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## Market Commentary: Private Equity in India

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The private equity market in India, while young, is well defined and offers numerous opportunities for investors to participate in the rapid growth of the economy. However, it remains a small market with significant challenges. Recently, activity has cooled considerably due mainly to high valuations and excess capital overhanging the market. Key drivers to the long term opportunity in Indian private equity include:

- Emerging 'middle market'
- Infrastructure needs
- Manufacturing consolidation and growth
- Improved education and healthcare
- Political structure and bureaucracy

### **Backdrop...through a China Prism**

When evaluating India's private equity market, comparisons to China are inevitable and not an altogether bad way to think about the risk. After all, China and India are competitors for the hearts and minds of investors seeking emerging market opportunities. However, they are in very different stages of development. With similar populations, China's per capita GDP is now about 4 times India's. Some of this can be traced to China commencing economic liberalization two decades before India (1968 v. 1991), although political structure is also a major factor. In the single context of economic growth, China's centralized planning and government appears to be trumping India's cumbersome democracy. India's democracy has spawned an enormous bureaucracy wracked by 28 often conflicting state interests and corruption. The federal government of the day is always looking over its shoulder at these multiple interests knowing it can easily be removed by something as simple as the price of onions (seriously). Admire or abhor it, China's approach for the moment seems to be more effective.

China's ability and intent to force growth, prosperity and international regard often raises the debate over social consequences, but for the time being it is perhaps decades ahead of India. India's infrastructure development, trade, social services e.g. healthcare and education, manufacturing, human development and economic prosperity all lag China significantly. Congestion, poverty, inadequate public education, and distribution bottlenecks are a drag on prosperity and growth. The movement of goods from state to state is plagued by individual state bureaucracies, conflicting policies and corruption. City planning is complicated by laws and regulations that have been in place for decades and are not in synch with current economic needs. The slums of Mumbai are a colorful illustration. Mumbai is a horribly congested and poverty stricken city. It is also the financial center of the country. From the 10<sup>th</sup> floor of the Four Seasons hotel, perhaps the city's finest, one can see signs of new development less than one quarter of a mile away...emerging high rises, etc. Yet in between are sprawling slums of tin, cardboard and mud. And, they are not going away soon. By law these people cannot be relocated, otherwise making way for improved access. Their 'rent' is controlled and there is no incentive for them to move. And, they vote. Infrastructure improvement, basic services, transportation and appearance are stifled. Infrastructure factoid: India has more color televisions than toilets. Think about it. (The Four Seasons erected a vine covered 30 foot high wall around its premises to make the problem "go away".)

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Trade is an issue. Exports as a percent of GDP are a fraction of China's and imports are far greater. India is much more consumption dependent whereas China is more investment oriented. India's dependence on imported commodities leaves it hostage to rising prices. Inflation is currently in the high single digits and internal free trade restrictions, political disputes and distribution constraints contribute significantly. The World Bank recently observed that distribution bottlenecks are an important part of India's high inflation rate. Food inflation alone is running at 18% and onion prices 70%. The latter is due to a combination of internal bickering and weather. Absent the will to resolve the political conflicts, monetary policy is the remaining alternative to containing inflation and already high interest rates are sure to rise.

There is a phrase in India... 'elephants and electronics'... which refers to the juxtaposition of cutting edge technology and Stone Age systems. While India's economic growth is high, it is not uniformly so across the country, leading to political issues and distribution problems. Infrastructure constraints cannot be understated. Peak power capacity is 12% short of demand. Major ports operate at 94% of capacity and demand there is growing at 10% p.a. Only 2% of the roads are national highways. Whereas India's economy is the 4<sup>th</sup> largest, its per capita income ranks 145<sup>th</sup>. Skilled IT and English speaking manpower make India the world's back office, but low literacy is also pervasive.

## **Opportunities in Private Equity**

With all of this in mind, what are some of the opportunities in private equity?

- Opportunities exist to participate in initiatives and policies intended to improve infrastructure, particularly where new technologies can be employed.
- As the 'middle market' expands, opportunities related to consumption will increase. However, it is unclear how rapidly this will happen. India has high unemployment and it is rising. Moreover, while jobs are not being created fast enough, the work force (15-64 years old) is expanding and is projected to continue so for the next 30 years placing pressure on employment and per capita economic growth. This is in stark contrast to China and most developed countries and represents a huge looming challenge.
- Investment in private education is an opportunity. The public education system appears inadequate to meet the needs of such a rapidly growing workforce. It is currently estimated that 45% of college graduates are unemployable. There is a predictable debate about the reasons for this unemployment. The quality of education seems to be a big problem. Operating people we talked with complained about the variability of engineering graduate skills, as an example. However, the brute growth of the workforce is going to be part of the issue and a bigger part in the years to come.
- Valuations are an important determinant to private equity activity. The BSE (Bombay Stock Exchange) is currently trading at levels at or above China. In the fourth quarter of 2010, the BSE traded at 22-25X, the Shanghai A Shares at 22-23X. Comparing average multiples for the four years 2006-10 and 2010 alone indicates a flip-flop, with China well ahead of India 2006-10 and India well ahead of China in 2010.<sup>1</sup> With a closer look, we find that at least one third of the market is represented by commodity companies, which should really trade at 10x or so. Taking them out, one can conclude that the remaining operating companies... more likely targets for PE activity... are trading at 25x. At these pricey levels, investing is likely to be muted for some time to come.
- Markets with the fastest CAGR growth rates are...
  - 40%+... Engineering R&D services, Gaming and Public Cloud Computing

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<sup>1</sup> Source: Bloomberg, January 2011.

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- 30-40%...Biotech contract R&D, two wheeler exports (principal form of city dweller transportation), passenger vehicle exports, health insurance, fruit and vegetable juice market
- 20-30%...Auto component exports, commercial vehicle exports, semiconductors, animation, data center services, housing, pharma exports, medical tourism, diagnostic services, energy drinks
- 10-20%...Passenger vehicles, commercial vehicles and tractors, specialty chemicals, networking equipment, construction equipment, generic drugs, shopping mall infrastructure, domestic IT

## **The Private Equity Market**

India's private market continues to evolve with minimal government interference.

- The number of institutional quality managers raising funds (about 75 of 150 total) continues to grow as does the percent of successor funds. But, some attrition can be expected from the total in the current environment
- Fundraising languished in 2009-10 and is now well below China.
- Valuations are currently very high. Indian private equity P/E multiples eclipsed China's in 2010 and are now higher than most other emerging markets. Yet, competition for deals is intense.
- Exits increased steadily 2008-10 but most are out of older funds, when entrance valuations were well below today's level.
- Growth equity dominates deal making and over 90% are minority transactions. A large part of deal making is PIPEs and pre-IPO. Early stage started in 1999, died in 2000 and began a modest resurrection in 2006. Conventional buyout is a sliver of the market activity.
- U.S. firm influence from afar abated in 2009-10. 'Fly-in' investing has given way to India-based domestic firms.
- The IPO market is more important than M&A since strategic buyers are scarce.
- The 'bet' on tech is getting more interesting, particularly applications to travel and hospitality, residential RE, logistics and distribution, etc.
- Consumer targeted businesses are easier than enterprise focused given India's higher levels of consumption (v. investment).
- Much has been speculated about PIPEs. While not offering an opinion, some perspective is in order. The PE market is now trading at a premium to public markets...anywhere from 0-100%. This is weakly explained by the premium for control. The more likely explanation is that there is too much capital overhanging the market. Finally, many listed companies went public during capital short times, have little float or following and might be better off private. One credible manager thesis is, if you can get everything you want through a public share acquisition...influence, board seats, trust...you have just as much as you would get in a private transaction. This might be right or yet another justification for putting money to work. Hard to tell.

## **Conclusion**

India's private equity market is maturing but still in its early days. India is challenged by internal social and political issues, and, external commodity prices. The private equity opportunity is there and the winners will be focused, patient, opportunistic and agile. Big funds will struggle. The consistent winners will be familiar with all of the internal currents and probably tight with target companies...money is abundant, trust and confidence is harder to come by. Private equity managers will need a special angle to create superior returns.

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