fin-sight
Apr 2014

MOTILAL OSWAL
Financial Services
Knowledge First

"As part of our ongoing initiative to share knowledge on the Indian financial services sector, Motilal Oswal Investor Relations presents its article series – Fin Sight. In each issue, we discuss a topic impacting this sector. We draw upon the Group's learning, experience and current thinking to develop these insights. We look forward to your questions and feedback to help us provide you a better perspective of this sector…"

Sameer Kamath, Chief Financial Officer

Our Business Verticals:

- Broking & Distribution
- Institutional Equities
- Investment Banking
- Asset Management
- Private Equity
- Wealth Management
- Principal Strategies
- Housing Finance

Business Updates:

- Motilal Oswal Private Equity's India (IREF-2) announced its first close at Rs 1.9bn
- Motilal Oswal Investment Banking appointed Girish Nadkarni as Managing Director, to head the ECM business
- Motilal Oswal Asset Management launched the MOSt Focused Multicap 35 mutual fund

- **Meet our Management:** Please email us at investorrelations@motilaloswal.com or sourajit.aiyer@motilaloswal.com; or call **Sourajit Aiyer** on +91 22 3982 5510 if you want to schedule a meeting to discuss this sector, its long-term opportunity and the company's strategy

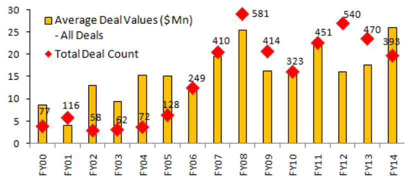
Private equity in India: Recent observations and emerging trends across various stages of the PE process

Current challenges bringing changes in approach…

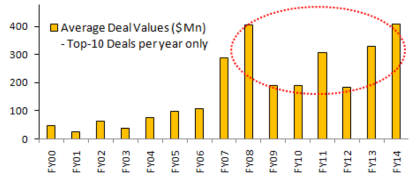
The decadal increase in Indian private equity (PE) activity levels shows how the industry's interest in India has grown. First-movers who entered in late 1990s with the dotcom rush saw good returns in mid 2000s as the economic cycle picked up. This attracted further funds, leading to a crowding effect. Many investments made during the boom years of mid 2000s were at high valuations. As the economic cycle dipped post-2008, many such holdings lagged their projections. Below-par performance of some holdings, coupled with an exit slowdown, has challenged track records. Total deal values rose successively to peak in FY08, thereafter dipping in FY09 and FY10. While it did pick up again in FY11, it has been flattish till FY14. Average deal values saw similar trends till FY09-10. However, it has risen successively since FY12 – indicating increasing comfort with larger commitments or preference for larger firms in uncertain environment. But the industry will mature 360^{o} only when the cycle of exits occurs systematically each year, as this would generate further fundraising from returns earned.

Challenging times warranted a transformation in approach from investors (Limited Partners/LPs) and fund houses (General Partners/GPs) both. LPs' now drill into manager-selection, identifying GPs with differentiated strategies, investing capabilities and track record, rather than just the India-story. Some GPs are using their global experience to build value-addition in portfolio companies to take them to the next level of growth. Investing decisions are focusing on the quality, capability and integrity of management, apart from the opportunity and business model. Fundraising strategies are also changing, be it in context of target investors, talent hiring and marketing collaterals.

Avg deal values peak in 2008; Recovering since 2011



Avg size of Top 10 Deals grew till 2008; Up since 2012



Largest Deals each year led by the foreign players

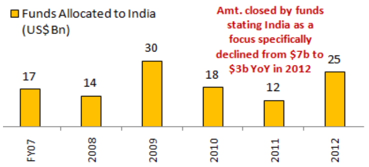
2000-2002	Warburg, IFC, Jacob Ballas, GIC, Pinebridge, Warburg, CS, BOA, Gen Atlantic, Intel, Actis, Symphony, eVentures, Walden, GE Cap, IFC
2003-2005	Gen Atlantic, Oakhill, Temasek, Warburg, TPG, Francisco, Stan Chart, Actis, Jacob Ballas, Citi, Henderson, IFC, FMO, ICICI Ven, Sequoia
2006-2008	GS, Temasek, Macquarie, Sequoia, Carlyle, Providence, Chrys, Farallon, SAIF, KKR, Gen Atlantic, Citi, NSR, LNM Internet, 31, New Vernon, MS
2009-2011	GIC, Bain Cap, Providence, Apax, General Atlantic, GS, MS, Blackstone, 3i, Quadrangle, KKR, Arcapita, NSR, IDFC, Temasek, MS, GS, CS
2012-2014	Qatar Found, GIC, Bain Cap, JP Morgan, KKR, Apax, CPPIB, SGRF, IDFC, Apollo, Blackstone, Baring, CX, MS, GS, Softbank, Warburg, Fairbridge

Fundraising…

Sources: Historically, ~80% of funds raised for India is estimated to be from overseas, though interest from Indian HNIs has picked up steadily. Indian regulations forbid insurance, pension funds from investing in PE vehicles - both key sources of funds globally. Investment arms of development banks and sovereign wealth funds (SWF) have evinced deal interest in India. Most major European, GCC, East Asian nations have a development bank or a SWF, and remain potential fundraising targets. Recent years stressed the need to send prospect teams to where 'new money' is growing - China, GCC, etc. With higher education becoming big business, India might explore creating endowment structures – another key mobilizer in mature markets. India's per capita income is still in mid-income level. As income grows and the wealthy-class becomes broad-based, the domestic market has potential to increase its share of fundraising.

Strategies: Fundraising by funds stating 'India as a focus' declined from US$7bn in 2011 to US$3bn in 2012, as per Preqin. In a challenging fundraising environment, funds are thinking strategically whom to approach. Investors with mature portfolios might be more interested in niche funds, while new investors might prefer generic portfolios. New launches are spending disproportionate effort conveying the team's experience, track record, etc. GPs have to be prepared to pay the price for experienced managers who can network and negotiate to crack key client accounts. Marketing collaterals of vintage funds need to showcase how the fund contributed value to its portfolio.

Fundraising in 2012: India-alloc up, India-focus dip



Fundraising universe is impacted as many LPs are yet to realize returns on prior investments – a key contributor for fresh fundraising. LPs are now focusing on manager selection, and committing to fewer funds - impacting the number of relationships held. Global LPs are looking beyond BRICs, at S.E. Asia, LatAm-ex-Brazil, Sub-Saharan Africa. Multi-geography funds diversify country risk, hence should evince more interest during downturn. When an upswing returns, country-specific funds should evince more interest

Deal Sourcing and Due Diligence…

With more funds competing, deal sourcing has become a specialized competency. Intermediated deals are picking up. Only ~40% of recent deals is roughly estimated as proprietary/co-investments, with the rest being sourced from i-banks, etc. Intermediated deals can impact pay-out for funds, as it would go to the best bid. **Referrals from existing clients are emerging as a key source**, preferable for funds since the need to pay commissions is not there. The aim is also to avoid situations of excessive dry powder, since that can lead to commitment risk/defaults.

Due diligence has become more stringent given the current economic slowdown, which has reduced the universe of investible companies. Funds are now cautious, backing only the best entrepreneurs and business models. Financial reporting practices are in focus, to avoid any overstating of revenues/profits. Hit-rate remains challenged as funds focus on the business model, management integrity, governance.

Economic slowdown contracted the universe of investible companies and hit-rate of deals, making funds more cautious

Valuation Multiples…

Capital market exuberance during the FY05-08 boom years led to high entry valuations. High competition amongst funds for few good deals also meant competing on entry multiples. High quality deals became pricier. However, weak economic outlook post-2008 led to a mismatch in valuation expectations, slowing down transaction closures in recent years. Unrealistic entry valuations paid on deals nearing exit-stage now, coupled with weak market participation impacting current valuations, means they are likely to yield lower returns. Also, the average stake taken during the mid 2000s was lower. When valuations are at the lower-end now, this is a double whammy for sellers as absolute amounts

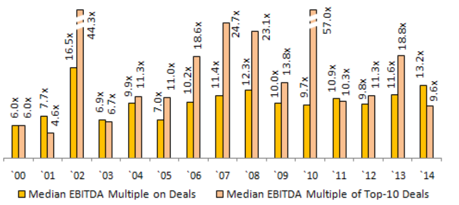
Access Fin-Sight Articles:

- Please use this link to read our previous Fin-Sight articles:

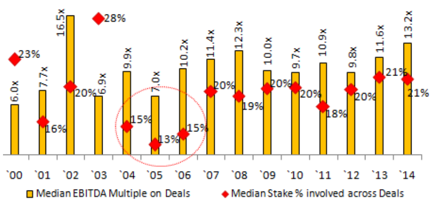
http://www.motilaloswal.com/Financial-Services/Investor-Relations/Presentation/

realizable are lower. Average sector-wise multiples coincide with trends in public equities, with services and consumer oriented sectors notching higher valuations than manufacturing, industrial, infrastructure. It is worth debating is whether entry valuations in India are high due to a higher proportion of family-owned businesses, who feel a high entry price would deter from acquiring further shares. However, investments made now when multiples are at the lower-end of the valuation cycle stand a better chance of realizing healthy returns in the next up-cycle. Also, clarity in policies by a new government might support holdings in realizing robust growth.

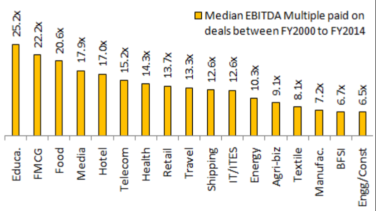
Valuation of Top Deals outpace Overall Deals as deals peak



2004-06 period saw high multiples for lower stakes



Higher multiples in Services, Consumer sectors

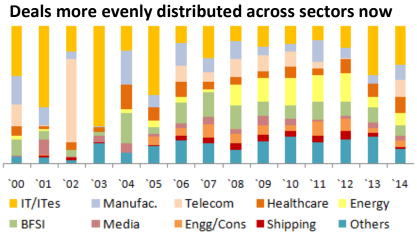


Sectors and Geographies…

PE in India took off with the dot-com era. As reforms picked speed, it created opportunities across sectors. IT/ITes, manufacturing and BFSI were mainstays till mid 2000s. Thereafter, telecom, healthcare, energy and engineering also clocked sizable values per year. To cater to this evolution, sector-specific funds came up. In recent years, capex slowdown reduced demand from infra, energy and telecom - large sectors for PE historically. Geographical expansion of sectors has seen concentration of IT/ITes & Energy in South, BFSI and IT/ITes in West, Telecom & IT/ITes in North and Manufacturing & Energy in East. Concentration has been in large cities, as opportunities in small towns are still limited.

The current slowdown has fuelled the debate whether to keep fund usage flexible: be it sector-agnostic or for inorganic growth. Counter-point is that given the current challenges in Indian PE, specializing in focus areas might help crack good-quality opportunities

Deals more evenly distributed across sectors now



Geographical-spread skewed towards specific sectors

Deals from FY00 to FY14	South	West	North	East	Others
IT/ITes	26%	14%	22%	2%	22%
Telecom	1%	7%	20%	0%	0%
Energy	14%	8%	14%	21%	36%
Manufacturing	6%	11%	13%	33%	10%
Healthcare & Life Sc.	13%	5%	7%	5%	5%
BFSI	11%	22%	3%	11%	6%
Engg/Construction	9%	7%	4%	4%	3%
Media & Ent.	1%	6%	4%	1%	3%
Hotels	1%	2%	3%	5%	0%
Others	18%	17%	11%	18%	15%
Total Value ($Billion)	23.3	30.4	22.0	2.0	3.1

During the Investment Period…

Although some funds do get a Board seat, a challenge that fund managers in India face is that having a minority stake restricts their ability to influence strategic changes or decision making in holdings. But economic challenges kept many companies from realizing their potential, and this calls for a change in approach. Funds are concentrating on showcasing their competency in providing operating/strategic inputs in such a way that the companies realize the true value-addition they bring - that their businesses can become bigger and better once they engage with PE funds more as partners. For the fund, it can enable exit within the expected holding period if it can help the company achieve value faster.

This also creates a differentiator for the fund in front of prospective investee companies who might require funding in future. With increasing number of funds today, even companies have a choice of funds – and the good companies know it. Those who are open to let PE funds take on a more strategic role would value those funds who can showcase their competency on this front.

PE funds can bring value-addition through benchmarking global best practices, enabling networking, senior hiring, operational improvements, advising on acquisitions, product or markets, monitoring, corporate governance, new technologies, guidance to directors and adding credence and reputation during future capital raising

But for this to happen, there has to be a change in attitude with which promoters view PE investors. Funds who put in the effort to enhance value through strategic initiatives would want a higher stake, otherwise the incentive to invest in that effort would be low. This can happen only when promoters realize the gains made from a larger involvement by their PE partners. **In cases where higher stakes are unattainable, funds might explore delivering components of value-addition through a consultancy role for a fee, akin to management consulting firms.**

Focus on value-addition also takes the form of institutionalized support system. The US industry created support systems (TiE, IAN) to share experiences, best practices, networking, mentoring and facilitation. Singapore's EDB made a VC fund and helped develop self-sustaining companies.

Concentrating on value-addition requires funds to look inward, to build their resources, knowledge and expertise in such niches. However, shortage of experienced talent at reasonable costs would be challenge in India

Academic institutions hold key – its role in business incubation support is a reason why the US PE/VC sector is largely based in Boston and San Francisco, cities which host top-notch research universities. Funds need to identify their own capabilities to identify niches, and use focused approaches based on sectors, deal types, etc. Opportunities exist in assets like distressed, buy-out, etc.

Deal Types…

Buy-outs were a major component of deals in USA, buying into family-owned businesses and improving efficiencies. In contrast in India, late-stage funding clocked the highest CAGR from FY01 to FY14 (42% vs. 36% in buy-out, 29% in PIPE, 26% in growth and 6% in early-stage). Buy-outs comprised just 10% of all deals from FY01 to FY12, but picked up sharply in FY13 possibly as companies looked to offload troubled businesses in a struggling economy. Scope for spin-outs, buy-outs, special situations might rise further.

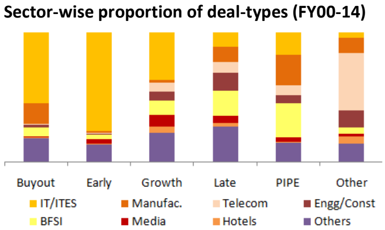
PIPE saw healthy annual volumes since FY01. India has a high number of listed companies with long-term growth stories, many being out of public equity investors' radar. Moreover, continued paucity of quality deals in private companies will keep PIPE in focus.

Early-stage was bogged down by risk perception, in a country where social acceptability of entrepreneurship is low and where support infrastructure for start-ups took time to develop. Increasing social acceptability and institutionalized support might bring in entrepreneurs.

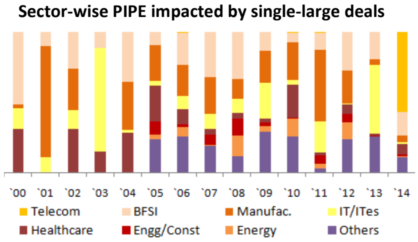
LBOs have not picked up, neither have turnarounds. In terms of proportion of deal values from FY01 to FY14, IT has seen a high share in early-stage and buy-out, BFSI and manufacturing in PIPE. However, late-stage and growth have seen deals across sectors.

Co-investments into deals might be a way for GPs to diversify perceived risks of any deal. A real challenge to implement, but it might help get deeper interests from LPs.

Sector-wise proportion of deal-types (FY00-14)



Sector-wise PIPE impacted by single-large deals



Corporate Presentation:

Please use this link to read our latest corporate profile

http://www.motilaloswal.com/Financial-Services/Investor-Relations/Presentation

Join our Investor Relations Mailing List:

Please email us at investorrelations@motilaloswal.com or sourajit.aiyer@motilaloswal.com

Exits – a major concern…

The single-biggest challenge for PE funds currently, even ahead of fundraising and investing. Exit slowdown has impacted unrealized AUM, track record and scope for further fundraising. The concern is both on the exit route and portfolio company performance. IPOs have been a popular route. But volatile markets and low participation dampened the IPO market in recent years. As a result, secondary sale became dominant, more so in cases when the investment had not done well where another fund's guidance could help turn it around. Strategic sale to peers never picked up, given the dominance of family-owned businesses who fear loss of control. Performance of companies also had a bearing. A weak economic situation meant variance in actual performances of many holdings, which were made at high entry valuations in mid 2000s when the economic outlook was rosy. Quite a few holdings are still at cost. Fund managers either have to sell at cost or book loss, or hold them longer. Either way, low-than-expected IRRs or delay in returning capital impacts the funds' reputation.

Concern is both on exit route and portfolio performance. In either case, lower-than-expected IRRs or delay in returning capital has an impact on the funds' reputation

Holding periods of investments might move closer to 8 years in India's case. Historically, even the stock markets have shown 8 year cycles since the early 1990s

Depreciating rupee challenged exits further for offshore investors, impacting their dollar returns. However, the rupee's depreciation might just have benefited fresh investments

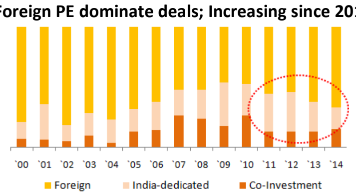
Any revival in the IPO market will be closely watched. In UK, an Unlisted Securities Market in 1980s helped exit of small firms with easier listing requirements. Similar platforms might be a possibility in India. However, sluggish retail participation does not evince confidence of achieving high interest. Secondary sale will be preferred where the stake is small to justify an IPO, or as long as market activity remains depressed. Buy-back as an exit mode has also not picked up. Strategic sale is an option where promoters are agreeable. **In fact, foreign strategic buyers are often willing to pay a high India-entry premium**, as it is compensated by the head-start they get into an established business and a chance to build value over the long term. In fact, inbound deals have been an active component of the Indian M&As in recent years.

Ownership and Organization structures…

Foreign firms have dominated India's overall PE deal activity, esp. the larger deals across years. Foreign funds are a preferred vehicle given the current tax regime. Some clarity on domestic taxation might be welcome. Domestic funds can assume a larger role as India's HNI wealth rises.

Organizational structures have evolved, with Front-office teams now segregated into units for deal sourcing, due diligence, investor relations, marketing; Back-office teams into fund accounting, accounting and taxation; and Mid-office into legal/company structures and treasury.

Foreign PE dominate deals; Increasing since 2010



Going ahead…

India has a robust private sector, unlike many emerging/frontier markets where state-owned enterprises still dominate business. Entrepreneurship is picking up. High interest rates and banks' asset quality concerns means PE will remain a key source of capital raising, esp. to fund innovative business models. The coming years can be a great vintage for entering India investments. For buyers, it would be at the lower-end of the valuation cycle. A fresh government can bring clarity in policies, which can open opportunities for companies.

Fundraising will concentrate on newer markets where 'new money' is growing. This is a business of scale. However, track records are equally critical and so exits will remain agile and opportunistic. Dry powder will remain as cracking quality deals in a challenged environment is a task.

Funds which are incentivized to play a larger role in guiding the strategy/operations of their holdings have a better chance of capturing alpha. Passive investors will depend on sector outlook and promoters' capabilities.

As the economy and incomes grow, products which India's expanding middle-class spends on and high-value products demanded by the wealthy-class will benefit. Changing aspirations means demand moves up the value-chain and products demanded would shift accordingly.

Join our Investor Relations Mailing List:

Contact **Sourajit Aiyer** on +91 22 3982 5510 or email us on investorrelations@motilaloswal.com, sourajit.aiyer@motilaloswal.com

Log on to our IR website http://www.motilaloswal.com/investor_relation/

To Unsubscribe, please email investorrelations@motilaloswal.com with **'Unsubscribe'** in the subject line

Follow us on

Source of data: Venture Intelligence database for all deal charts, Bain & Co PE Report for fundraising chart only

Disclaimer: This article is based on analysis made from secondary research and is meant for information purposes only. It does not construe to be any investment, legal or taxation advice. It is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Any action taken by you on the basis of the information contained herein is your responsibility alone and MOFSL and its subsidiaries or its employees, directors or associates will not be liable for the consequences of such action taken by you. We have exercised due diligence in checking the correctness of the information contained herein, but do not represent that it is accurate or complete. MOFSL or any of its subsidiaries or associates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this publication. The recipient of this report should rely on their own investigations. MOFSL and/or its subsidiaries and/or directors, employees or associates may have interests or positions, financial or otherwise in the securities mentioned in this report.