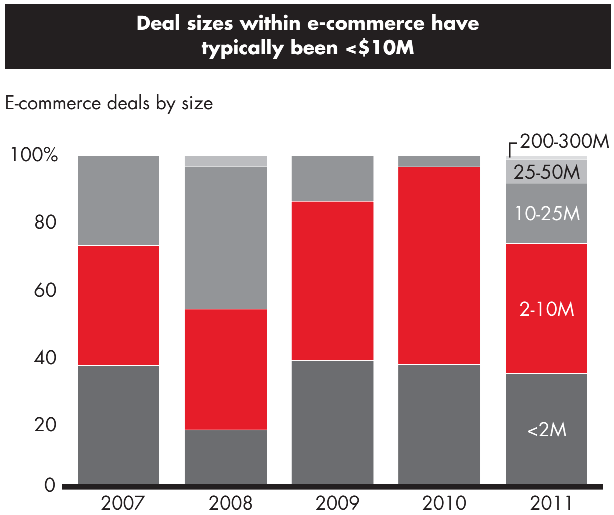




Note: Enablers include payments (facilitation/infrastructure for online payments, payment gateways, etc.), delivery and supply chain infrastructure (providers of warehousing, shipping, etc.) and IT infrastructure (providers of domain names, storage servers, data centers, webpage design, encryption services, etc.)
Source: Bain PE deals database

Figure 4.2: E-commerce deals in India grew nearly sevenfold in 2011





Note : Only deals with disclosed deal sizes have been used to arrive at size-wise breakup
Source: Bain PE deals database

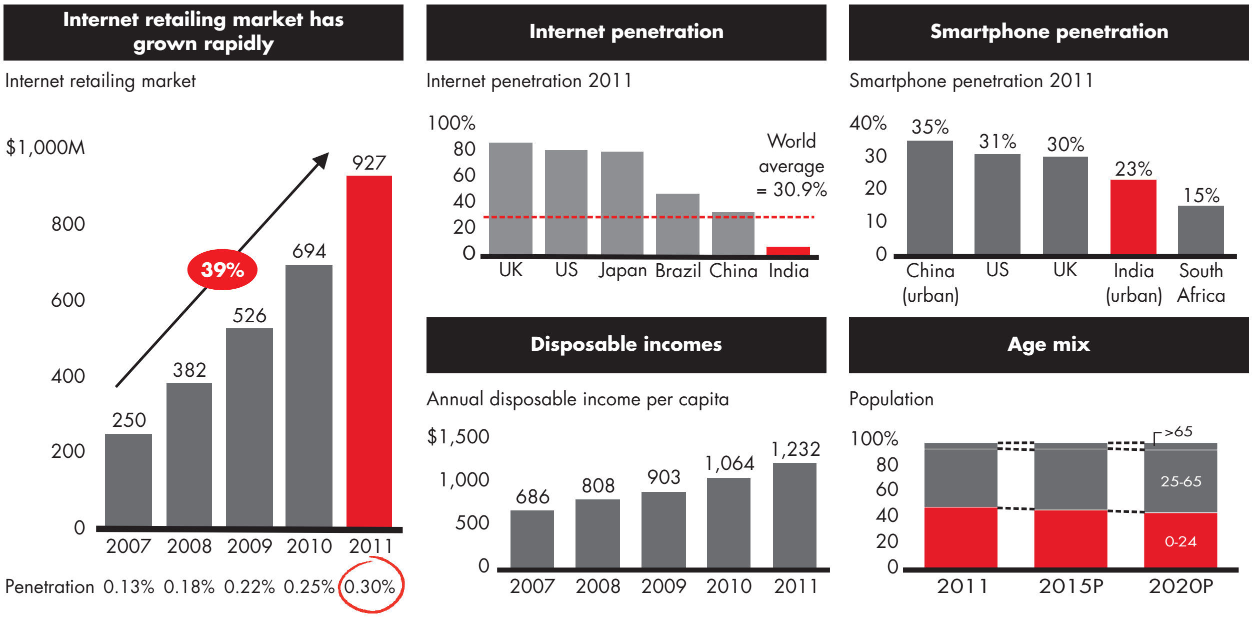
E-commerce includes m-commerce and constitutes the following seven segments:

- Online and mobile merchants
  - Fashion and apparel retailers
  - General retailers (gadgets, books, etc.)
  - Travel merchants, including online ticket booking
  - Group deals sellers
  - Other (education, financial management, training, etc.)
- Online marketplaces (classifieds, auction sites, etc.)
- Search/advertising
- Business services (HR, recruitment, maps, etc.)
- Social networking
- Multimedia and content (videos, news, reviews, games, etc.)
- E-commerce enablers
  - IT infrastructure providers (domain names, storage servers, data centres, webpage design, encryption services, etc.)
  - Payments infrastructure providers and facilitators
  - Delivery and supply chain infrastructure providers (warehousing, shipping, etc.)

The e-commerce opportunity in India: The role of VC and PE

E-commerce as a transaction medium is relatively small and nascent in India. While the Internet retailing market, estimated at about $900 million, has been growing at a compound annual growth rate (CAGR) of almost 40% since 2007, the market is still far behind other developed and developing countries. In India, online retailing accounts for only 0.3% of all retail volume, compared with 5% in the US and 1.8% in China (*see Figure 4.3*).

Figure 4.3: Significant headroom exists for e-commerce to expand, despite 39% growth over the last five years



Note: Internet retailing does not include C2C marketplaces, such as eBay, or B2B marketplaces; Figures converted with a constant exchange rate of Rupees 50
Sources: Euromonitor, secondary research, Bain analysis

Given India's small e-commerce footprint, market research firm Euromonitor estimates that online retailing in India is set to explode. Based on their projections, the market will expand at a CAGR of 25% over the next five years to reach $2.8 billion by 2016. There are five key reasons why this expansion is expected to happen.

Increase in broadband access. The first factor that is likely to give a fillip to e-commerce is the increase in broadband access across India. Between 2009 and 2011, Internet access points proliferated, increasing Internet users from 5% to 8% of the population. Better data transmission technology and growth in services such as broadband wireless certainly helped the movement to more access. With roll-outs of WiMax and other technologies pending, the adoption of broadband access is likely to continue to grow rapidly.

Increasing penetration of smartphones and similar devices. The second factor that will spur e-commerce in India is the increasing penetration of smartphones and other devices. The shipment of smartphones to India is expected to multiply by more than 10 times in only five years—from 6 million units shipped in 2010 to a projected 70 million units or more by 2015. Along the same lines, the number of 3G subscribers in India is expected to grow at a compound annual growth rate of more than 100% during the next few years, to total nearly 150 million subscribers by 2015. While mobile data usage is paltry today, it has the potential to provide a substantial growth platform for e-commerce in India within three to five years. If the adoption of smartphones, mobile data usage and mobile applications grows, the adoption of e-commerce and mobile commerce will no doubt follow.

Growth in enabling infrastructure and services. A third important factor in the development of India's e-commerce market is the rapid maturation of the eco-system of enabling services, particularly logistics and payments infrastructures. There is consensus that a lot remains to be done in this regard, but e-commerce entrepreneurs agree that there is a significant momentum to bridge the gap. As these enabling services mature, more consumers will grow comfortable making transactions through e-commerce (or m-commerce) channels. Over the last few years, there has been a noticeably positive change in how consumers view online transactions and payment for their purchases. Most experts we spoke to confirmed that the number of e-commerce transactions has been growing and consumers are using a wide variety of payment modes, from credit cards to net banking. An e-commerce entrepreneur added: "The introduction of cash on delivery to our website has increased our sales manifold. The success of this model is driving even nontrusting consumers to use e-commerce."

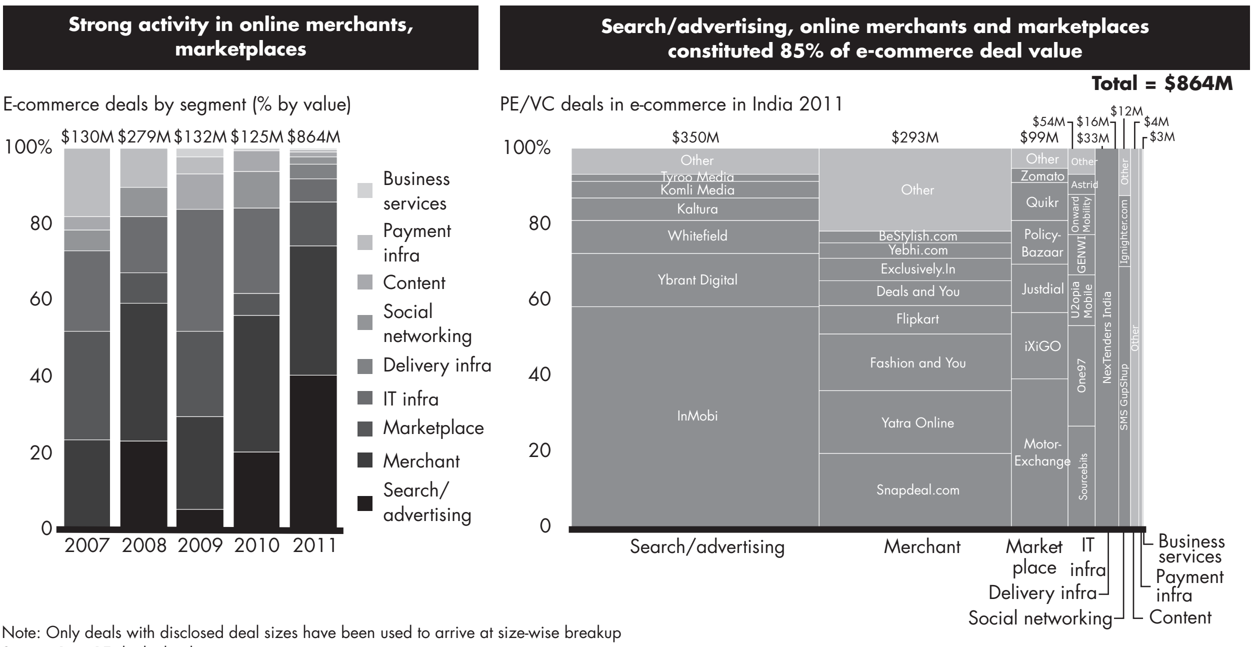
Widespread consumer acceptance. Fourth, a healthy dose of momentum is helping to stimulate online commerce. The depth and breadth of e-commerce merchants across product and service categories is expanding quickly. In most economies, e-commerce growth has typically been led first by content (i.e., books, movies), consumer electronics (i.e., laptops, accessories) and services (i.e., travel, job site). As consumers get comfortable with transacting online, growth in other categories such as clothing, cosmetics and other general merchandise categories follow. This model of growth has played out in the US and is now unfolding in China. Indian consumers are likely to follow a similar adoption curve, with opportunities abounding already.

Demographic dividend. Finally, the fact that India's population is relatively young and increasingly wealthy bodes well for e-commerce in the country. More than half of India's 1.2 billion people are currently below 25 years of age. It is from this set of people that the adopters of e-commerce are most likely to emerge and provide a strong customer base for e-commerce merchants. With another 46% of the population considered to be working age (25 to 64 years old), e-commerce in India is also likely to benefit from rising rates of disposable income. In 2011, disposable per capita income in India was expected to increase to $1,230, 16% higher (as per conversion rate at press time) than 2010 levels.

As a result of all of the factors stated above, e-commerce firms with compelling value propositions have enjoyed rapid growth in the last few years. However, it's important to consider that creating a successful e-commerce venture is not inexpensive. After the initial ramp-up, e-commerce firms usually need more funding to take the business to the next stage, given the significant investments required for customer acquisition and operations.

Bain groups the e-commerce market into seven key segments: online and mobile merchants, online marketplaces, search/advertising, business services, social networking, multimedia/content and e-commerce enablers. Three of these segments—online merchants, marketplaces and search/advertising—were clearly most attractive to investors and together garnered more than 85% of the total investments made in e-commerce in 2011 (*see Figure 4.4*). These segments are also the ones that produced some of the largest deal sizes.

Figure 4.4: Search/advertising witnessed strong growth in 2011; online activity is at historic highs



Note: Only deals with disclosed deal sizes have been used to arrive at size-wise breakup
Source: Bain PE deals database

The largest single e-commerce investment in 2011 was in InMobi. The Japanese PE investor SoftBank invested $200 million in the independent mobile advertising network in September 2011. This deal is notable because the company was less than five years old, and the $1 billion valuation it commanded has attracted other PE and VC investors to the potential for value in Indian e-commerce companies. Ybrant Digital, a digital marketing company, was another firm which successfully raised a sizeable sum—$48 million through a combination of debt and equity from Oak Investment Partners, existing investors Asia Pacific Capital and ICICI Bank. While both of these large deals were in the search and advertising space, Snapdeal, a leading online deals discount site, was able to secure investments in the same range. IndoUS Venture Partners, Nexus Venture Partners and Bessemer Venture Partners invested $52 million in the firm through multiple rounds of funding.

Deal values were far lower in other segments of e-commerce, though, including in IT and payment infrastructure. Although these areas see a lot of activity in the US and other marketplaces, investment in them declined last year in India.

India still has only a small fraction of the 16,000 e-commerce companies now operating in the US, and PE and VC funding for them is relatively new. However, these investors have already played a significant role in helping these firms. Our analysis reveals that of the top 25 most-visited Indian websites, two-thirds are backed by PE or VC capital. There are several factors that place venture capitalists and in some cases PE firms as preferred sources of funding for e-commerce entrepreneurs.

First, a majority of e-commerce business models are new and have not been tested in India before. Given the inherent risk profile of these companies, they have a difficult task in raising money through traditional debt and equity channels. Also given that most are asking for relatively small amounts of capital, they may not meet the investment mandates of many investors. Therefore, these ventures require partners that have both an appetite for risk and a willingness to spread their investment dollars broadly.

Second, most e-commerce entrepreneurs are first-time business owners. While they are savvy about technology, they are at times less familiar with other core business capabilities, such as marketing, talent management and supply chain management. Along with funding, they are often looking for management support and counsel from a partner who has seen several cycles of growth in similar businesses.

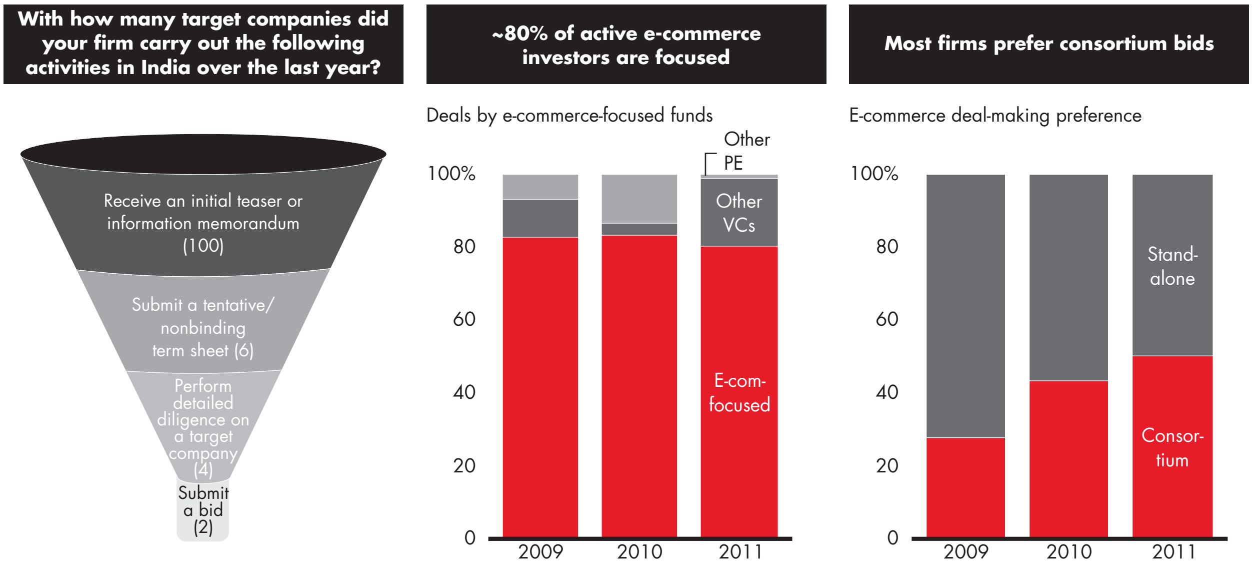
Our interviews with e-commerce entrepreneurs indicated that they find PE and VC support most valuable in the areas of setting business strategy, expanding customer contacts and running the organisation more effectively. The founder of a large travel portal said, "One of the biggest advantages of having a PE investor on board is the regular advise on potential 'watch-outs' as we grow. For example, they had warned us a year in advance that we would face issues with our performance management systems, which we eventually did." Another e-commerce founder remarked, "We benefited significantly from the sales process management inputs that our funding partner had to offer. Our team now looks forward to sessions with them as they find the inputs quite energizing."

Finally, though the culture is slowly changing, new ventures in India often have difficulty attracting and retaining talent, particularly at the more senior levels. Funding from known PE and VC firms allows start-up ventures to tap into the networks of the funds and to leverage the funds' relationships with search firms to identify and acquire the best talent. Given that the single largest success factor in start-up ventures is having the right management team, the support of PE and VC funds in this regard is vital.

Investing in e-commerce: Trends and future outlook

Historically in India, PE and VC investing has remained relatively small, as there are still a limited number of funds operating in the country. The industry is now moving from adolescence to adulthood, leaving more room for newer sectors, like e-commerce. Deal activity in 2003 stood at less than $1 billion, of which virtually none went toward funding e-commerce enterprises. By contrast, in 2011, $864 million was invested in e-commerce alone. However, these deals have not been easy to strike. Funds evaluated a large number of potential investments before taking any decisions. For every 100 deals considered by these funds, final bids were submitted to only two companies (*see Figure 4.5*).

Figure 4.5: 80% of the funds active in e-commerce have an e-commerce focus; strong preference for consortium deals



Notes: Active funds are defined as funds with at least one e-commerce deal in a year; e-commerce-focused fund is one with a substantial share of portfolio in e-commerce or a team dedicated to investing in this space
Sources: Bain PE deals database, Bain IVCA VC/PE Research Survey 2012 (n=66); only e-commerce respondents considered above

To help mitigate some risk, more deals are being done in a consortium, rather than by single funds. Consortium deals made up almost 50% of the total in 2011, compared with 30% in 2009 (*see Figure 4.5*). The consortium strategy helps PE and VC funds to spread their risk across several investments and to have a chance at being part of the growth story in multiple companies. It also satisfies the funds' desire to keep a war chest for next series of funding. "E-commerce business takes a lot of capital to scale up," said one VC who is focused on the sector. "We would rather wait to spot the winner in our portfolio and then invest in its next round at a higher valuation than invest significant sums upfront in multiple deals." Another GP commented, "Undertaking consortium deals ensures that the company can have access to capital at a later stage if need be, or if things don't go as planned."

However, this diversification of risk can be a double-edged sword. With portfolios already swollen and exit strategies tenuous, "sustaining the current deal flow is causing serious bandwidth issues in several funds," said one GP who has stayed away from consortium deals so far. In this environment, "spreading yourself too thin might not bear fruits in the long run."

Though most of the PE and VC funds we spoke with considered e-commerce deals in 2011, it seems that those with experience in the sector were more likely to take the plunge in investing. The deals are concentrated among a relatively small number of firms: More than 50 of the 356 PE and VC firms in India had invested in e-commerce between 2009 and 2011, and about 60% of those have the bulk of their portfolios in e-commerce companies (*see Figure 4.5*). This specialisation is something that promoters see as an asset. The founder of a large e-commerce content provider said, "The choice of our final partner was strongly influenced by the fact that they had done this successfully before, not once but several times." Naturally, this factor becomes less important once a company has established itself.

With much of the Indian e-commerce market still uncharted territory, and entrepreneurs ready to explore, our analysis indicates that angel investment in the sector is also on the rise, along with funding from PE and VC firms. Angels tend to target even younger companies than VCs, often looking at so-called seed-stage firms, which makes them a good fit for this market. "One of the reasons why angel funding has increased is primarily because the angel network in India has become more active and open to supporting many more entrepreneurs," said the founder of a large e-commerce portal.

"In addition, the current e-commerce market will eventually consolidate, and this realisation has pushed the VCs toward investing in early-growth stage rather than seed stage."

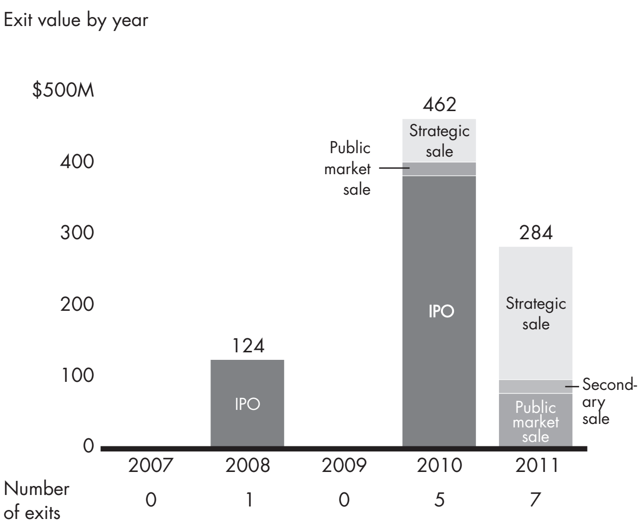
Entrepreneurs are also more open to working with angels as they realise that securing VC- and PE-led funding is becoming more competitive. As the industry matures, businesses find it increasingly necessary to reach a minimum size and profitability level before approaching the VCs. "Timing the fund raises is an important decision for an entrepreneur," said one GP who has spent a lot of time meeting e-commerce entrepreneurs. "Also, the valuations at each fund-raise have to be fair for the company's success, even if it means that the promoter has to settle down for lower valuations to start with. Seeking funding at higher than fair valuations early on could block you out from the possibility of raising funds again." In fact, our analysis reveals that only one in four e-commerce companies that have received PE or VC funding since 2007 has been able to get more than one round of funding.

Overall, e-commerce deals in India still do not have an established track record of exits and value creation. Only three of the largest 25 e-commerce deals in the past five years have exited, although their combined returns—$630 million—are impressive, making up 80% of the $770 million total invested in the deals. The biggest such exits in 2011 were TutorVista and MakeMyTrip.com.

The most common ways to exit these investments has been either by selling the stakes to another fund or by selling the holdings in an IPO. About 50% of the exits in the online commerce space in the last three years (2009 to 2011) were through the public markets. However, in 2011, the marketplace started to follow the global trend of exiting through strategic sales. Often, established businesses buy online start-ups to expand their operations, as in the case of Microsoft buying Skype from a consortium PE investor group. In 2011, e-commerce investments returned $284 million, and most of these exits were by means of strategic sale to another business (*see Figure 4.6*). About two-thirds of respondents to Bain's survey expect strategic sales to continue as the most common route of exit in 2012 and over the next three years, as well (*see Figure 4.7*). Secondary sales should also become more common over the next three years. Interestingly, about one-third of respondents also expect the IPO market to again provide a common exit route in the next one to three years.

Figure 4.6: E-commerce exits totaled $284M in 2011, primarily through strategic route

$284M in exits in 2011 (as compared with none in 2007)

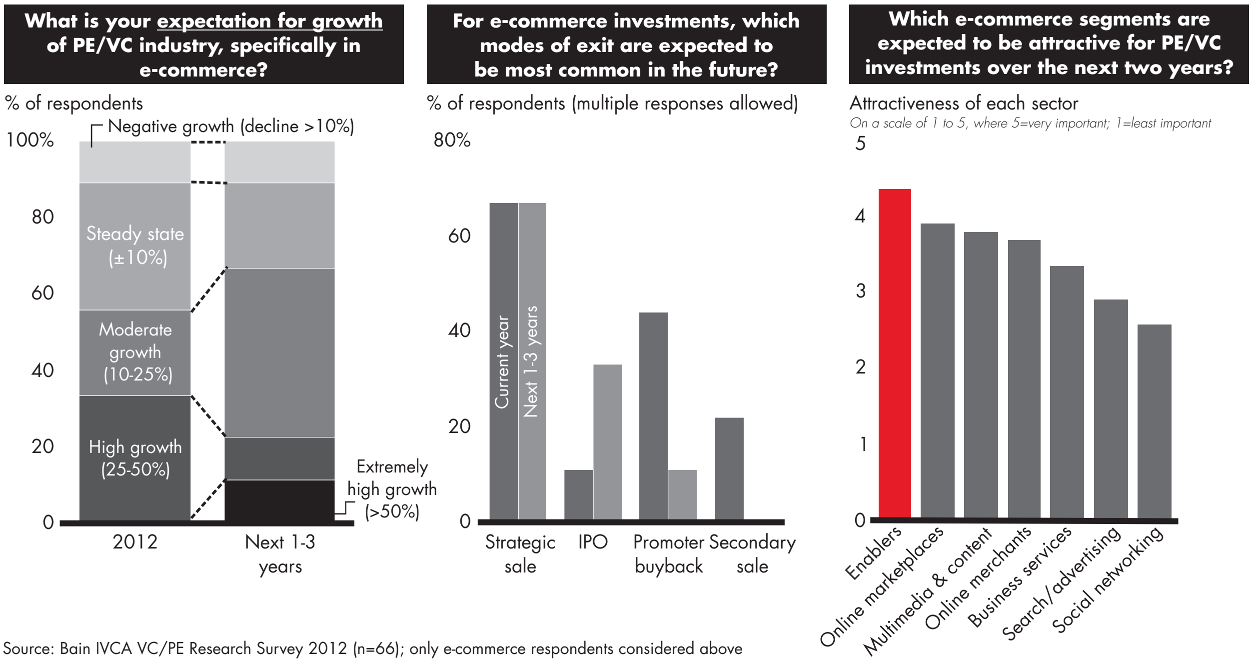


Top five e-commerce deal exits

Fund	Target	Exit value ($M)
• Sequoia Capital • Lightspeed Venture Partners	TutorVista	127
• SAIF Partners • Helion Venture Partners	MakeMyTrip	77
• Nexus Venture Partners • Index Ventures	Dimdim	31
• BAF Spectrum	iXiGO.com	19
• Reliance Ventures	Pelago	15

Source: Bain PE exits database

Figure 4.7: Annual investments for e-commerce set to increase; strategic sales expected for exits; segment focus expected to shift



Source: Bain IVCA VC/PE Research Survey 2012 (n=66); only e-commerce respondents considered above

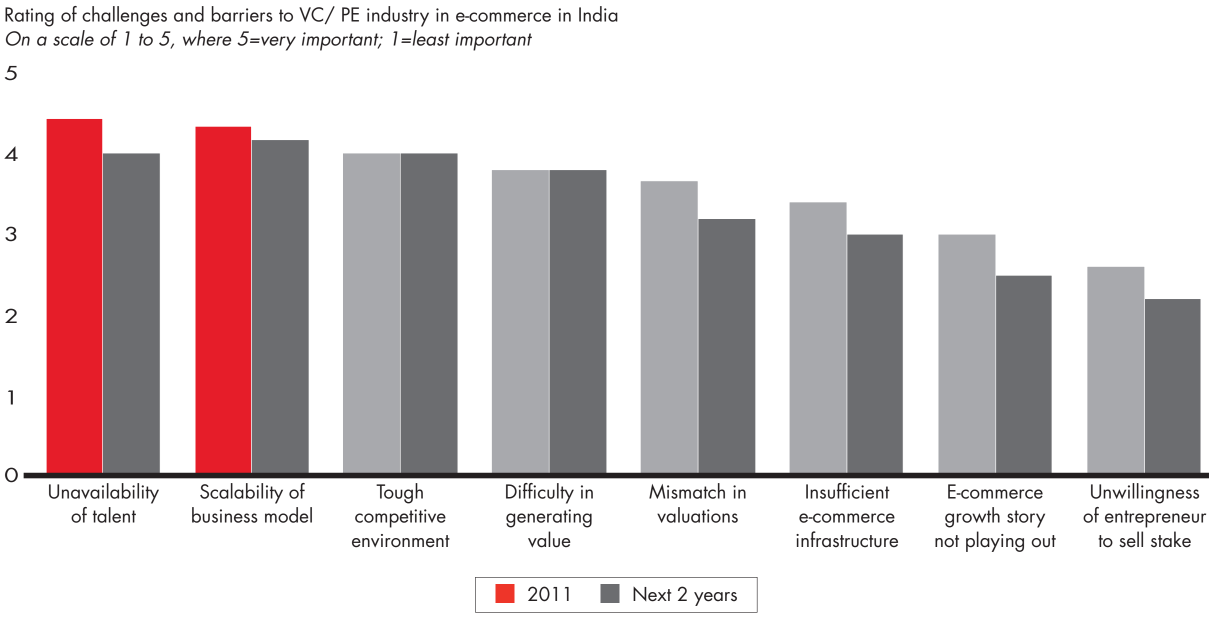
Looking ahead, PE investors continue to be optimistic about investing in e-commerce. As our survey shows, both the number of deals as well as the volume of funds to be invested in e-commerce is set to grow (*see Figure 4.7*). About 20% of the PE and VC firms surveyed said that they expected a 10% to 25% increase in investments this year compared with 2011. Another 30% expect this growth to be even greater, in the range of 25% to 50%, or even more. Those rates are likely to moderate over the next three years, though, as about 44% of the respondents expected investment growth to stabilise in the range of 10% to 25% annually. "Investing in e-commerce is still a VC game in India. Only one in 10 such businesses will take off; there will be few winners," noted one GP we spoke to. "However, the sector is still attractive for investments, as this is really one of the few where you can still target returns of more than five times on invested value." Without a doubt though, funds will find it easier to exit when entrepreneurs are also willing partners in planning and helping with the exit and have an equal interest in diluting their holdings.

Challenges and risks

Clearly, e-commerce presents an attractive investment opportunity in India, but is not without its attendant risks and challenges. Several factors cluster as top challenges, according to GPs (*see Figure 4.8*). Besides a lack of sufficient talent to hire, one of the greatest difficulties in the market is to scale up businesses enough to achieve a critical mass. Even on a global basis, e-commerce has had few winners in each vertical, be it online marketplaces or social networking. It remains to be seen which companies in India will differentiate themselves among several "me-too" websites and become the top dogs. The winners may be determined in part by which firms can bankroll the substantial customer acquisition costs that come along with scaling up an e-commerce business. As the founder of a large online content provider remarked, "Too much money is being burnt in drawing eyeballs, and the main reason is fragmentation of market share. The market is headed in a direction where only a few players will survive in a segment."

China's e-commerce market appears to be on a similar path as India's. A Bain analysis of China's consumer-facing online market reveals that the top two e-commerce players in a segment typically garner 40% to 75% market share in large consumer product categories, such as apparel, electronics and books.

Figure 4.8: Several challenges to overcome for e-commerce to realise its full potential



Source: Bain IVCA VC/PE Research Survey 2012 (n=66); only e-commerce respondents considered above

GPs see a number of current challenges receding over the next several years. One is the valuation mismatch. While the market saw entrepreneurs demanding some prohibitive valuations in 2011, the problem seemed to correct itself as time progressed, with the same deals reportedly available later at tempered valuations. This challenge is likely to moderate further as exit expectations become clearer, as well.

Beyond these issues, the infrastructure of e-commerce needs to be improved for the sector to blossom. The most critical areas of infrastructure development include more secure payments gateways, more efficient delivery systems and better broadband access. As mentioned, it is also important for entrepreneurs to hit upon the right business model that will help them grow the business to a scale that makes it viable for VCs to fund it.

In summary, e-commerce is set to grow in India, and PE and VC funding is well positioned to help fund this expansion. Entrepreneurs value the management expertise, skills and networking that these funds bring to the table. However, as the sector matures and some of the larger investments come closer to the end of their holding periods, the sector will need to show a more robust exit track record to continue its exponential growth.

5. Implications: A tremendous opportunity laced with a great deal of hard work

2011 was a landmark year for India's PE industry due to the impressive increase in deal volumes, despite the macroeconomic uncertainties. At the same time, the PE industry showed notable signs of morphing from infancy to adolescence. Overall, deal values were just 13% off the peak levels seen in 2007, with India showing the strongest growth among the funds invested in Asia.

Funds from LPs are still abundantly available to Indian PE and VC firms, even though they have yet to establish a robust track record on returns. Although the exit environment remained volatile in 2011, there were some pockets of optimism because of the growth in buybacks and secondary sale transactions. Even so, the success of the exits will depend largely on the revival of the public markets.

Meanwhile, LPs carefully evaluated how various funds engineered their exits and helped them book capital gains. They became more selective in committing incremental capital and are getting more deeply involved in the funds' operations. A key benchmark for GPs will lie in their ability to create value through better operating performance, rather than just expanding earnings multiples or riding the underlying industry growth. The reputable GPs are already altering fund strategies to navigate through this uncertain, but exciting, phase by engineering exits on attractive terms for investments they currently hold.

On the other hand, the deal-making environment looks promising, as valuations in India have moderated. One fall-out of the uncertain economic environment has been a stronger appreciation for the value that PEs bring to the table for promoters. In a positive move, promoters have started seeing the PE industry as "patient capital" that brings true partnership, not just tighter controls and governance. This has meant that Indian entrepreneurs have become more open to having PE and VC investors as collaborators who can help them create value in their business through their vast network and veteran experience in growing other nascent businesses.

The coming years are likely to see hectic activity, both in deal making and exits. As Indian PE enters its third phase, adolescence to maturity, the winners will start to separate from the rest of the crowd. The competition for deals is likely to moderate as fund managers without a strong track record fail to raise next rounds of capital and are forced to drop out of the game.

Increasingly, regulators are starting to pay attention to alternative investments, including PE and VC, as an asset class that is distinct from other sources of capital. We hope that there will be clarity on regulations around foreign investment in key sectors and the improved rules for taxation and treatment of capital gains, which could provide a further fillip to PE funds.

In the end it's clear that all stakeholders have a role to play in shaping the future of the Indian PE industry. There are a number of implications for the various stakeholders.

GPs in PE and VC funds. The India market continues to be highly intermediated by investment banks, accountants and lawyers, and there is general consensus that high-quality deals are always fiercely contested. In such an environment, it is imperative for GPs to build strong relationships directly with entrepreneurs as early as possible in the deal cycle and find the ones whose management approach and philosophy matches their investment approach. This "click with the entrepreneur" approach goes a long way in establishing breakout growth and superior value creation.

Promoters are increasingly appreciative of the value that PEs bring to the table. In fact, we spoke with an entrepreneur in the entertainment space who raised two rounds of funding. At one point, he rejected a PE fund that was offering a higher valuation than others because of its unfriendly attitude. "We finally selected a PE fund at 10% lower valuation because of the positive vibe we got and the relationship we could establish with the fund managers," he said.

It's a well-established practice that most investors go through a process of due diligence before closing a deal. The events of 2011 have reemphasised the need for PE funds to conduct diligence in much greater detail, mapping all the potential opportunities and risks that an investment poses. Various GPs we spoke with agreed that they may have overlooked some aspects of a deal while they were caught up with deal negotiations, be it the regulatory risk or an assessment of the management capability of the investee. There are enough examples to show how such deals have gone wrong, reinforcing how crucial it is to spend more time on diligence and treat it with as much importance as deal making and exits.

In fact, the top-rated GPs see diligence not only as an opportunity to arrive at the right bid value, but also as an opportunity to uncover key strengths and weaknesses. A robust commercial diligence gives the fund an overview of the various aspects of the business, including customer feedback, potential cost pressures and pricing trends. The insights gained during the diligence can be used to show the fund's knowledge of the business and its sincerity to partner with the investee in value creation. Entrepreneurs are increasingly assessing the PE funds' potential to add value to their business. The diligence document should serve as an objective source that funds can refer back to as they draw up their value creation blueprint. Beyond this, GPs have to explore all means of differentiating themselves from the other funds.

One of the key areas of concern for PE funds is managing exits from the existing portfolio. At the same time, funds have to keep an eye on the multitude of opportunities that the Indian business environment is currently producing. Hence, PE funds ought to build sufficient executive capability and bandwidth so that they can pay enough attention to both the present and the future. There are several ways of doing this, including working with adviser networks, building in-house operating teams and expanding the management team.

Indian entrepreneurs. Indian entrepreneurs seeking PE funding should try and make the most of the expertise, network and fiscal discipline that PE capital brings to the table. Entrepreneurs who are transparent and open in their relationship with the PE fund are more likely to land higher valuations, as the PE funds get a chance to explore the full potential of the asset.

It is critically important for entrepreneurs to bear in mind that PE funds typically come on board with a particular exit timeframe. Entrepreneurs whose exit objectives and investment returns are in sync with those of the fund will be a better fit for the portfolio.

In taking the funding, entrepreneurs should agree on an operating model with the PE fund and also agree on the level of involvement that the fund will have in the business. This means that the investee ought to pick a fund whose philosophy and vision plan for the company is similar to his own, so there is little room for divergence in management approach. Periodic meetings with investors should be used to brainstorm ideas, spot areas of weakness and seek support to plug the gaps, allowing the PE fund to be an enabler and partner to growth. When entrepreneurs identify and share problems, even thorny issues, PE players tend to respect the fact that they value integrity.

LPs. The LPs that understand the nuances of the business landscape will find themselves at an advantage in placing their capital. Developing an independent view will also help them empathise with the issues that shape the investment behaviour of the GPs to whom they are extending funding. In India, one great way to truly understand the environment in which GPs operate is to reach out to entrepreneurs and regulators. LPs should also seek more details from GPs around their approach to deal sourcing, value creation and, more importantly, ensuring liquidity.

Indian PE has already witnessed a full investment cycle, spanning 2002 to 2008, and is coming closer to the end of another exit cycle. Though there have been several examples of attractive returns to the PE investors, there have been plenty of challenges, as well. LPs could consider taking greater interest in fund operations through the commitment periods, as GPs can benefit from their networks, experience and advisory support.

Public policy makers. Much of the investment climate in any country is shaped by the policy framework that is provided for different asset classes. In India, policy makers have yet to recognise PE as an important source of capital that could play a pivotal role, building the nation through investments in infrastructure, education and healthcare.

Policy makers need to appreciate that PE funding is a unique source of capital in several ways. It is considered "involved capital" because the interests of the fund and the business it gives money to are much the same—they jointly foster it and grow it in value. That makes PE an equal partner in the risk of that business, unlike other sources of capital such as debt. Moreover, PE funds typically bring better business practices, management skills and corporate governance practices to the business culture, all of which go a long way in cementing a country's reputation as an investment destination of choice.

Another area where regulatory changes would significantly enhance the environment for PEs is in deepening the domestic capital pool. Policy makers could consider allowing Indian pension funds and insurance funds to invest in PE as an asset class, albeit under the umbrella of appropriate regulation.

Overall, it is fair to conclude that India's PE space is all set for the next phase of maturity. But for all the stakeholders to fully benefit from the growth potential, changes in PE fund strategy, promoter attitudes, governance practices and regulation are needed. As the industry develops, though, there is little doubt that PE will emerge as a key player in boosting economic activity and growth in one of the fastest-developing economies in the world.

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 (VC) and private equity (PE) firms to promote industry in India. It seeks to create a more favourable environment for equity investments and entrepreneurship. It is an influential forum, representing the industry to governmental bodies and public authorities.

IVCA members include leading VC and PE firms, institutional investors, banks, corporate advisers, accountants, lawyers and other service providers to the VC and PE industry. These firms provide capital for seed ventures, early-stage companies, later-stage expansion and growth finance for management buyouts and buy-ins.

IVCA's purpose is to support the examination and discussion of management and investment issues in PE and VC in India. It aims to support entrepreneurial activity and innovation, as well as the development and maintenance of a PE and VC 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 other.

IVCA stimulates the promotion, research and analysis of PE and VC in India, and facilitates contact with policy makers, research institutions, universities, trade associations and other relevant organisations. IVCA collects, circulates and disseminates commercial statistics and information related to the VC industry.

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Bain & Company maintains a global network of more than 400 experienced professionals serving PE clients. In the past decade, we estimate that Bain & Company has advised on 50% of all buyout transactions valued at more than $500 million globally. Our work with buyout funds represents 75% of global equity capital. In India, we have a leadership position in PE consulting and have reviewed a majority of the large PE deals that have come to the market—more than three times that of our next competitor.

Bain works across asset classes, including infrastructure, real estate, debt and hedge funds. We also work for many of the most prominent limited partners (LPs) to PE firms, including sovereign wealth funds, pension funds, financial institutions, endowments and family investment offices.

We have deep experience working in all regions of the world across all major sectors—from consumer products and financial services to technology and industrial goods. We support our clients across a broad range of objectives:

Deal generation: We help PE funds develop the right investment thesis and enhance deal flow, profiling industries, screening companies and devising a plan to approach targets.

Due diligence: We help funds make better deal decisions by performing diligence, assessing performance improvement opportunities and providing a post-acquisition agenda.

Immediate post-acquisition: We support the pursuit of rapid returns by developing a strategic blueprint for the acquired company, leading workshops that align management with strategic priorities and direct focused initiatives.

Ongoing value addition: We help increase company value by supporting leveraged efforts in revenue enhancement and cost reduction and by refreshing strategy.

Exit: We help ensure funds maximise returns by identifying the optimal exit strategy, preparing the selling documents and pre-qualifying buyers.

Firm strategy and operations: We help PE firms develop their own strategy for continued excellence, focusing on asset-class and geographic diversification, sector specialisation, fund-raising, organisational design and decision making, enlisting top talent and maximising investment capabilities.

LP and institutional investor strategy: We work with PE LPs to develop best-in-class PE programmes and with institutional investors to achieve optimal performance of their overall investment portfolio. Topics we address cover asset-class allocation, governance and risk management, organisational design and decision making, PE portfolio construction and fund manager selection. We also help LPs expand their participation in PE, including through co-investment and direct investing opportunities.

Bain & Company India Pvt. Ltd.

New Delhi Office

5th Floor, Building 8, Tower A
DLF Cyber City, Phase II
Gurgaon, Haryana, 122 002
India
Tel: +91 124 454 1800
Fax: +91 124 454 1805
www.bain.com

Mumbai Office

Platina, 2nd floor
Plot No. C-59, G Block
Bandra Kurla Complex, Mumbai, 400051
India
Tel: +91 22 4233 2600
Fax: +91 22 4233 2699
www.bain.com

Key contacts in Bain's Global Private Equity practice

Global: Hugh MacArthur (hugh.macarthur@bain.com)

Europe, Middle East and Africa: Graham Elton (graham.elton@bain.com)

Americas: Bill Halloran (bill.halloran@bain.com)

Asia-Pacific: Suvir Varma (suvir.varma@bain.com)

India: Sri Rajan (sri.rajan@bain.com); Arpan Sheth (arpan.sheth@bain.com)

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

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