

India's allure still glitters; but real risks remain

Fund raising and new private equity investment have backed off. But top LPs say there is still plenty of money converging on the sub-continent – maybe too much

At the risk of sounding trite, one could say that LP views of the state of play in Indian private equity today are that while the pot is on the boil, the *rogan josh* has yet to be tasted.

They further note, though, that many of the themes and developments in the country are echoed in large part elsewhere in the region, and even the world at large. This underscores the complex interlock that the global economy has now become.

Data file

AVCJ data to year end 2009 shows some interesting peaks and valleys, with the Indian segments showing, perhaps, greater extremes, higher volatility.

The industry's capital-under-management totals in the country have expanded impressively year-on-year, from \$26.1 billion in 2008 to \$31 billion in 2009, a gain of 18.6%. By comparison, the China quotient of the same total grew by 21.4%, while South Korea's expanded by an even greater 24.3% over the same period. Overall regional growth in this category was pegged at 10%.

Total funds raised is another story, however.

These plummeted by 64% in India, from \$8.4 billion to \$3 billion year-on-year. China's efforts fell even further though, 69% from \$14.4 billion to \$4.4 billion. And the same sharp downtrend was reflected regionally, where

the success rate sank by a whopping 70.3%, from \$50.2 billion to \$14.9 billion.

Among the top ten funds raised, India had only one: the \$1 billion Macquarie Capital Funds/State Bank of India fund.

New private equity investments followed the same track, being off 61.9% on the sub-continent (from \$10.5 billion to \$4 billion 08 to 09). China's dip of 15.4% in this category was much less pronounced. Korea, on the other hand, spiked by 68.3% to \$6.1 billion from \$3.6 billion. But regional private equity investment totals were off by 6%.

There were no Indian investments in the top ten.

Finally, in terms of private equity-backed IPOs, India was the regional winner with \$1 billion in 2009, compared to \$835 million in 2008, a 21.8% rise. China, by contrast, slipped by 8.8%, and Korea by 47.1%. IPOs generally were off 5.4% in Asia.

M&A and trade sale exits were off 61.1% in India, however, vs 52.9% regionally.

Interest still running high

Obviously these are very mixed indicators. But as Rebecca



Gautam Kainth

Xu, co-founder and managing director of fund-of-funds Asia Alternatives LLC, noted at last year's AVF India conference, "LPs from all over the world are here. This shows the breadth of LP interest in the Indian market."

So what's driving it?

Aazar Zafar, private equity principal with Alberta Investment Management, was succinct on this point:

"Demographics is one big factor, for Asia generally but even more so for India. A very young population, and so we see a fast developing market with a great range of opportunities across many sectors."

His Canadian confrere, Ian Carew, VP with Northleaf Capital Partners (formerly TD) agrees, saying the growth rate evident in regional economies (and especially in the majors like China and India), plus the clearly increasing affluence of their populations adds up to a "compelling dynamic."

Chihsung Lam, co-founder and MD of Singapore-based Axiom Asia Private Capital Ptd Ltd, concurs:

"Growth and demographics are main attractions for us as LPs too," he claims. "But there are others as well, including a broad range of quality key people being available. Also, they are looking to develop a private equity market with the US and Europe. So while we are, in a sense, guinea pigs, it could be good if the deal flow doesn't become overpriced."

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Domestic Indian fund-of-funds player Religare Private Equity and its VP of investments Gautam Kainth is likewise enthusiastic, saying the entire landscape is there to be tapped, nearly all segments thereof. Distress and infrastructure are particularly prominent at the moment. But he also stresses diversification and a close evaluation of GP past performance and records.

Differentiation is key

Axiom's Lam take this idea further, saying differentiation is key. India is a more competitive market than many others, he notes. And the determining factor will be being able to demonstrate the ability to add value. A best bet segment in achieving this is the growth investment middle market.

"Those who can create and execute control transactions are those who will best generate real value add," he contends.

Northleaf's Carew likewise notes the heated level of competition in India and adds that because of it LPs need to clearly understand how a fund can add value: otherwise why ought LPs put their money into private rather than the less heated public markets?

Zafar like also cites volatility as a factor, one that is perennial in India. But he also feels that it's a little early (post-crisis) to be making forward judgment calls. And meanwhile there remain interesting opportunities in the secondaries space.

Chihtsung Lam claims, again from an LP point of view, that there may be too much capital for the size and

pricing of the Indian market. But there's another positive as well:

Sharpened downside focus

"In talking to a group of GPs recently, people seemed to be more wary," he says. "There is a stronger sense of the downside, and I view that as a positive. Particularly in the context that in the public markets there hasn't been that much of a decline from pre-crisis levels."

Carew agrees, saying he hopes an important lesson has been learned by GPs in different parts of the world; and that he sees some indication that they are now starting to use these 'learnings' to operate their funds – and their companies – better. He sees closer attention being paid to cash flow and better organization. But on the other hand, the short duration of the downturn may mean such newly disciplined focus will slip.

Other challenges

To Aazar Zafar, current valuations in Asia (and India) are a major challenge, despite the promise implicit in the macro-economic story. And this makes convincing conservative boards, like his, that attractive specific revenue opportunities can be found so far afield difficult.

Worse, the valuations issue is a two-edged challenge, because feedback he's getting from GPs suggests that, even when valuations edge down, as they have in some segments, entrepreneurs worry that they will continue their descent and so they pull back offers. This, of course, adds up to less deals in the pipeline, and when juxtaposed with supply and demand, also helps to keep prices high.

Asia Alternatives' Rebecca Xu has a similar continued >> p9



LPs on the stand in India (l to r) Aazar Zafar, Chihtsung Lam, Rebecca Xu, Gautam Kainth, Ian Carew

p8 >> continued take:

“Earlier in 2009, companies were struggling with the slow market environment and trying to rebuild their earnings capacity. But as the market quickly recovered, and valuations even more so within that, GPs are now saying that it’s hard to find value, i.e. target businesses that can be expected to generate an ROI above 20%.”

Which suggests that perhaps LP expectations will have to drop; except that too implies a slowdown at the fund level in terms of deploying capital. And complicating the picture further, as Ian Carew points out, is that LPs reason that “...when you commit to emerging markets, you expect a premium.”

The fundraising environment is another concern, adds Axiom’s Lam. He expects it to be in retreat for some time. And this will put the onus on LPs to assure that their funds achieve critical mass. But given the unknowables this amounts to, GPs will have to bolster these assurances with as much detail as possible.

That was then, this is now

Which leads to the assertion by these LPs (as with others polled in this survey) that the LP/GP relationship – and the balance of power within it – is changing, and tilting in the former’s favor.

Ian Carew says that having a realized track record is vital for Northleaf to properly evaluate the GP’s objectives.

“Every GP I talk to references proprietary deal flow and mentions market multiples. But having solid examples of what you mean by that is a necessary bit. You have to have the examples that *demonstrate* that you really do have proprietary deal flow.

Indian LP Kainth adds that while Indian private equity

is evolving every year, realizations in exit performance need to improve.

“We really haven’t achieved the kind of exit levels we need to see,” he asserts. On the other hand, older, vintage funds are likely to produce good returns further on.

Terms and conditions

Upgrading communications with LPs, and assuring the depth of due diligence conducted is what all LPs would like to see from GPs going forward. Additionally, teams will need to be more LP-friendly, with the carry well spread in order to motivate entire GP teams. Fund sizes will also need to be adjusted downward, and key man provisions enhanced Axiom’s Lam adds; budget-based management fees too.

Another pressure point he sees developing is a function of US and European funds adding to the capital available in Asia, in their search for more dynamic returns. This will cause, for example, pan-Asian funds to likely suffer.

Finally, there is the inevitable flight to quality to consider:

“The best brands that have demonstrated optimal performance in and immediately after this crisis period will be the ones who end up taking the cake.”