HUNT PARTNERS PE WHITE PAPER

Foreword

Private Equity and Venture Capital has had a bull run for the past three years with deals galore hogging print space. Never mind the fact that it was difficult to separate fact from fiction! But that was the kind of frenzy that PE generated with obscure companies talking the valuation game. Too much money chasing too few deals was the oft cited complaint.

Circa 2008, saw it all come to a grinding halt. And Hunt Partners wanted to capture this moment which is every bit as momentous as the dizzying heights were. Our forum aptly titled 'What's on your Plate?' became a metaphor for a sign of the times which is both cautious and optimistic. The questions came in thick and fast- where are the deals, who is investing, what do the valuations look like and what do the cash- strapped entrepreneurs do? With an eclectic mix of PE and VC professionals, lawyers and entrepreneurs putting forth their views the discussion was always sparkling as was the attendance.

While everyone is uncertain about the duration of the market downslide, there is no doubt about the recovery. And, India is still hot as an investment destination. Most PE players are taking treading cautiously and would rather not make an investment than a bad one; there are enough takers for stellar companies. While closure is a long-winded process and valuations are being negotiated, the PE and VC community continue to believe that this is a smart time to invest in India. The pertinent question is- who will blink first; the illiquid entrepreneur or the investor who needs to get a deal done.

The dynamism of the market forces is also clearly reflected in India's competitiveness index and the fact that global funds continue to repose their faith in the system. The Indian story is well and truly alive albeit faced with a few tremors.

PE LUNCHEON- PART I

This Lunch forum aptly called "What's on your plate?" is Hunt Partners' endeavour to bring like- minded professionals together for a casual free-flowing discussion. A gastronomic experience coupled with intellectually stimulating discussion will result in a truly evolving White Paper. Here is a sample of the first, with the theme under fire being- "Investment Opportunity and Valuations" -:

The session unfolded under two macro themes with Abhay Havaldar moderating the session-

- Valuations and Deals
- Portfolio work

Deals are justified by the operating performance with the past performance is a harbinger for the future. With valuation, no matter what the stage one must take a 5 year model and while the exit multiples are important, growth is the most important factor. All PE firms deal with business where governance, regulations and structure are some key decision-making parameters.

In the prevailing market conditions, promoters are more concerned about valuations as compared to the "terms" of the deal. While each entrepreneur has his own structure, driving valuations has become the need of the hour for them. PE firms always tend to benchmark valuations in the market and without focusing on the business and wonder whether the company will give a return of 3 or 4x.

Meanwhile, India is a heavily integrated market and one is witnessing certain trends. One trend is that an influx of new funds at the VC stage has not affected the existing players in the PE space and the US ventures which have come in are only managing large global funds instead of an India dedicated one.

The market has matured and today companies have quite a few funding options, as last year it was Hedge Funds that was top of mind and not PE. With the markets heading south, entrepreneurs are hesitant to do deals and this is the stage wherein structure plays a large role. A lot of PE players have benefited from this sort of structuring and the exit multiples reflect that.

The one factor that is certainly a challenge is the entry EPS and whether it is sustainable. You have to price the margins; if you have a good promoter then you are lucky otherwise it is going to be a tumultuous. The most important consideration while making an investment must be the entrepreneur; one should have known and tracked the person for five years.

A strategic question now is – What is going through the promoters mind? If you look at the Ranbaxy transit—are they looking at value maximization or complete control? A lot of entrepreneurs actually prefer heading big companies as that is a greater need than money in the bank. PE folks are still grappling with this disparity in view.

Today, the difficultly that entrepreneurs face is—how to grow strategically without relinquishing control of operations. PE investors are driven by references while selecting a promoter—the fact that he must have a clean chit, the next step being getting into his house and meeting the family which can prove to be truly insightful. In India, even the CEO needs to be entrepreneurial; the US CEO mentality does not work here.

All promoters don't approach PE in the same manner. While some are humane, others have a bad attitude and all the investor can do is stand up to them by walking away from the deal. There are situations when one has to decide at the time of the deal whether to finish the deal and handle all the problems later or simply walk away. Moments of decision such as these are pure adrenalin for most PE professionals.

Another factor that comes into play is flexibility; that is if the PE firm has not invested in the core company. You get the flexibility of structuring the whole core along with the promoter. So, PE investors are increasingly stepping away from the core and thus, end up doing more to help the company.

At the end, the promoter is just looking for control and what he ends up with is some hidden level of control at the whole core level. He gets the funding he wants and is able to sort out his immediate capital needs at a particular valuation. And the PE firm gets another deal done.

PRIVATE EQUITY LUNCHEON- PART II

Gastronomy and Ideation, the twain meet again in our second edition of the Private Equity Luncheon. The theme continues from where the discussion last left off- “Investment Opportunity and Valuations” albeit a different set of participants get to air their views.

The session started amidst a great amount of hilarity with Pravin Gandhi, the moderator decrying his role in a Private Equity forum being a Venture Capitalist himself. The discussion quickly moved to the most pertinent question in these times- markets. The biggest challenge in the downward spiraling market is the rapidity of the fall with the accompanying strain on the credit markets and the entire banking system. Garnering funds from the public markets and private equity will be a challenge as everyone will reduce risky assets. On the positive side, there are better investing opportunities for the classic PE investor as there will be no competition from hedge funds or top investment banks and the valuations will be realistic for a change. One of the biggest challenges is that the investment community cannot look at the public markets as a measure.

But this begs the question, are the entrepreneurs for today’s valuations? With a credit freeze and liquidity drying up, investment bankers don’t make the ‘take it or leave it’ calls to PE players. But, deals will still take time to close as promoters will face the reality of the market and think a deal over as many times as possible before committing. The crux of the matter is that most PE players are investing in a time when there is substantial slow-down and the exits will span a good 4-6 years instead of the quick flips that had become common. That kind of time horizon ensures reasonable valuations and long drawn out deal closures.

Entrepreneurs on the other hand are really looking for a PE partner who will stay with them over a period of 4 to 6 years and really show faith in the company. The promoters feel that PE investors behave more like debt funds rather than pure equity that they are supposed to be. And as a result, companies are coming up with innovative ideas to fuel growth without relying on investments from PE players. But, promoters in today’s market are stuck with projects that they can’t complete due to lack of funds.

There is a trend of increasing capital allocation to Asia is quite visible. So while the 2% may have gone up to 5%, the aim is to garner over 15-20% in the next five years. The LP’s are clear that they need to move money to Asia sooner than later but they want to do it without creating disruptions and flooding the market with capital. So an international fund like Carlyle is sitting on $ 46 million in cash with over $1.25 billion raised but they made no deals in 2008 in their growth capital space. Meanwhile, Englefield has increased its fund size to 1.5 billion euros to primarily invest in India and the US, which is a strong statement of intent.

But, the reality of the situation is that all the PE players felt bad about missing out deals till the first quarter of 2008. The last 6-9 deals finalized have become talking points in the market and are beginning to look ugly. That may change in the next five years but in the interim, nobody wants to look ugly and justify themselves to their LP’s. Even for the deals that close, there are hectic parleys and valuations are being re-negotiated keeping the markets in mind. But, there are still some sectors that PE players are betting on- Healthcare has a high degree of stability as are sectors such as education and Print Media.

While there are challenges in the financial services market, there is a severe paucity of talent for the portfolio companies. It is especially tough to get CFO’s. There are two kinds of individuals who make the move into PE portfolio companies- professionals who take a risk and move for the equity upside in early stage companies and others who make a move to a regular operating company with over 500 crore in revenue. The lack of equity upside with IPO’s looking scarce will keep one set of people away while it will be business as usual for the others.

HUNT PARTNERS- PE LUNCHEON BANGALORE- PART III

The third edition of our private equity had all the usual ingredients- good food, stimulating discussion and this time to top it all a new city Bangalore. The theme under discussion in these dynamic times was once again – “Investment Opportunity and Valuations.”

The Bangalore financial services circle had its definite views and began on a serious note with advisory services noting the differences in the past six months. While earlier boutique banks gave the established players a run for their money, deals are easier to bag now but difficult to close. To ensure closure, the big players are putting their best people behind these deals.

The word that encapsulates the mood of the market perfectly is uncertainty. Both the entrepreneur and the investor want more than 100% assurance when they finalize a deal which has never been possible as no deal is foolproof. As a result, no sector has been spared in this down turn unlike in 2001-2002 when the impact was slightly narrow. The venture capitalists are sitting on volumes of money waiting for the right company to come along but when it does, they get mired in the valuations game.

Entrepreneurs are caught between the credit crunch, shy investors and promised expansion plans. Harking back to the down turn in 2001, it was a slow buildup which allowed all to prepare for the crises. There is a general feeling that this time around it was a blitzkrieg which allowed no room for contingency planning. Promoters have a cause for worry with export oriented players having to grapple with lesser orders and changing payment terms. Most entrepreneurs have taken the approach of cash- in-hand, no unnecessary expenditure and a delay in investments for three months.

When it comes to making investments, the VC players are especially focused on teams that they invest in. In the last quarter for the first time, the funds raised by the VC firm were more than what they returned to their LP’s. This net outflow phenomenon has happened after 6-7 years.

This theme of uncertainty has percolated down to hiring, where companies and investors perceive that it is easier to get good quality people whereas it is harder to get people out of their safety nests and move to possibly riskier opportunities. While the need for good people is as strong as ever especially in the mid market area, there are even more reasons for expectation in salary increase. People try and bargain for a salary increase as high as 90% and are no longer enamored of ESOP’s as a tool for retention or wealth creation.

For some Venture Capitalists, this time is for investing and scouting for opportunities as they have the funds to deploy. In the technology arena, there is a bunch of founders who are geared for their second innings after discovering themselves in their first stint of employment. So these people are keen to either back start up’s in India or start something of their own.

Most PE and VC players will stick to their DNA and comfort zone where venture capitalists will in a large part look at building the early stage and the rest would be keeping an equitable valuation discipline in mind. Companies that are doing interesting things in niche spaces will meet their milestones and look attractive to PE players at reasonable valuations. Most investors have tailor made their investment strategies for India and have deviated from their head offices in US and Europe. They are looking at sectors beyond technology and are doing a mixture of stages instead of being straitjacketed.

While conducting due diligence, most PE and VC players scope the existing talent in the potential portfolio company, put an operational structure in place and then identify the gaps to be filled. It’s actually a great positive if the entrepreneur knows his areas of strength and weakness otherwise they are always resisting the transition that is apparent to everyone else.

While professionalizing a company is a step in the right direction entrepreneurs, the boards and professionals should ensure that the entrepreneur still keeps his fingers on the pulse of the company. The investors would also get their returns quicker with the entrepreneur’s ability to make quick decisions and swift action. This will ensure a happy medium between the investor and the entrepreneur.

PE AND WHARTON BREAKFAST FORUM- PART IV

The fourth edition of the Private Equity forum was a slight departure from its previous editions. For one it took advantage of the rare, pleasant Mumbai morning and it also had an audience which consisted of Wharton students. The topic for the panelists was topical and controversial "Competitiveness of India".

With most of the big PE players invested in India in a big way, most of the panelists found it difficult to critique India's competitiveness quotient but nevertheless an enervating discussion ensued.

Some of the grouses were familiar with most of the PE players highlighting low exports resulting in a negligible share of global trade. With most of these investors focusing on both China and India the differences seem even starker. India is also ranked a meager 27th when it comes to business sophistication and ease of conducting it. With bureaucracy and red tape at every turn, negotiating a business path in India is tough going. When it comes to Innovativeness, India is ranked 32nd which is quite a big stumbling block for investors. With most venture capitalists and PE players having been bred on the 'ideation boom' in Silicon Valley, scouting for that innovative pearl is a big challenge. As a result, there is too much money chasing too few deals.

While India may be third in terms of talent availability, its record of spreading literacy is abysmal. Education at all levels across the country is extremely poor which puts a shadow of doubt over the talent pipeline in the future. Infrastructure is another bottleneck in India especially when the comparison invariably is China. While China has readied the infrastructure in anticipation of future investments, India is struggling to play catch up. A bulk of India's efficiencies is dependent on cheap labour which is not an extremely reliable resource as is the fickle monsoon. With a large part of India's economy agriculture based, the woes begin with lack of rain. India shining is not inclusive with very few genuine wealth creation vehicles, the discrepancy between the affluent and the poor is unbridgeable. Another clear indicator of India's lack of competitiveness on the global scale is that very few Indian companies figure in the Top 500 List and this is compounded by the fact that there are very few genuine entrepreneurs. The macro view is that India is governed by political economy rather than the real economy with deeply embedded corruption that affects the man on the street.

But India still beckons with the country riding up on the competitiveness indices. Recent trends suggest that there is slow but sure progress on the front of production, education, ethics and a vibrantly large domestic market. When compared to China, one facet that is flourishing is an immensely buoyant private enterprise, while entrepreneurs may be far and few in between there is clear indication of enterprise at the grass-root level which keep the venture capitalists interested. Companies such as Tata's, Birla's, Bharti have been success stories despite poor infrastructure and with the Indian government committed to improving infrastructure, Indian enterprise can only get more competitive. This finds reflection in arenas such as IT and ITes, manufacturing, agriculture and the fact that India has a high ROE. The last few years has seen India's confidence exert itself in overseas acquisitions propelled by its young socio-demographic profile of youth. There is also plenty of opportunity in India when it comes to infrastructure and the fact that private participation can improve conditions rapidly and scale up to accommodate growth.