

Privcap Private Equity in India Webinar

David Snow, Privcap:

Hello, and welcome to Privcap. This is David Snow. I am Co-Founder and CEO of Privcap, and today we are going to be learning about the state of the private equity opportunity in India. We have with us three experts on the Indian private equity opportunity, and so we are going to be listening to a fascinating conversation about, again, investing in one of the largest countries and economies in the world – and one that has been receiving quite a bit of excitement given recent developments.

Before we begin the conversation, I would like to ask our three experts to briefly introduce themselves, and perhaps we could start with Mayank Rastogi of EY. Mayank, can you tell us a little bit about yourself, and EY's participation in the Indian private equity market?

Mayank Rastogi, EY:

Yeah, thanks David. Mayank Rastogi, I'm a partner with EY in India based out of Mumbai. EY is the king in Asian private equity right from funds set up to origination of deals through due diligence, optimization, all of that. In fact, we are the largest investment bankers in the country. We're largest tax firm and all of that. So in that droll there's a very close relations with B, and it's one of our largest client sets in India.

Snow:

Thank you very much. I'd like to move now to Manish from Kedaara Capital Advisors. Manish, please tell us a little bit about yourself and your firm.

Manish Kejriwal, Kedaara Capital:

Absolutely, thanks David for having us. Manish Kejriwal, I am a Co-Founder and a Managing Partner for Kedaara Capital. Kedaara is a first-time fund. We raised our maiden fund in 2012, 2013 – so about two years ago. We hit a hard cap of about \$550M, combination of pension funds, endowments and sovereign wealth funds. Our anchor is Anterior Teachers Pension Plan. We have a bit of a differentiated philosophy in terms of investing in India. We have a very heavy dosage of operating partners' methodology we've adopted from Clayton, Dubilier & Rice. And secondly, we do a lot of controlled transactions. We're about 40%

deployed in Fund 1, with three controlled deals and two non-controlled deals.

Just a quick way of background, I was an undergrad from Dartmouth and have my MBA from Harvard. I was a partner at McKinsey & Company in New York, London and Bombay and then opened Temasek Holdings – first office outside of Singapore and Bombay. I ran the office for eight years and deployed about \$4B in private and public markets in India from 2003 through 2011 on behalf of Temasek Holdings.

Snow: Thank you very much. Cyrus, can you please tell us a little bit about yourself and Partners Group?

Cyrus Driver, Partners Group:

Sure, thank you, David. Partners Group is a global private markets investment manager. We're entirely focused on private markets, but we invest across private equity, real estate, infrastructure and debt transactions. I head the Asia private equity team. I've been investing in the region for the last 15 years, primarily focused on India in the past and now in a more regional role across Asia. I've also been an entrepreneur in India, so I've kind of been on both sides of the table in business building.

Snow: We're very excited to have the three of you on the webinar today. Just a quick note to our audience, we will have time at the end for some of your questions, but it's not too early to begin thinking of some excellent questions for our Indie experts. You simply enter a question anonymously, using this question function that you see before you.

Why don't we start with a 1,000 foot view of the Indian market, and perhaps we can throw the first question over to Manish. Obviously there have been a number of important changes in the Indian market over the past year or so. There's been a historic election, and of course, the markets have shown some momentum. Can you talk a bit about what this means for private equity. What have been some of the most important differences in the macro, and even the political, landscape over the past 12 months that spell a difference for the private equity opportunity?

Kejriwal: Sure, David. Let me take a crack at this and I'm sure Cyrus and Mayank will pitch in. I'd like to just set the context by saying India's a bit of pendulum from our perspective. India was never as bad as people made it out to be two years ago, when we were raising our fund. And India's definitely not as good as people make it out to be today. So the pendulum swings in extreme directions. We sort of remain in the middle.

Having said that, I think the biggest change which has happened in India, leads from the politics. It's the first time in 30 years that India has had a

government which is a majority by itself in the lower house of parliament, and doesn't have the need to do some degree of alliances and then whittle down what they're trying to do in parliament. So we have a government which is in absolute majority in the lower louse, which is very pro-business, and has introduced a number of reforms including opening up the insurance sector to the foreign insurance players.

I say that because that's all the world and the *New York Times* and Journal talks about. The little secret is the contributive, which has been as big as the politics, has been the price of oil. The dramatic decrease in the price of oil has made a substantial positive impact on India's macro. The two biggest issues we faced as a country were the high budget deficits or the current account deficit and the budget deficit. The lowering of the oil prices has allowed the current account deficit to fall dramatically and given the way the government is handling petroleum prices in India, it's also decreased the budget deficit substantially. All this has given a substantial dividend to the government, stabilized the Rupee versus the dollars. So while it's still stead against the dollar, it's probably appreciated against most of the other major currencies, including the Euro and the UK pound. And I think the combination of lower oil prices and a very pragmatic government has led to a promise of significant reforms over the next 12 to 24 months.

Driver:

If I could take a slightly different take on that, David, and this is Cyrus here. I must admit I'm more of a bull on India, so to put it in perspective, Partners Group has invested over \$5B across Asia over the past 15 years, yet we largely stayed out of India during the boom years of 2008 through to about 2011. Even though we saw growth happening, it was just over-competitive and over-priced in our view.

We became bullish on India in 2012 at a time when it was not fashionable to do so. Closed two investments in 2013, built up on our team on the ground, and have been bullish since except that our opinion has unfortunately turned into the majority opinion sooner than we would have liked. We were quite enjoying investing at a time when India was out of favor.

The biggest challenge we see now is not to growth, but to entry valuations. In my experience, India has always grown despite its government, and now to have a business-friendly, reformist, fiscally-responsible government – just India has the opportunity because of its young demographics and just the huge room to grow it. We are the poorest country amongst the brick nations, and that growth will keep us going for a long time. The challenge, I see India – and I'd be interested to know how Mayank and Manish see it – is really not of growth at this point, but of paying the right price for growth.

Snow: And we'd love to talk about the deal flow on the valuations that you all are seeing. Maybe first, we can talk to Mayank about what's – Mayank, what is your analysis of the recent changes in the Indian political landscape to the economy?

Rastogi: In addition to – David, this is Mayank – in addition to what Manish and Cyrus mentioned, I think one of the other key changes that the current government is sort of moving along is give the evolution of power to the states.

I think what this government is trying to do is sort of take it down to the government, or take it down to the state governments – the 29, 30 state governments that we have – and almost telling them that, listen, you are to run your own budgets. We will support you in whatever shape and form we can, but it is your economy. Run it. And as EY right now, we're sort of working with at least three or four state governments trying to define why their states are a better place to invest than the others in India. So there is a lot of competitive tension that is building among states to say, listen, come here, invest. So that is a great enabler in getting the business done.

The other key change that has happened – and it has all come about due to the things that Manish and Cyrus, again, mentioned. I mean, the whole political situation has led to a large degree of shift in how India is seen overseas. And we see so much of inbound interest in India now 12, 18 months ago that the deal momentum is – I won't say it's still there where it was in 2008, pre the crisis. But it is almost getting there where people like us do not have themes to manage the next deal. But what it has done to the valuations, and which is what Cyrus alluded to, is their gain going from – India was always an expensive market – but some of the deals that we hear about, and they are again, going bonkers.

So a lot of deal flow across sectors. Some of the sectors in India have always done better than the others like consumption detectors. So they keep on experiencing large amounts of deal flow. But generally overall, we are seeing interest in infrastructure picking up. There's a rebound in real estate. So pretty much a broad brush of sectors that are looking up.

Snow: Well Mayank, I'm glad you mentioned going bonkers. We definitely want to hear from the three of you, in fact, what you're seeing in today's market. But first, I think it would be useful to start with a little bit of a history lesson about the development of the Indian market. And maybe we can start with a question for Cyrus. Cyrus, while there have been definite successes in the Indian private equity market, there has also been some disappointment from institutional investors that a lot of the deals

and funds that were started more recently have not performed as expected. Can you talk about what has driven, or what has caused, some of that underperformance?

Driver:

Sure, sure. If I could just dial back to the early 2000s, when I joined my first fund, it was a time when there was a handful of active investors in India. The Indian economy started growing after 2000, picked up steam after 2003. Delivered strong returns, strong distributions, and by 2005-2006, that had become a popular story with global capital allocators. So a lot of capital rushed in. I think we went as a country from deploying \$2 billion per annum in private equity in 2004 to \$15 billion by 2007, and a large part of that capital was then being deployed by teams that had not done it before.

And I think just the aftermath of that surge in capital – we were a much smaller economy then. We were a shallow market. It was easy to get overwhelmed by capital. The consequence was higher entry valuations, shorter diligence periods, aggressive investment structure. Due to which, it's been a weak vintage by any standards, for again, private equity from 2008 right until about 2010-11 when that vintage of funds still had some investment life left.

I think there's been a consolidation in the space. A lot of Fund 1's have not raise their Fund 2 – especially in the mid market. Due to which, today even though there is a lot of optimism in the air, I find investment managers and peers across deal sizes as having been nascent to fair extent. So it's different than the boom years of 2007-08. But there is a lot of optimism and public market valuations are setting comparables really high.

I've heard many queries about why they've done so poorly in India from the vintage 2008-11. Some relate to the fact that the deals were minority stakes so investors are not in control. Others relate it to the relative immaturity of investment managers. I've heard queries about how Indian entrepreneurs are particularly difficult to deal with. In my view, all of these are true to some extent, but the fundamental flaw was just too much capital for a then shallow economy to absorb in a productive manner. At least that's my take.

The other – the big changes I see now are again, we're entering a phase where we may get carried away. But there's been a consolidation in the industry. A lot of private equity managers have learned hard lessons, and have honed their skills now over 15, 18 years. And I see capital being concentrated in fewer hands. There has been a churning. Successful managers have built platforms. Unsuccessful ones have been weeded out, and I think that's a healthy development for private equity overall.

Also, finally just the move towards a greater proportion of buyouts. All goes well for the industry as well, because controlled positions do allow private equity managers to better bring to the floor global best practices. It also gives better control over corporate governments. It also gives better control over the exit process. And I see all of that happening as India matures on the private equity side.

Kejriwal: The only thing I would add to what Cyrus summarized extremely well: One of the other big contributors were obviously the dollar volatility. And even in those situations where managers had relatively decent or respectable repeat returns, given the significant depreciation of the Rupee versus U.S. dollar, it fell by almost 50% between '07-'08 when there was 40 Rupees to a dollar to almost 67 Rupees to a dollar in 2013. That played havoc to U.S. dollar investors.

And to summarize what Cyrus was saying, the two biggest issues – again led by excessive capital – were significant overvaluations in '07-'08 leading to really bad behavior amongst the GPs, sharp elbows. And frankly even when valuations were not that bad, the inability to get out of the investment given these were small, minority, under 10% holdings. So that summarizes exactly what the issues were.

Snow: Well, I would love to move now to a conversation about what you're seeing in today's market. And maybe we could start back with Cyrus. Mayank gave a little bit of preview about the incredible interests going on in the Indian market, but Cyrus from your point of view, what does your deal flow look like? What kinds of companies are seeking to partner or are open to partner with private equity, and what do they want in addition to your capital?

Driver: Yes. So our deal flow is, at this point, the strongest it's been in the last three, four years. And in particular, after the budget, I think a lot of sellers of businesses have finally decided to do transact. India is a heavily intermediated market. That's the reality of it. So a lot of sellers of assets, be they institutional investors or families, do get advice very well. And they've waited until the budget came through and there was even more clarity on the intentions of this government before assets coming to market.

So right now, we're working on multiple buyout opportunities. We have two offers out where we're hoping to secure exclusivity early. The deal flow for us – and it's not a reflection on the market – the deal flow on us, is driven by our own investment selection. It's focused on sectors that have demonstrated relatively low volatility historically. So we'll be focusing on healthcare and consumer. We've also done investments in IT

services. We've tended to stay away from overly cyclical sectors, some of which may well be good cyclical picks at this point in time. Perhaps in some parts of the power-generation value chain maybe, but that's not our style.

Also we seeking controlled situations, often backing parts of existing management but typically buying a controlling stake, bringing out operating partners globally to bear on the business. And that's reflecting the kind of deals we're working on. But I must say, there are a lot of quality businesses that are raising capital right now that have waited out a long time, are coming to market now unfortunately all bunched together. But we've seen quite a few businesses with really strong, consistent historical growth over the past five years in a macro situation that wasn't always helpful.

Many of them have had small amounts of institutional capital in the past, and the management teams have matured, and under that corporate governance. So the quality of assets we're seeing is something we're very pleased about. The price of these assets are getting bid up is something we're very, very nervous about. And so we're – while we're working on a lot of thing, I think we'll be very circumspect in which ones we close.

Snow: Manish, same question for you. The kinds of situations that you seek to invest in with your operating focus. What kinds of companies are coming to market, and what are their motivations to partner with a group like yours?

Kejriwal: No, absolutely. Listen, we're seeing a very, very different market than from '07-'08. I want to just step back for a second and say, listen. The context of private equity in India, which we often fail to recognize and often criticize, is the Indian entrepreneur. And the Indian entrepreneur is, while he's known for a variety of mistakes and missteps that they have taken, frankly the quality of the top-quartile is probably as good as anywhere in the world. The challenge is making sure you find the right price and back and support them.

So what has – cause our – we're absolutely paranoid on entry valuations. And I'm proud to say that even of three controlled deals that we've done in the last six months have all been in single-digit EBITA multiples. And the reason we believe we're getting a significantly lower entry valuation than what the market demands, has been our true standout in terms of operating partners as well as a philosophy of partnership. We have three of the most senior operating partners in the country.

But more importantly, what we're seeing to your question, is a significant number of entrepreneurs – two types. One is the large family groups who

are now allowing themselves to carve out or spin out the non-critical subsidiaries – something which you didn't see ten or even five years ago. One of the deals we did was a carve out from the large Mahindra group. And the second thing we're seeing dramatically, is many first-generation entrepreneurs reaching their 60s and 70s, seeing that their children were normally the inheritors, while they'd love to inherit the wealth have refused to inherit boring, industrial, manufacturing companies.

So in both these situations, our approach has been to partner with both the family groups, as well as the first-generation entrepreneurs, and buy between a 40 to 70% stake in the companies. Often work alongside the existing entrepreneur, really push the company to achieve the full potential – these aren't broken companies, it's just that they aren't realizing the full potential. And then we jointly sell with the current owner – which then becomes a minority shareholder – normally to a strategic. A domestic strategic or a global strategic. That's been our approach. It was a bit of a pie in the sky when we launched two-and-a-half years ago, but I think that the short track record already shows as far as we're saying, a significant amount of opportunities coming our way in the controlled space.

Snow: That's very interesting. And Mayank, as someone who advises many different private equity groups on transactions, I heard Manish use the word carve out or spin out. Is it true that the kinds of private equity transactions that you see more often in places like the U.S. and the UK are finding their way to India?

Rastogi: If you were to look at the daily books that the funds are running, or the kind of work we are doing, there's just so much happening around carve outs or divestitures from the larger corporates. So clearly, yes. But if you go back into the history of India, a large part of businesses in India, or the new age businesses started in India, post three deregulation in 1990s. A number of those entrepreneurs were then in their early 30s and their early 40s. All of them are reaching their retirement age now. And I guess with the globalization and all of that, their kids as Manish was saying, are almost turning away and saying sorry. Money is welcome, but businesses are not. So the amount of these that we are seeing coming out that bucket is just enormous.

Snow: And a quick follow-up question for you Mayank. Obviously if there is an investment opportunity to take a control position in a company, or to really drive the operations of a portfolio company, that's a certain kind of skill set that not necessarily every private equity firm has. So if the Indian private equity market has many GPs who perhaps six, seven years ago were doing largely minority, pre-IPO style investing, do you think there is sufficient operating skill within these GP groups to really drive value

creation now that they have the opportunity to make control-style investment?

Rastogi: I think the entire managerial ecosystem has developed in the world over time. So you will find a number of cases now where there are management deals which are moving from one successful deal to another. There are people like Manish and Cyrus that are actually enlisting managers on their – I won't say their payrolls, but almost that. Where they want ready management teams which they can sort of insert into situations.

So we see more and more fund managers actually coming and telling us, listen, I've got a great management team so let's forget the deal if it is too expensive. Can we start something a fresh, and we will build it from scratch. There is also that associated realization that's coming that it takes slightly longer to market than it has been thought earlier. It may not be a three, four year investment market, a whole market. It may actually be five, six, seven year hold market. So that extent – if they're able to create businesses within that period, you might as well get the A-class management team and pull the capital and build it. I mean, Goldman Sachs – I'll just take their example. But they've done that reasonably successfully on latest platforms.

Snow: Manish, as someone at an operations-focused private equity firm, I'm sure you have an opinion about this. But obviously, is the skill set of operating improvements a resident at many private equity firms? Or do you find it to be somewhat of a rare approach, at least in today's market?

Kejriwal: I think Mayank summarized it well, David. I think it's something that we are realizing is badly needed to have the longer-term impact that we all demand there to be. So I think if you look at relative to ten years ago, it's dramatically different. But it's still a long way from where it should be on aggregate.

I think there are at least four or five firms which have started building the operating partner capabilities. And again, it's not a one approach fitting all. It's – people have taken many different approaches to this. There are some who've done down the path of hiring younger subject matter experts and actually throwing them against the different portfolio companies. And I'm not saying that's good or bad. It's just one method which works, or may not – which may work versus others like ours, who have taken more the approach of hiring very senior operating executives. People who have demonstrated the value add in a variety of different sectors. And they join and become sort of executive chairman in the companies we deploy capital behind.

Now they may not be day-to-day guys who turn up their sleeves and go fix a certain machine. But they know exactly who to get to solve the problem, and they really do play the role of an executive chairman in the companies they deploy capital behind. So I think the format of the operating partner is being formulated as we speak, but it's definitely the trend. And I think different players will try different approaches, but I think all with the purpose of really providing incremental value to the current management teams to eke out the maximum potential from the investments they make.

Snow: Great, well why don't we move to one final topic before we throw the webinar over to questions from our audience. We already have a few questions that are in and I would encourage everyone to please send in your questions for our experts. But a question for you, Cyrus, about the exit markets for private equity. How have you seen the various exit channels developing recently? That could be the IPO market, and it might also include perhaps international buyers of Indian businesses. But what's most exciting and relevant for your investment platform?

Driver: So for us, David, given that we typically seek to do buyouts and acquire a controlling stake, trade sales or secondary sales to other private equity shops together are the largest source of our exists. That being said, for the broader market, if you see the inventory so to speak of private equity investments that are seeking exists, the large majority of them – and these are investments made four, five, six years ago – involve minority stakes and are dependent on a capital markets window opening.

And the IPO market in India was shut for the better part of three years, and is now opening this year. So I expect to see a lot of exits and a lot of distributions from an earlier vintage of Indian private equity investments by the end of this year. So to that extent, it's a good market to be exiting in. Also foreign strategics, who always paid great valuations to acquire segment-leading assets in India, are again showing a lot of interest in how India is performing for them or in adding India to their portfolio of markets. So even though I think public markets will drive exits this year, there will be a knock on positive effect on trade sale exists as well.

Snow: Why don't we move now to some questions from our audience. Again, we have some great questions in, but we would love to encourage everyone who's listening in to this webinar to please send in some questions for our experts. And it is anonymous, and we will simply pick the question that we want to answer, and I will read them.

So why don't we start first with a question from someone in the audience about controlled transactions, and the fact that at last most often in the West, there is often debt financing that is accompanied with LBO-style

transactions that are often used to drive returns as well as operating improvements. So a question for either Manish, Mayank or Cyrus.

Driver:

So I think it's a great question. I saw it on my screen while we were chatting earlier. I think it's very pertinent. So I spend a lot of time ruing the fact that LBO debt is not available in India. The way Partners Group operates, we have a common investment committee for investments around the world. So each deal has to stack up on its merit against potential deals around the world. And I often see transactions in markets where debt is easily available where EBITA grows at 4%, 5%, 6% a year. You're really able to deliver an equity return of 25% and above, largely due to conducive financing being available. And nowadays, it's not even as if that leverage places undo risk on the asset because you get covenant like seven-year tenor that – which is actually fairly safe.

In India the big challenge is that banks will not lend for the acquisition of shares. The tax structure is not conducive, so you don't get a tax hit on the interest being paid. And there are many, many restrictions on overseas, foreign currency, denominated debt extended to local borrowers. As a combination of which, in India, our capital structure is very heavy on equity and we require at least – I'd say at minimum – 17% to 19% EBITA growth annually through our holding period to get us to our target returns. And therefore, that places a very high bar on what the kind of sector the target asset is in, and the kind of transformation it's making in its business. If there was similar LBO data available in India, I think the industry would be much, much larger.

To the question on my screen, do we see debt markets changing? Unfortunately, I don't see it changing any time soon.

Snow:

We have another good question here, having to do with the expansion of corporation earnings in India. And I think the question has to do with if we expect corporate earnings to expand generally in India over the next five to seven years. Do you also expect to see the price to earnings expansion as well. A bit of a macro question, but I wonder if anyone may be – Mayank or Manish – has an opinion about this.

Kejriwal:

Mayank, do you want to go ahead?

Rastogi:

Yeah, I...so I think this is – I mean as you build your idea for this, this is a slightly macro question. At an opportunity level, we've seen it time and again. Some of the investments that were done in pre-crisis – 2006, '07, '08 – actually ended up with expanded valuations on exit. In fact, as Manish just mentions, some of their recent investments have all been single-digit EBITAs. So even there, I mean weekly, the clear hypothesis will be the expansion.

So there is nothing more opportunities that are available where we generally expect the marketable expansion. But a large part of what I have seen, I think – and as Cyrus mentioned – large part of piece is around profitability expansion..

Kejriwal: If I can just have a quick word there. I think where the governments going and the major reforms will have a trickle-down effect to significant enhancements of EBITA over the next three to five years. However, as B investors, we assume literally an exit multiple the same as an entry multiple to be conservative. And we really drive our returns from growth in underlying EBITA numbers. Have said that, I do think there will be an upside swing in this current vintage of funds. There will be an EBITA growth, but more important than that, is we will see a couple of turns of higher EBITA when we exit – especially if you're selling controlled stakes to local or global strategics.

Snow: We have a question here from an LP that I will throw out to all of you, and I'll let you decide whether or not you want to answer it. It's sort of the billion dollar question, which is, what is the target IRR or the target multiple that you underwrite to? And being that this is India and an emerging market, should investors expect a premium for investing in that market? That must be a question that many of you get from LPs all the time. What is your answer, maybe starting with Manish.

Kejriwal: Sure. Not to be flippant at all on this one. It's a very important question. But I do see, just to answer it explicitly, the base number. We all work through hurdle rates which are much lower, but what we target in a classic private equity return would be between a 23% to 27% IRR per year. Now obviously in some of these situations, when we have a few structures or the downside protection, then our return threshold goes to a 20%, 22%. But typically for a classic private equity investment, I would say the range that we would look at as a threshold is about a 23% to 27% returns.

Snow: We have about one more minute, so I'm going to throw one final question to Cyrus. We have a question here about take private deals. In the West, take private deals are often a very important source of controlled transactions for private equity. Do you see an opportunity for take privates in India?

Driver: I'll take two seconds to answer that. Impossible. It's just impossible in this country, with current regulations. It's just way too complicated, too time-taking. We would love to have that opportunity, David. It's just proven very, very difficult to do. And therefore, it's not on our radar at this point in time. But if I could respond to the earlier question as well – what one

change would we like to see. It's back to the question asked earlier by a listener. We'd just like to have access to LBO-style debt. Just as it's available in most of the world. That would change things dramatically, from my point of view.

Snow: Just in a few seconds, Manish. Do you agree with what Cyrus just said...

Kejriwal: I completely agree with Cyrus that it's almost impossible, given the regulations. We – having said that, we just, we are in the process of doing our first take private, which is a controlling stake in a consumer derivative company. And it's been a nine-month long, painful process. But I'm proud to say, the outcome is excellent because that company stops trading on the stock exchange as of Friday of this week. And we essentially – a very complex process where we managed to get 90% of the shared brought in. And again, it was so painful, we probably will hesitate before doing the next one. But we feel very good about completing the first one.

Driver: Congratulations, Manish. You're a brave man, and you probably have no hair left now.

Kejriwal: Well the team – it's all the team.

Snow: Well it sounds like the Indian private equity opportunity is both painful and exciting at the same time, so I wish all of you the best of luck as you pursue this great opportunity. Thank you very much for sharing your expertise with Privcap and with our audience today. We'd love to return to the India topic in the future, but for now, we're going to say thank you and good-bye.