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# Indian Private Equity: Route to Resurgence

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# Preface

Private equity in India has witnessed euphoric highs and frustrating lows since the start of the millennium. As it sets a course for the future, the industry has a chance to reclaim a position as a vibrant contributor to the nation's economy, but it must be guided by the lessons gained from its experiences.

Backed by significant reserves of primarily foreign capital, the private equity industry contributed substantially to the India's growth story, investing more than $100 billion into more than 3,100 companies between 2001 and 2014. With strong economic growth, the private equity industry in India, on an average, realised gross returns of 21 per cent up to 2007, but following the global economic crisis of 2008, the environment changed. After 2007, returns at exit dropped to 7 per cent, well below capital market benchmarks[1], fundraising stalled and exit options became scarce. Adding to the trouble, financial market regulations became more focused on shareholder protection and tax gaps, with spill-over effects on the private equity industry.

As signs now point toward renewed economic strength in India, the time is right to reflect on the lessons of the past and consider the future. To contribute to the dialogue, McKinsey & Company took a detailed look at India's private equity industry and its impact on the country. The effort included extensive data analytics, which accessed prominent industry databases and our own proprietary knowledge, supplemented by a comprehensive survey of stakeholders, including about 40 private equity managers, 22 limited partners and more than 40 executives at portfolio companies. Officials with Ministry of Finance, Securities and Exchange Board of India, Insurance Regulatory and Development Authority and Pension Fund Regulatory and Development Authority were also canvassed.

This report synthesises the key insights collected from our study and offers a view of the route ahead. Chapter 1 discusses the impact of private equity on the Indian economy since 2001, Chapter 2 examines the industry's performance between 2001 and 2014 and factors that influenced it, and Chapter 3 outlines a framework for reinvigorating India's private equity industry, focusing on lessons from the past and potential avenues of growth, including a rethink of the regulatory framework.

The private equity industry in India has a real chance to contribute again to the country's overall economic development, offering benefits to multiple stakeholders. Choices made over the next few years can forge a route to resurgence.

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1 S&P BSE Sensex

# Executive summary

Private equity in India as an asset class has evolved significantly over the past two decades. Starting in the late 1990s, private equity provided an alternative source of financing for local businesses accustomed to limited credit options from banks or turning to public equity markets to underwrite their growth ambitions. Today, the asset class is accepted more readily by Indian entrepreneurs as a source of strategic capital that can play a transformational role in the growth of their businesses by bringing in required new capabilities and discipline unavailable from other forms of capital.

Over the past 20 years, the industry has been a relatively stable source of capital despite many challenges, including gaining acceptance, navigating the recent weak economy, performance setbacks, and a complex regulatory environment. The industry has learned from its experience, and today it better understands the nuances of working effectively in the local environment. As the general economic sentiment in India turns positive, the country's private equity industry has a real opportunity to regain its past vibrancy and move towards making an even greater impact on the economy.

## Impact on India's economy

Between 2001 and 2014, the private equity industry invested more than $103 billion into the country, establishing itself as a stable source of equity capital across several business cycles. Private equity investments were made in more than 3,100 companies across sectors, and the risk appetite of this asset class has helped shape several new industries in the country, such as mobile telecommunications and information technology services.

In addition to providing stable capital, private equity has also offered *'strategic'* capital, especially by helping their portfolio companies strengthen internal capabilities. Several relevant metrics reflect the improvements that appear to be enabled by private equity involvement. The link may be a selection bias, with private equity investors tending towards businesses that are better run and have stronger prospects than others. Still, the correlation between private equity ownership and superior performance and skills compared to businesses not backed by equity back companies – even while controlling for sectors – is compelling:

- **Stronger job creation record.** In the five years following initial investment, companies backed by private equity grew direct employment faster than companies not backed by private equity in a comparable period. This correlation holds true in aggregate and at a sector level.

- **Superior financial performance.** Also in the two years following initial investment, revenues of private equity portfolio companies grew 28 per cent more than revenues of companies not backed by private equity in a comparable period. In addition, profits were stronger. This holds true in aggregate and within each sector.

- **Greater export earnings.** Portfolio companies increased their export earnings much faster than companies not backed by private equity in aggregate and across all sectors. Beyond the natural and partial hedge export oriented sectors offer against currency risk for investors, export sales capabilities appear to support this correlation.

- **More acquisitive and global.** In our sample set, 80 per cent of the companies participated in their first cross-border merger and acquisition (M&A) only after receiving private equity funding. Once again, the correlation holds in aggregate and by sector, suggesting new M&A capabilities are being forged.

- **Better corporate governance and higher tax contribution.** Companies backed by private equity generally improved their corporate governance by, for example, introducing independent committees for audit and compensation and enhanced board oversight. When survey respondents were asked to name the most significant contribution by private equity board members within six months of initial investment, 65 per cent of executives pointed to material changes in compliance measures, including new auditors. In addition, private companies with revenues less than INR 7.5 billion (about $125 million) linked to private equity contributed about 18.8 per cent of the corporate tax receipts for all companies of a similar size, more than their 13.1 per cent share of total revenue within this group.

## Performance in India

Despite the positive impact on the Indian economy, returns generated by private equity investors have been mixed. Until 2007, average realised gross returns from private equity exits were 21 per cent, but this dropped to 7 per cent in later years. Several factors contributed to the shift, including a sharply deteriorating macroeconomic environment, a challenging investment ecosystem and substantial capital raised during this period. The average holding period for investments increased from an average of 3.1 years between 2001 and 2007 to 4.4 years during 2008 to 2013. Furthermore, as exit options became more limited, only a quarter of the $51 billion invested between 2000 and 2008 has been returned to investors to date, on a cost basis.

Several major factors hurt private equity performance after 2008:

- **Competition for a small pool of assets.** Quality assets suitable for investment were limited in India and came with high levels of intermediation, forcing investors to pay richer valuations.

- **Challenging macroeconomic environment.** After 2008, annual economic growth fell sharply, from an average of 9.5 per cent between 2005 and 2008 to 6.7 per cent from 2008 to 2013. Meanwhile, increased market volatility and inflation brought higher return expectations from investors, while record fundraising drove private equity to larger-ticket, capital-intensive sectors with longer payback periods. A weakened rupee also dampened dollar-based returns.

- **Narrower exit options.** About 32 per cent of private equity capital invested in India between 2000 and 2008 has exited, leaving $75 billion still under investment. Following the global financial crisis, public markets became extremely selective and, with increased regulatory uncertainty, strategic interest in Indian businesses dried up. Deals with other private equity firms emerged as a more popular exit option, accounting for more than 30 per cent of all exits by value in 2013.

- **Limited influence.** The prevalence of minority investments restricted the ability of private equity firms to exercise influence on entrepreneurs and their portfolio companies. In our survey, private equity firms emphasised their key challenges were with management capabilities, corporate governance and capital discipline, all of which impact value creation.

## The route ahead

For the industry to realise its unmet potential for all stakeholders, it will need to create a supportive framework that addresses the structural shortcomings of the asset class.

Private equity managers, investors and executives at portfolio companies are already taking steps in this direction by employing the lessons learned in recent years. Private equity firms are refining their investment strategies, focusing on high-quality entrepreneurs and capturing greater levels of influence and control. They are also becoming more rigorous in valuation and risk assessment. At the same time, limited partners, investors in private equity firms, are choosing private equity firms more carefully, looking for deep local expertise and team stability. Entrepreneurs have also started recognising private equity firms as strategic partners that can contribute to enhancing corporate capabilities.

Along with the shifts in approach among key stakeholders, an enabling regulatory framework is needed to ensure the continued growth of the industry. While most regulatory efforts have rightly focused on protecting minority shareholder interests and improving compliance, there has been limited direct regulatory effort focused on the private equity industry itself. Private equity as an asset class will need recognition as a distinct investment class, much the same way as investments from foreign institutional investors and foreign direct investment are recognized as carrying unique attributes.

While the last few months (including the Union Budget 2015) have seen developments on many policy fronts, there are four areas where regulations could further help forge a resurgent path ahead for the industry. First, mobilising greater domestic institutional capital for private equity will require existing allocation ceilings to be shifted for certain types of investors. Second, it will be critical to create an enabling environment for overseas investors by removing practical impediments related to withholding taxes and safe harbour norms for advisors to overseas investors. Third, simplifying delisting norms for closely held companies and defining a robust court receivership process will expand the investible universe available for investors. And last, providing a more certain and robust securities and tax regime will help private equity investors exit in a timely manner.

After several challenging years, the private equity industry in India can take advantage of newfound economic optimism and a record of impact on portfolio companies to chart a route to resurgence. Change in strategies of private equity firms and their investors, as well entrepreneurs and executives at portfolio companies, point towards a stronger industry that can offer significant contributions to the Indian economy. To reach this potential, challenges must overcome through cooperation and continued dialogue among industry players, regulators and industry associations.

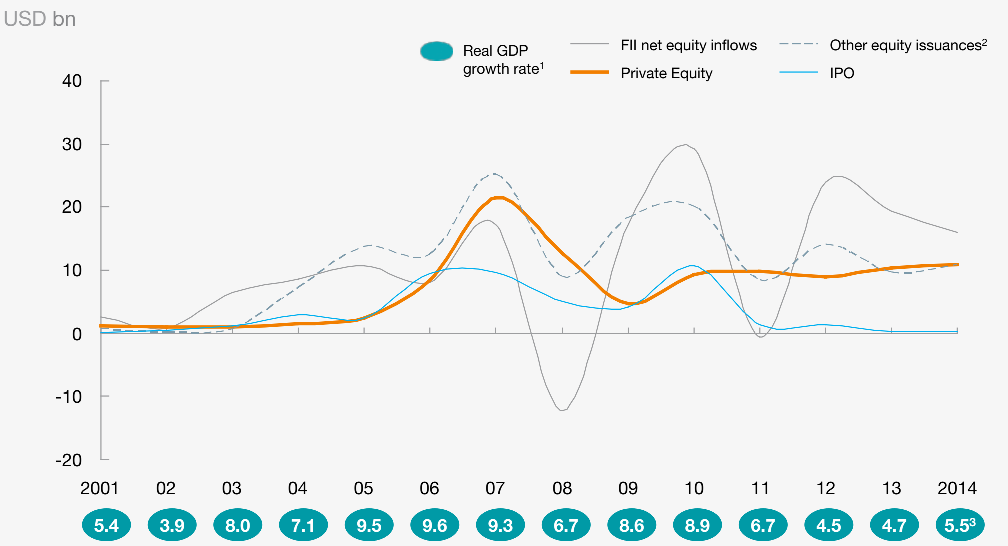
# Chapter 1: Impact on India's Economy

Private equity as an asset class has had an interesting journey in India over the past twenty years. The seeds of the industry were sown in the 1990s when a few private equity and venture capital funds served as alternative sources of financing to local businesses that were accustomed to limited forms of bank financing or using public equity markets to underwrite their growth agenda.  Investments from the industry have meaningfully contributed to India's development at the macroeconomic and microeconomic levels, and, over time, the asset class has increasingly been accepted by local entrepreneurs as a stable and strategic source of capital that can potentially help them drive transformational change in their businesses.

## Impact on the Indian economy

Private equity has been a significant contributor to India's economic growth since the turn of the century. Between 2001 and 2014, the sector invested a total of more than $103 billion[2] in the Indian economy and, despite a drop in 2008, capital inflows from private equity have been more reliable than those from other sources of equity funding, including foreign institutional investment, IPOs and equity issuances, such as secondary offers and convertible instruments (Exhibit 1.1). Private equity inflows have remained strong, even as India's GDP growth rates plunged from a peak of 9.6 per cent in fiscal 2007 to 4.7 per cent in fiscal 2014[3] amid high market volatility[4].

**Exhibit 1.1:** Private equity is a stable source of equity capital, contributing over USD 103 bn since 2001




1 GDP growth rate at factor cost (2004-05 base year) for corresponding fiscal year (e.g. 2014 refers to FY 2015)
2 Includes follow on offers, convertible bonds
3 CSO estimate

SOURCE: SEBI; Central Statistics Office (MOSPI); Dealogic; AVCJ Research; VCCEdge; McKinsey analysis

2 Total private equity investments in India from 2001 to 2014, AVCJ Research and VCCEdge.

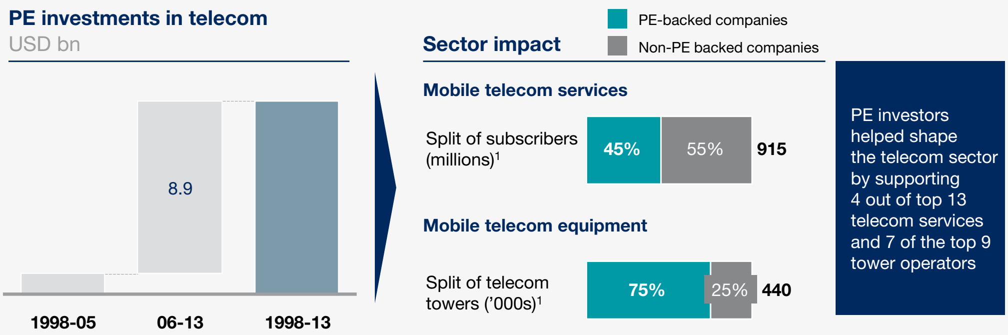
3 Central Statistics Office (Ministry of Statistics and Programme Implementation).

4 The average beta of MSCI India index against S&P 500 Index increased from 0.3 to 1.1 between 2001 and 2013, Thomson Reuters Datastream.

Private equity has represented a broad-based source of equity capital, both in terms of sectors covered and individual companies. From 2001 to 2014, private equity in India invested in more than 3,100 companies across 12 major sectors[5], including those critical to the country's development, such as telecommunications (Exhibit 1.2). Funds have been channelled to early-stage companies with annual revenues of less than $2 million, as well as more mature, mid-size growth-stage enterprises with revenues between $25 million and $125 million. Together, companies from early stage to mid-size corporations accounted for about 80 per cent of all private equity deals (46 per cent by value) in India between 2001 and 2013 (Exhibit 1.3).

**Exhibit 1.2:** PE supported telecom services and tower operators account for a significantly large share of the overall market

**Sector impact of private equity to telecom sector in India**




1 2013 figure; PE backed sample comprises of 4 companies for mobile telecom services, and 7 companies for mobile telecom equipment

SOURCE: AVCJ Research; VCCEdge; CMIE Prowess; TRAI; company filings; IBEF; press articles; McKinsey analysis

**Exhibit 1.3:** Private equity contributes towards the development of companies of all sizes, in particular early stage to mid corporate

| Categories | Turnover USD mn[1] | # companies in the organized sector | Value of PE investments %, 2001-13 | Volume of PE investments %, 2001-13 |
|---|---|---|---|---|
| Early-stage | < 2 | ~760,000 | 17 | 48 |
| SME | 2 - 25 | ~100,000 | 11 | 12 |
| Mid corporates | 25 - 125 | ~12,000 | 18 | 19 |
| Large corporate | 125 - 500 | ~1,300 | 24 | 16 |
| Very large corporate | 500+ | 250 | 30 | 5 |

1 Segmentation of turnover categories done in INR, and exchange rate of 1 USD = 50 INR used for representation purposes

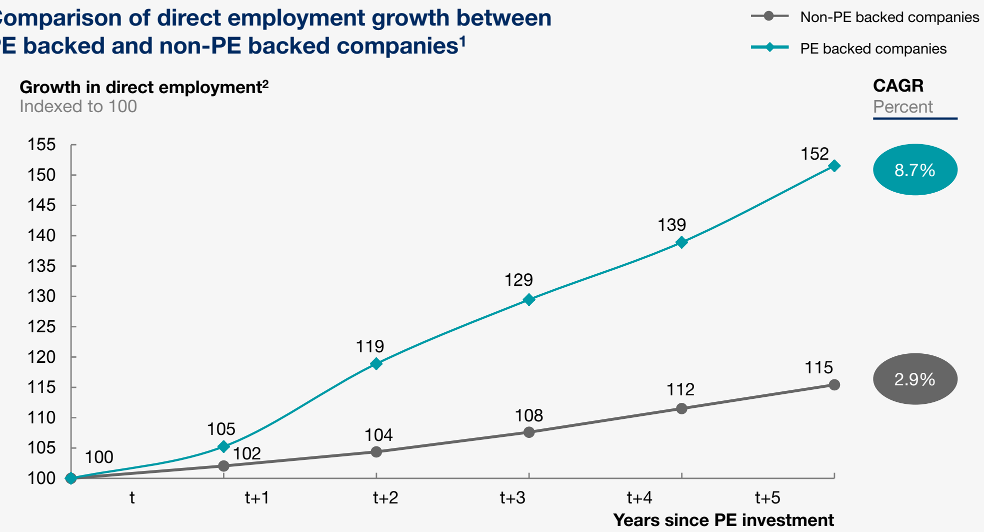
SOURCE: CMIE Prowess; expert interviews; AVCJ Research; VCCEdge; McKinsey analysis

5 Companies back by private equity were identified from transactions data from AVCJ Research and VCCEdge.

Also, private equity appears to accelerate job growth through its portfolio companies (Exhibit 1.4). Between 2001 and 2013, the number of jobs at companies backed by private equity posted a compounded annual growth rate on average of almost 9 per cent during the first five years after investment. The annual growth rate at comparable companies without private equity funds was just under 3 per cent.

**Exhibit 1.4:** PE investments help accelerate employment when compared to non-PE backed companies

**Comparison of direct employment growth between PE backed and non-PE backed companies[1]**




1 PE backed sample consists of 52 companies that saw PE investments between 2003 and 2007 while non-PE backed sample of companies consists of 171 private sector companies.
2 Analysis uses employment data from FY04 to FY 13 to compare job growth in PE backed companies over a 5 year period after PE investment with growth of non-PE backed companies over the same period

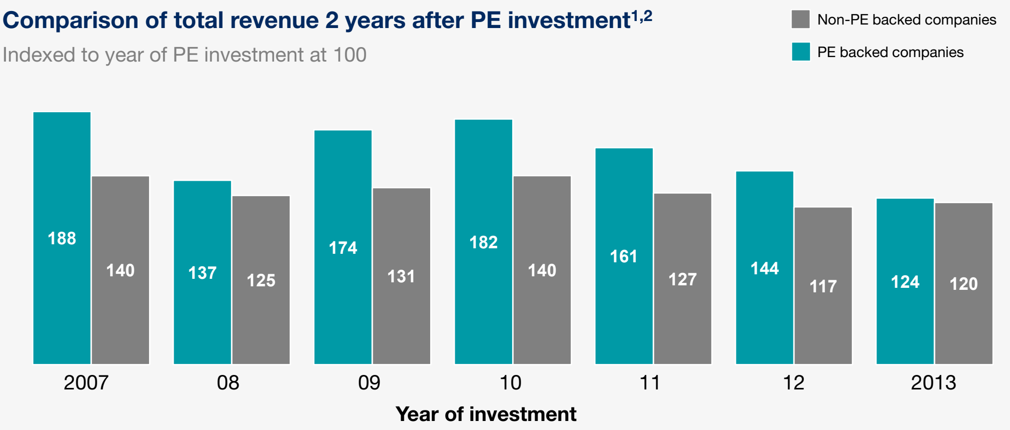
SOURCE: CMIE Prowess; AVCJ Research; VCCEdge; McKinsey analysis

## Impact on portfolio companies

Private equity's impact on the overall economy is the culmination of its effect on myriad companies that benefitted from these investments. In general, private equity firms selected companies with high growth potential and worked with them to exercise and expand their corporate capabilities to exploit this potential. A look at revenue and profit growth data since 2007 shows portfolio companies consistently outperformed their peers without private equity funding (Exhibits 1.5 and 1.6)[6].

6 Comparison of revenue and EBITDA growth between comparable set of PE-backed and non-PE backed companies for a period of 2 years following PE investment; S&P Capital IQ, AVCJ Research.

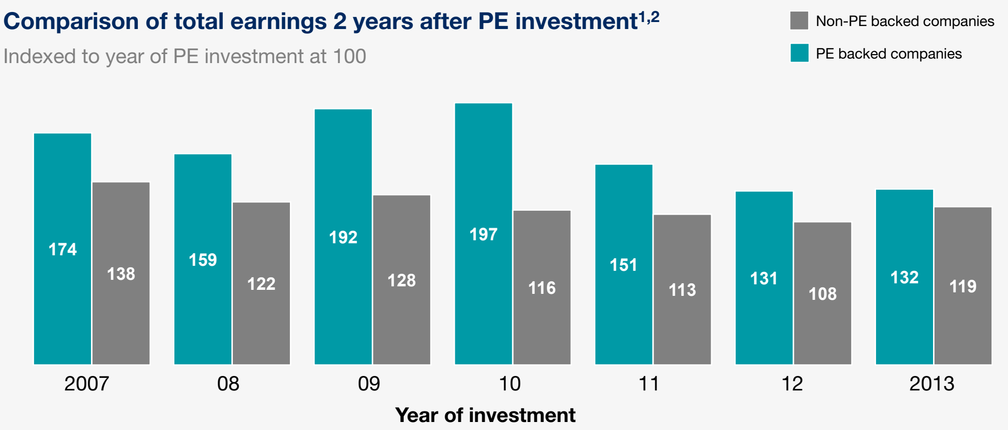
**Exhibit 1.5:** PE-backed companies demonstrate higher revenue growth




1 PE-backed company sample is based on 200 PE investments in listed companies between FY 07-15
2 Sample of non-PE backed companies consists of 1075 comparable listed companies for FY 07-15

SOURCE: Capital IQ; AVCJ Research; VCCEdge; McKinsey analysis

**Exhibit 1.6:** PE-backed companies demonstrate higher earnings growth



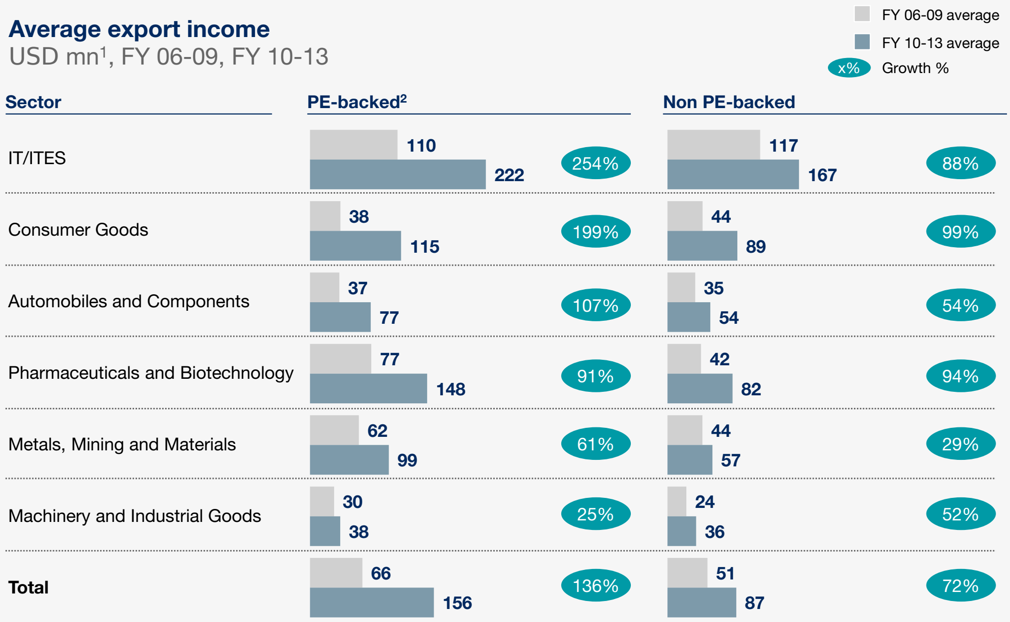

1 PE-backed company sample is based on 200 PE investments in listed companies between FY 07-15
2 Sample of non-PE backed companies consists of 1075 comparable listed companies for FY 07-15

SOURCE: Capital IQ; AVCJ Research; VCCEdge; McKinsey analysis

In many instances, private equity investors focused on building capabilities in their portfolio companies, notably evidenced in export growth and cross-border mergers and acquisitions (M&A). Often private equity investors brought their own expertise in international markets to these companies and in several instances eased access to foreign customers in an effort to drive export growth. As a result, export income in portfolio companies appears to grow much faster than that of their peers (Exhibit 1.7)[7]. The strategy supported growth at portfolio companies and helped reduce risks associated with domestic growth volatility and currency rate changes.

7 Export income data, CMIE Prowess.

**Exhibit 1.7:** PE investors facilitated more aggressive export growth




1 Exchange rate of 1 USD = 50 INR used
2 Sample of 120 PE-backed companies from 6 export focused sectors that received PE investments between 2000 and 2014. Energy and utilities, a major export sector was excluded due to very small constituent sample for PE backed companies (n < 5)

SOURCE: CMIE Prowess; AVCJ Research; VCCEdge; McKinsey analysis

Cross-border M&A also accelerated in portfolio companies. Analysis covering 2001 to 2013 shows that companies backed by private equity appear more likely to engage in cross-border M&A than their peers without private equity funding[8]. The trend was seen across most sectors, including automotive, pharmaceuticals, manufacturing, metals, and consumer goods in particular (Exhibit 1.8). In sectors such as IT & IT services, companies backed by private equity lagged their much larger and cash-rich peers.

Significantly, among the portfolio companies that engaged in cross-border M&A, about 80 per cent completed their first cross-border M&A deal only after the initial private equity investment. Private equity firms contributed their experience, proprietary knowledge and networks to help these companies find and obtain appropriate strategic partners.

Analysis also shows that, in addition to accelerated earnings growth, companies with private equity funding appear to be more diligent in ensuring good corporate governance. Among companies with revenues of less than 7.5 billion rupees (about $125 million), those backed by private equity accounted for 3.7 per cent of companies and 13.1 per cent of corporate revenues in fiscal 2014 in India, yet they contributed 18.8 per cent of total corporate tax collections[9] (Exhibit 1.9). The consistent and increasing tax contribution trend is supported by private equity-backed companies that achieve scale and higher profits.

8 Cross-border M&A activity of PE-backed companies and non-PE backed companies between 2001 and 2013 was analyzed. Out of 2,849 PE-backed companies, 126 companies undertook cross-border M&A, of which 100 did it for the first time after PE investment. The sample of non-PE backed companies comprised 26,564 companies, of which 583 undertook cross border M&A. M&A data, AVCJ Research.

9 Tax contribution data for companies backed by private equity, CMIE Prowess and VCCEdge.

**Exhibit 1.8:** Global M&A accelerated in PE-backed companies

## Companies involved in cross border M&A

Percent, 2001-13

| Sector | PE-backed[2] | Non PE-backed[3] | First time after PE investment |
|---|---|---|---|
| Automobiles and Components | 11.3 | 2.8 | 83% |
| Pharmaceuticals and Biotechnology | 10.0 | 6.2 | 80% |
| Metals, Mining and Materials | 8.8 | 2.2 | 88% |
| Engineering and Construction | 7.8 | 3.2 | 75% |
| Machinery and Industrial Goods | 6.1 | 1.9 | 90% |
| Consumer Goods | 5.8 | 1.5 | 77% |
| IT/ITES | 5.7 | 14.1 | 78% |
| Others[1] | 1.8 | 1.2 | 76% |

1 Includes energy and utilities, financial services, real estate, media and entertainment, telecommunications, business services and other misc. sectors
2 Sample of 126 PE-backed companies that did cross border M&A between 2001 and 2013
3 Sample of 584 non-PE backed companies that did cross border M&A between 2001 and 2013

SOURCE: AVCJ; CMIE Prowess; McKinsey analysis

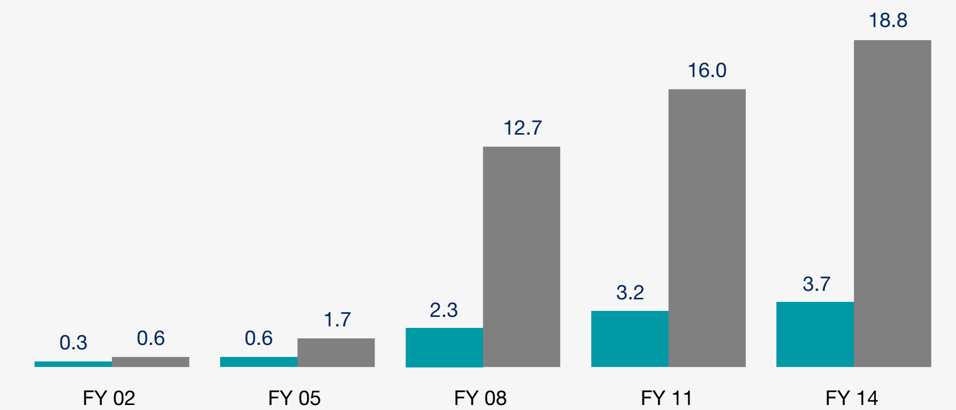
**Exhibit 1.9:** PE-backed entities contribute a disproportionate share of direct taxes

## Direct tax contribution of PE backed companies

n=717[1], Revenue < ₹7.5 billion

Share of number of PE-backed companies among total[2] (%)

Tax contribution by PE-backed companies (%)




1 Sample of 717 PE-invested companies (~25% of PE backed companies) with revenue < ₹750 crore. In FY 2014, total tax contribution for this sample was ~INR 29 billion
2 Total sample refers to 19,195 companies with revenue < ₹7.5 billion

SOURCE: CMIE Prowess; AVCJ Research; VCCEdge; McKinsey analysis

When investing in a company, private equity firms often introduce specific measures to improve corporate governance processes, such as establishing independent audit committees and compensation committees. Portfolio companies are also generally encouraged to maintain lower loan default rates and show better credit discipline. From a practical perspective, such governance initiatives benefit private equity firms by making their portfolio companies better candidates to be listed on capital markets and more attractive to potential acquirers.

As private equity gains greater acceptance in India and its benefits are more broadly recognized, the industry will likely continue to play a major role in building private sector capabilities and India's economic development.

# Chapter 2: Performance in India

The global financial crisis in 2008 marked a turning point in the fortunes of private equity investors in India. Until 2007, the average realised return for private equity investments at exit was 21 per cent, and after 2008 this average dropped to 7 per cent[10]. This precipitous fall in returns resulted from several compounding factors within India, many unrelated to the economic challenges facing the rest of the world. The confluence of these challenges has pushed private equity firms to re-evaluate their investment strategies and operational models and become better versed in the nuances of local business conditions.

## Factors contributing to lower realised returns

### 1. Limited investment options

Following the initial success that private equity investors had in India, in 2005 international capital inflows into the asset class soared. Between 2001 and 2007, private equity investment in India was equivalent to 3.1 per cent of GDP, compared to 1.3 per cent in China in the same period[11]. After 2008, the ratio edged downward to 2.9 per cent, but remained almost twice the level seen in China during that time.

This disproportionately large flow of capital was forced toward a relatively small pool of quality, investment-grade private assets and business owners. While it is widely accepted that India is an entrepreneurial economy and it has many early-stage investment options (companies with annual revenues of less than $2 million), growth-stage investment options (companies with revenues of $2 million to $500 million) – the segment of most interest to private equity firms – are far fewer when compared to other emerging markets (Exhibit 2.1). This might be because in India, companies have historically had easier access to public listings, so fewer companies have remained private and available for private equity investment. India, for example, has about 2,600 listed companies with annual revenues of less than $125 million compared to about 1,000 such companies in China[12]. The country's preponderance of smaller unlisted companies is reflected in the median revenues of public companies: $20 million in 2013 in India, compared to $140 million in China, $490 million in Brazil and $950 million in Russia.

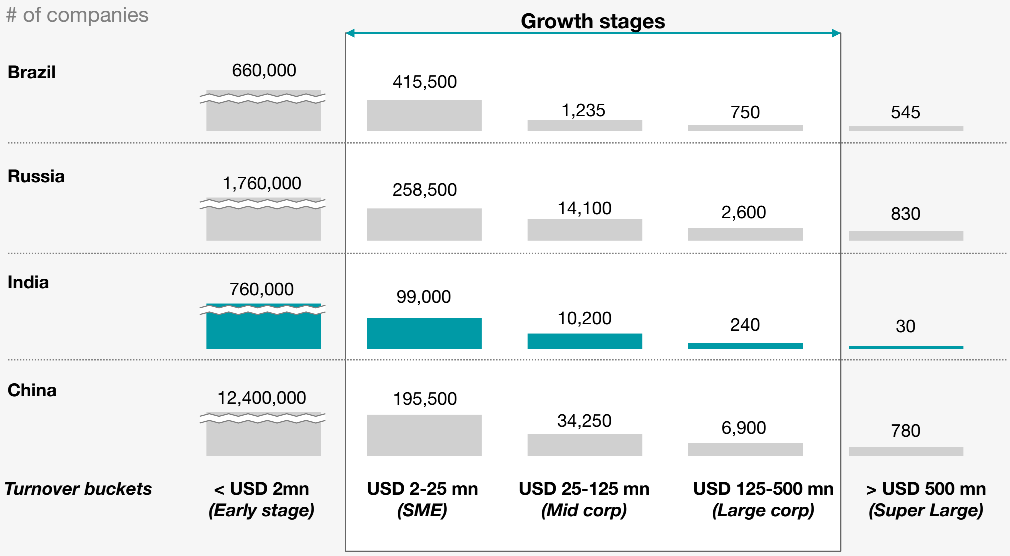
10 Based on gross IRR returns by investment year, calculated from 610 exits between 1998 and 2013 aggregated from Preqin database, AVCJ Research, VCCEdge.

11 PE investments data, AVCJ Research, VCCEdge. GDP data, IHS Global Insight World Market Monitor database.

12 S&P Capital IQ database.

**Exhibit 2.1:** India offers relatively lower growth stage options compared to BRIC peers

**Estimated number of investable private companies split by turnover[1]**




1 Total companies excluding those which are PSUs/Government or are public companies or belong to unorganized sector

SOURCE: Rosstat; OneSource; IFC SME database; expert interviews; Press search; McKinsey analysis

Also between 2007 and 2014, the number of private equity firms active in India more than doubled, climbing from 65 to 137, with many of the new funds established with limited experience in investing. In several cases, the mismatch of demand for investment-grade assets and the available supply of capital led to inflated valuations.

Valuations were also pushed higher in India by a heavy reliance on intermediaries, who work with entrepreneurs to secure funding. These intermediaries, paid a percentage of a transaction's value, benefit from higher valuations. In a market with fewer quality assets and an abundance of capital to be invested, they can agitate competition to drive valuations to unwarranted levels. India is a rare market in which private companies often command a premium over similar public companies. Several private equity managers mentioned during our research that asking prices for companies was up to 30 per cent higher than their own valuations during discussions with targeted companies. Private equity investors responded by negotiating structured deals with downside protection clauses and put options, but these structures often led to misalignment among stakeholders, broken agreements and poorer returns for the private equity firm.

## 2. Challenging macroeconomic environment

After steady real GDP growth of about 6 per cent from 2001 to 2004, India's economy soared for the next four years at an average annual rate of 9.5 per cent. With inflation in check at 4.8 per cent, the country's equity risk premium remained steady at around 4.8 per cent[13]. Other indicators also pointed to a robust economy: India had 88 million

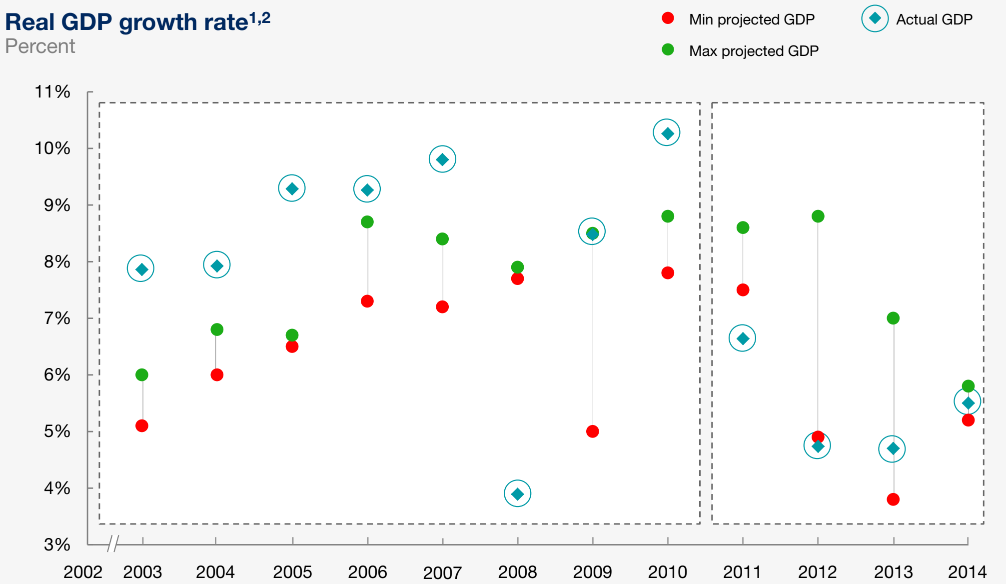
13 Bloomberg, Thomson Reuters Datastream.

middle-class households in 2007, its urban population had grown from 300 million in 2001 to 351 million in 2007[14] and the labour force participation rate was nearing 60 per cent[15].

After 2008, a series of macroeconomic factors pummelled India's private equity industry, cutting realized returns dramatically. Up until 2007, average gross returns to private equity investors were 21 per cent, compared to an average of 18 per cent for public market returns[16]. After 2008, average returns dropped to 7 per cent when exiting investments, while public market returns dropped to 11 per cent.

As seen in many countries, India's growth slowed dramatically after 2008, unsettling several sectors and the markets generally. GDP fell from an average annual rate of 9.5 per cent between 2005 and 2008 to around 6.7 per cent between 2008 and 2013, bolstered by a brief rebound in 2010. Also since 2008, actual economic growth repeatedly fell short of expectations, signalling that optimistic outlooks were suspect (Exhibit 2.2)[17].

**Exhibit 2.2:** India GDP growth fell short of expectations after several years of exceeding them




1 GDP growth rate based on expenditure approach (2004-05 prices)
2 Actual GDP for 2011-14 do not account for retrospective revisions due to change in base year. CSO estimate in place of Actual GDP for 2014

SOURCE: World Bank, IMF, press search, McKinsey analysis

Beyond the global crisis, other macroeconomic factors contributed to the sharp drop in realised returns. Encouraged by the positive business sentiment leading into 2008, private equity firms had begun investing larger amounts, in aggregate and per deal, into sectors that would potentially benefit most from the country's efforts to improve its infrastructure. Industries included real estate development, hospitals, roads and power stations, which were capital intensive and

14 United Nations Population Division.

15 World Bank.

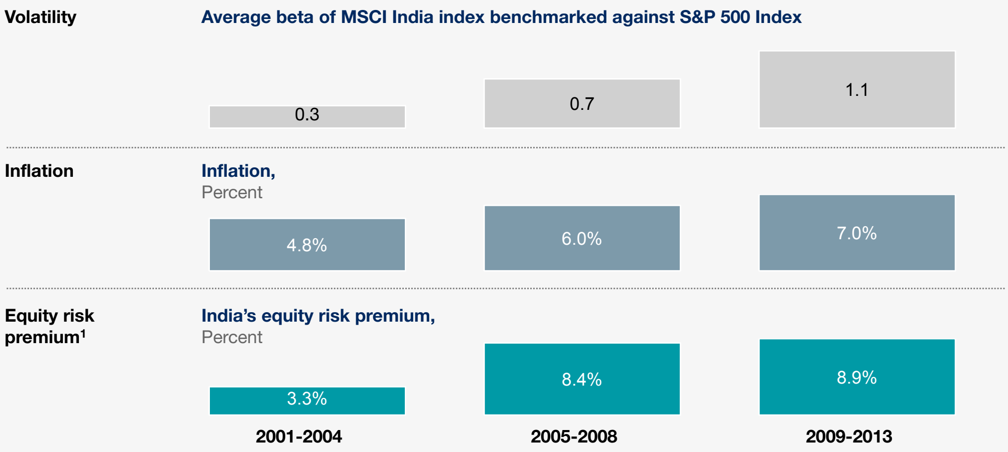
16 Thomson Reuters Datastream.

17 Comparison of forecast estimates of India's GDP growth rate as made by World Bank, IMF, analyst comments in press clippings at different points in time against actual GDP growth rate.

had long gestation periods before returns were realized. In particular, real estate, engineering and construction, among others, delivered high returns on invested capital before 2008.

Such companies appealed to private equity managers trying to meet increased expectations of their investors. As inflation and market volatility increased in India, investors began demanding higher risk premiums from their private equity investments (Exhibit 2.3). Credit rating downgrades for Indian debt between 2009 and 2013 and policy delays only exacerbated the situation.

**Exhibit 2.3:** Inflation, volatility and equity risk premium increased significantly




1 Equity risk premium is the product of 1) the average spread of yield between 10 yr GOI bonds and 10 yr US Treasury bonds over a period of 4 years (normalized country default spread) and 2) the relative deviation of equity market over the India bond market for the same time period

SOURCE: IHS Global Insight; Thomson Reuters Datastream; McKinsey analysis

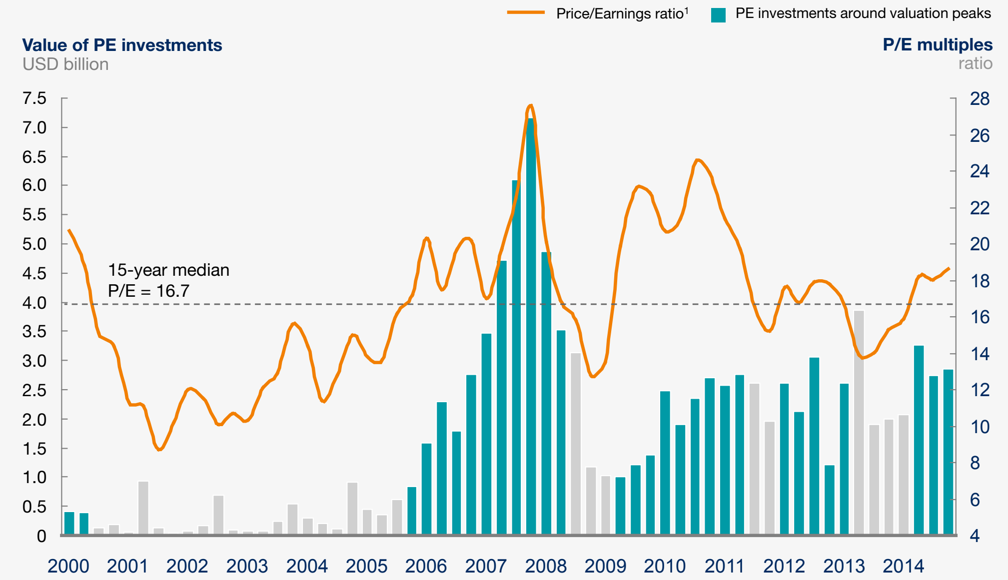
By 2013, all of the 25 largest private equity firms in India had at least one infrastructure investment in their portfolio, and altogether this type of asset represented 43 per cent of the $77 billion private equity firms invested in India between 2007 and 2013[18]. Beyond specific sectors, this excessive optimism also led to about 75 per cent of new investments being made at valuations higher than the median for the previous 15 years (Exhibit 2.4). By contrast, Chinese investors invested about 50 per cent above its 15-year median P/E ratio of 9.8. One effect was that exits could not support these valuations and became difficult.

After 2008, however, more greenfield investments emerged, macroeconomics and government policy delays worked against these companies, and returns dropped precipitously (Exhibit 2.5). Moreover, with higher inflation, while revenues grew for all sectors, profits did not grow at the same rate as revenue, dampening valuations (Exhibit 2.6).

The change affected private equity returns, as well as investor sentiment toward India. Between 2001 and 2008, private equity firms raised about $65 billion for investing in India, but from 2009 to 2013 fundraising dwindled to about $29 billion.

18 Based on VCCEdge, AVCJ Research data on PE firms and their portfolio mix.

**Exhibit 2.4:** In last 15 years, ~75% of PE investments in India were made when market traded above the median




1 P/E ratio is defined as current market cap. divided by 12-month trail earnings

SOURCE: Thomson Reuters Datastream; AVCJ Research; VCCEdge; McKinsey analysis

**Exhibit 2.5:** Most sectors underperformed compared to prior periods

| | PE allocation by sector %, '05-'08 | | PE allocation by sector %, '09-13 | Return on invested capital[1] %, '05-'08 | | Return on invested capital[1] %, '09-'13 | ROIC – WACC spread %, '09-'13 |
|---|---|---|---|---|---|---|---|
| IT/ITES | 9% | ↑ | 14% | 43 | ↓ | 39 | 26% |
| Real estate[2] | 24% | ↓ | 13% | 39 | ↓ | 6 | -8% |
| Financial services[2] | 14% | ↓ | 10% | 15 | ↔ | 14 | +1% |
| Energy and Utilities | 4% | ↑ | 10% | 12 | ↓ | 9 | -1% |
| Engineering and Construction[3] | 7% | ↑ | 9% | 14 | ↓ | 10 | -2% |
| Healthcare providers[3] | 2% | ↑ | 6% | 10 | ↔ | 9 | 0% |
| Business and consumer services | 3% | ↑ | 6% | 12 | ↑ | 14 | +1% |
| Telecommunications | 14% | ↓ | 6% | 10 | ↓ | 7 | -4% |
| Consumer Goods[4] | 6% | ↔ | 5% | 16 | ↓ | 13 | +1% |
| Travel, Transport and Logistics | 4% | ↑ | 5% | 9 | ↓ | 6 | -6% |
| Others | 10% | ↑ | 16% | 13 | ↓ | 8 | 0% |

1 Calculated using reported currency (INR)
2 ROE, cost of equity (CoE) and ROE-CoE spread has been used for real estate and financial services
3 includes related equipment suppliers
4 Includes consumer products, food and beverages, retail, leisure and textile;

SOURCE: AVCJ Research; VCCEdge; Preqin; McKinsey Corporate Performance Analysis Tool; CMIE Prowess

**Exhibit 2.6:** Higher input costs and pricing pressure led to lower profit growth relative to revenue growth for most sectors

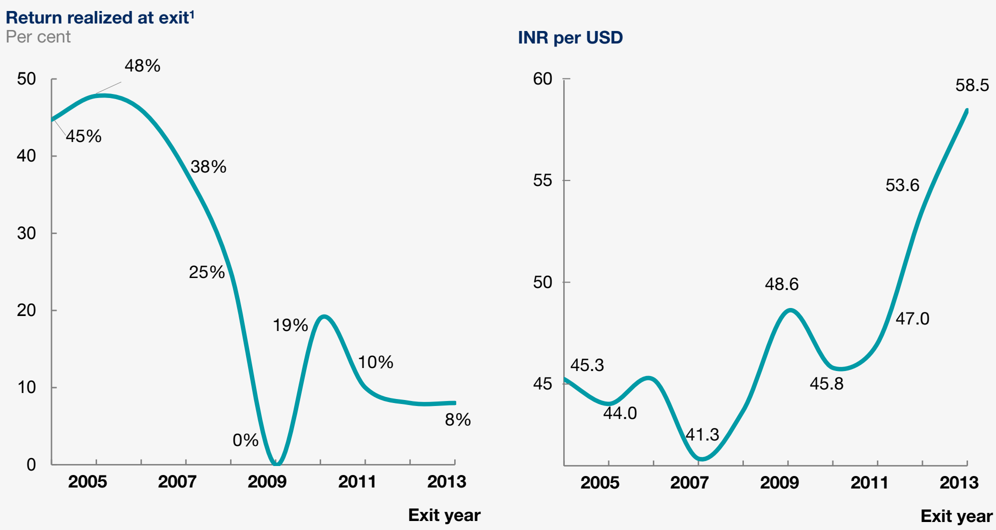
| | PE investments<br>%, '09-13 | Revenue growth[1]<br>Growth %, FY '09-'13 | Profit growth (PAT)<br>Growth %, FY '09-'13 |
|---|---|---|---|
| IT/ITES | 14% | 76% | 78% |
| Real estate | 13% | 27% | -23% |
| Financial Services | 10% | 90% | 78% |
| Energy and Utilities | 10% | 73% | 39% |
| Engineering and Construction[2] | 9% | 56% | 6% |
| Telecommunications | 6% | 24% | -215% |
| Consumer Goods[3] | 5% | 93% | 50% |
| Travel, Transport and Logistics | 5% | 38% | -133% |
| Automobiles and Components | 4% | 84% | 115% |
| Others[4] | 24% | 47% | 38% |

1 Based on filings available with CMIE Prowess for companies with total revenue > INR 1 crore
2 Also includes related equipment
3 Includes consumer products, food and beverages, retail, leisure and textile
4 Includes business and consumer services, healthcare providers and equipment, machinery and industrial goods, media and entertainment, metals, mining and materials, pharmaceuticals and biotechnology

SOURCE: AVCJ Research; CMIE Prowess; McKinsey analysis

A sharp weakening of the Indian rupee on foreign exchange markets also cut into dollar-based returns realized by private equity firms. One US dollar traded at about 44 rupees in 2008 and at about 59 rupees in 2013 (Exhibit 2.7). While rupee-based returns when exiting investments in 2013 were 14 per cent, dollar-based returns were 8 per cent.

**Exhibit 2.7:** Dollar returns partly affected by rupee depreciation —especially over the past 8 years




1 Gross dollar IRR estimated for a sample of ~610 exits between 2000-2013

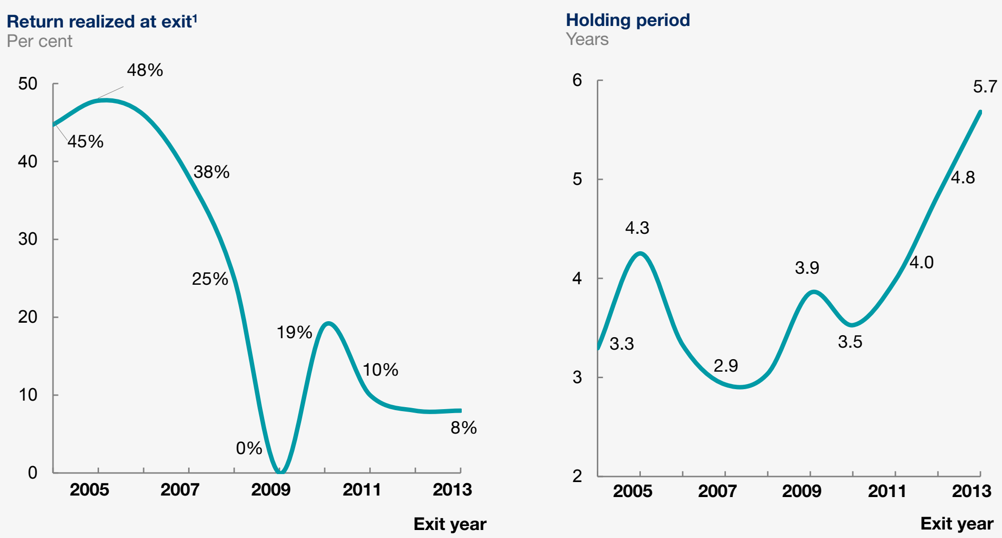
SOURCE: Oanda; AVCJ Research; Preqin; VCCEdge; McKinsey analysis

## 3. Narrower exit options

The changing environment also restricted the options available for private equity investors to exit investments at the end of their intended investment periods. Unfavourable capital market conditions ruled out public offerings, and global strategic interest in Indian assets was low due to stressed conditions in the developed markets amongst other factors, making direct sales difficult. In addition, projects by capital-intensive portfolio companies were often behind schedule, delaying any prospect for a reasonably profitable exit.

Between 2001 and 2007, private equity firms held investments in India for an average of 3.1 years, and, from 2008 to 2013, the average holding period for exited investments jumped to 4.4 years, climbing as high as 5.7 years in 2013 (Exhibit 2.8). Also, while overall private equity firms had exited from about 32 per cent of investments made between 2000 and 2008 on a cost basis (Exhibit 2.9), exits from infrastructure and related industries were much slower: about 20 per cent in engineering and construction, about 15 per cent in real estate, and about 10 per cent in and utilities and energy (Exhibit 2.10).

**Exhibit 2.8:** PE exits are tougher: Returns declined as average holding period increased




1 Gross dollar IRR estimated for a sample of ~610 exits between 2000-2013

SOURCE: AVCJ Research; VCCEdge; Preqin; McKinsey analysis

**Exhibit 2.9:** Of ~$51 bn invested 2000 to 2008, only ~$16 bn has exited so far at a value of ~$27 bn

| Investment period | Investment USD bn | Exits, cost basis USD bn | Exits, value basis USD bn | Exit to entry Multiple |
|---|---|---|---|---|
| 2000-2004 | 5.8 | 3.3 | 8.5 | 2.6 |
| 2005-2008 | 45.1 | 13.0 | 18.7 | 1.4 |
| 2009-2013 | 43.1 | 2.0 | 3.1 | 1.7 |

SOURCE: AVCJ Research; VCCEdge; Preqin; McKinsey analysis

**Exhibit 2.10:** Exiting investments and realising returns have been difficult across most sectors

| | PE Investments 2000-2008, USD billion | PE investments exited % of total investments exited, 2000-2013 | Returns where exited[1] Per cent | Holding period of deals exited 2000-2013 |
|---|---|---|---|---|
| Real estate | 9.8 | 14% | 2% | 5.3 |
| Telecommunications | 7.2 | 25% | 5% | 4.2 |
| Financial Services | 7.2 | 34% | 13% | 4.4 |
| IT/ITES | 5.9 | 39% | 21% | 4.4 |
| Engineering and Construction[2] | 3.3 | 21% | 16% | 4.0 |
| Consumer Goods[3] | 2.8 | 21% | 18% | 3.8 |
| Travel, Transport and Logistics | 2.0 | 29% | 6% | 4.1 |
| Machinery and Industrial Goods | 1.9 | 38% | 17% | 4.3 |
| Energy and Utilities | 1.9 | 9% | n/a[4] | 3.7 |
| Healthcare Providers | 1.0 | 39% | 19% | 4.9 |
| Others[5] | 7.9 | 31% | | 4.3 |

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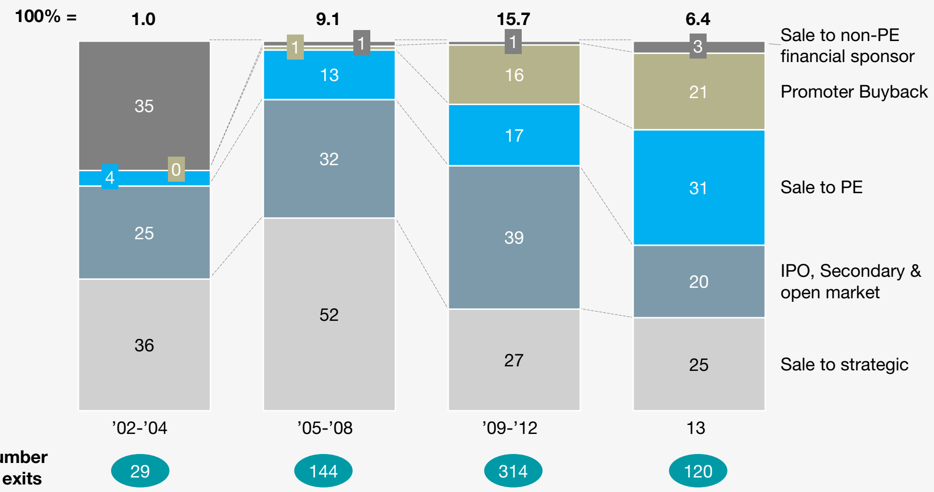
1 Gross dollar IRR estimated for a sample of ~610 exits between 2000-2013
2 Also includes related equipment
3 Consumer goods includes consumer products, food and beverages, retail, leisure and textile;
4 Number of exits less than 10
5 Others include metals, mining and materials, pharmaceuticals, automobiles, business and consumer services and media and entertainment

SOURCE: AVCJ Research; VCCEdge; Preqin; McKinsey Corporate Performance Analysis Tool; and Prowess

Further, the texture of exit options changed. From 2002 to 2008, sales to strategic investors accounted for about half of the portfolio exits for private equity in India, with IPOs and other market options accounting for 31 per cent. Both options lost ground after 2008 as potential investors became unwilling to commit to mid-sized growth companies (Exhibit 2.11). Regulatory restrictions on overseas listings and share lock-in periods added further challenges. Meanwhile, while some long-established funds sought exit options, newer ones were deploying more capital. By 2013, sales to private equity firms accounted for almost a third of portfolio exits, a greater proportion than any other exit option.

**Exhibit 2.11:** As exit routes narrowed with a decline in strategic sales and IPOs, GPs recently emerged as single largest buyers of GP assets

**PE exits by exit value and type of exits**
%, USD bn




SOURCE: AVCJ Research; VCCEdge; Preqin; McKinsey analysis

## 4. Limited influence

Another factor contributing to lower returns after 2008 was the limited influence private equity could exercise on their portfolio companies during a period of high volatility, except in cases of a few well governed portfolio companies, where minority investing still worked well. The vast majority of assets held in India by private equity firms were minority stakes – 87 per cent, based on number of portfolio companies in deals between 2009 and 2013[19]. This ownership structure did not have any adverse impact in a vibrant economy, but after 2008, private equity firms were stifled by their inability to bring their expertise and experience to bear fully and influence the direction of portfolio companies, given their minority positions. They were called upon for advice when needed, but had limited scope for direct intervention.

Adding to the challenges of navigating as a minority shareholder, many portfolio companies were family businesses, a very common structure in India. Private equity firms needed to adapt how they tried to exert influence to the complexities and operational preferences of these family-owned businesses in areas such as managing demands of multiple family stakeholders and introducing professional management, business process and corporate governance structures.

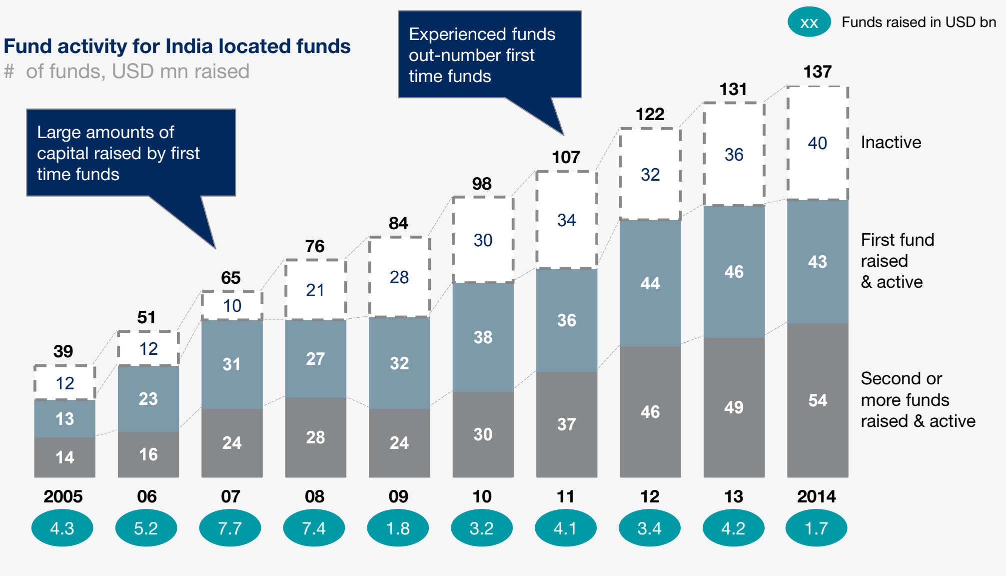
19 AVCJ Research and VCCEdge, covers only deals where stake information available.

# Chapter 3:
# The Route Ahead

In the wake of the challenges that followed the global economic crisis of 2008, the Indian private equity industry again finds itself at a turning point, this time with the opportunity to chart a new route to resurgence. It begins the journey, burdened with a largely mediocre invested portfolio (a legacy of the economic slowdown), a proliferation of private equity funds with abundant capital and a fragmented regulatory framework. The lessons learned while enduring these challenges put the industry in a strong position for accelerated growth, even as it seeks exit options for about $75 billion invested from 2001 to 2013. Improving business sentiment, a growing recognition among Indian enterprises of the strategic benefits of private equity and a pro-reform government will aid the resurgence, but concrete action is also needed to rekindle the industry's vitality and longer-term performance.

Already, the industry is showing signs of greater maturity. For one, it has a greater number of experienced managers than ever before. For example, the number of private equity managers who have handled more than one fund more than doubled from 2009 to 2014 (Exhibit 3.1). In addition, more funds are now domiciled in India. In 2014, for instance, the number of Category II Alternative Investment Funds (AIFs), which includes private equity, has grown from 45 to 61 and the funds invested rose from about $270 million to about $730 million.

**Exhibit 3.1:** Industry showing signs of maturity with increasing fund manager experience and several first time funds becoming inactive




1 Covers only India located funds
2 GP classified as inactive if not invested in either the current or previous year

SOURCE: Preqin; McKinsey analysis

As part of our research, we interviewed stakeholders throughout the industry –private equity managers, investors, executives at portfolio companies, regulators, tax and legal consultants and leaders at industrial groups. The recurrent theme from these interviews was that a strong alignment between stakeholders within the industry and the country's economic objectives is needed for private equity to deliver its full potential to the country's economy. Three factors – learning from the industry's past experience, suitable growth opportunities for the industry and a supportive regulatory framework, were seen as critical to success.

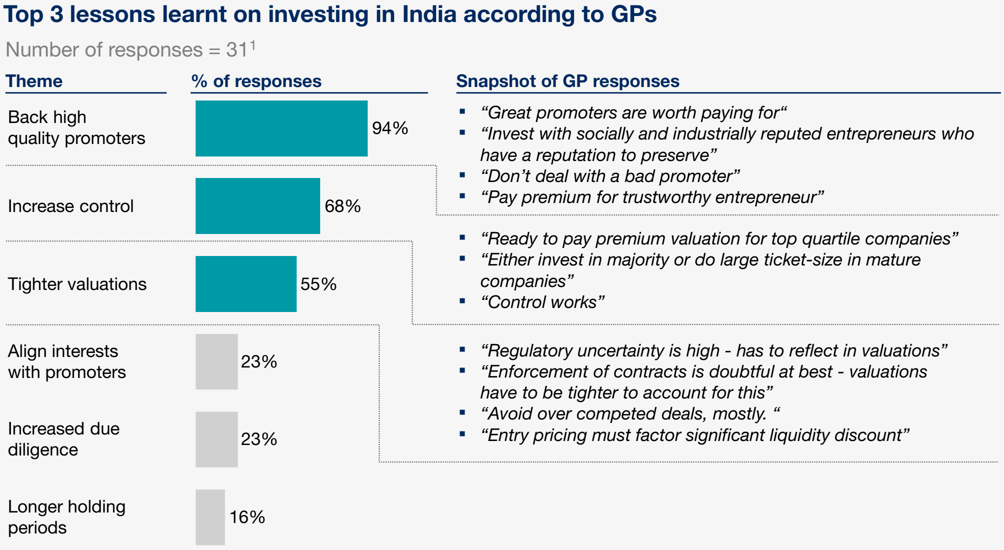
## Learning from experience of the 2001-14 era

Private equity managers are already acting on lessons garnered from more than a decade's experience on the Indian market, spanning both fruitful and austere periods. To continue this route to resurgence, they must vigorously apply what they have learned as they select new investments, negotiate ownership structures and engage with portfolio companies.

### Seeking higher quality entrepreneurs

We surveyed 31 private equity managers, and their overriding priority was to identify higher quality entrepreneurs to fund, followed by increased influence over portfolio companies and better entry valuations (Exhibit 3.2).

**Exhibit 3.2:** GPs plan to tighten entry valuation, while maintaining focus on promoter quality and increasing control




1 9 of the 40 respondents were venture capital funds and their responses were excluded

SOURCE: McKinsey-IVCA General Partner Survey; McKinsey analysis

The targeted company's brand equity, credentials, level of professionalism and understanding of the role of private equity as a source of capital were amongst the critical criteria often noted for selecting a quality investment. Evaluating these factors is especially important in the case of family-owned businesses, which comprise more than 70 per cent of the enterprises in India and can be less transparent, especially when it comes to ownership structure and influence models.

A second lesson highlighted by our survey was that private equity managers increasingly want to structure deals that offer controlling or significant stakes. They want to enhance their influence over strategic decisions, corporate governance, capital discipline and planning for an IPO or strategic sale. Finally, managers said they must tighten their valuation methodologies and risk-assessment capabilities to account for various uncertainties in the Indian market, including regulatory shifts and the difficulties of enforcing contracts.

## LPs focusing on local expertise, specific thesis & stable teams

Investors into private equity (aka limited partners) are also adjusting their approach to India in the wake of recent experiences. About 90 per cent of the 22 limited partners we interviewed said they are focusing more on private equity managers with deep local expertise, a stable team and an established track record (Exhibit 3.3). In particular, investors want assurance that their managers offer strict adherence to global standards of due diligence, sectoral experience, operational discipline and a comprehensive exit approach. Recently, we have observed that several local funds have shown positive momentum in their subsequent fundraising efforts.

**Exhibit 3.3:** LPs also plan to over-invest in identifying the right GP with deep local knowledge and right investment theses for India

**Top 3 lessons learnt on investing in India according to LPs**

Number of responses = 22

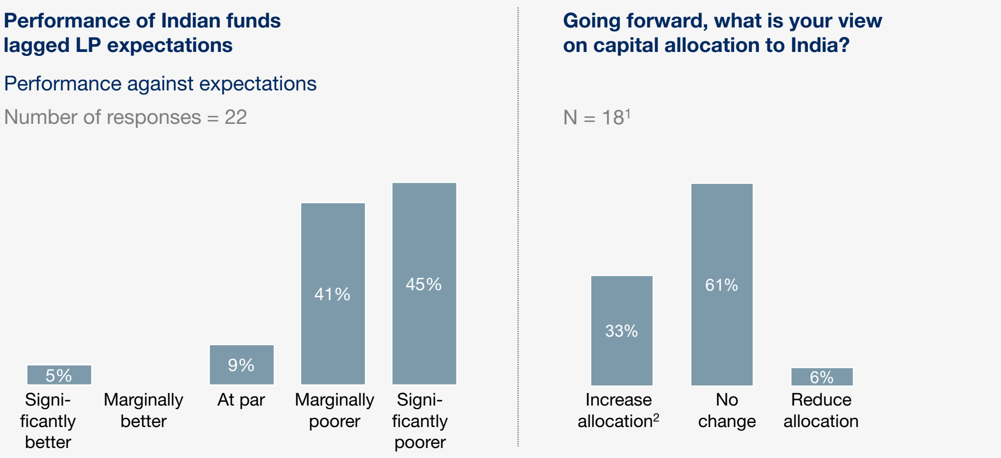
| Theme | % of responses | Snapshot of LP responses |
|---|---|---|
| Pick the right GP | 91% | ▪ *"Team stability and credibility is very important"*<br>▪ *"Focus on GPs with track records of exits"*<br>▪ *"Need to find GPs who can create unique deal flow"*<br>▪ *"Back local GPs over global GPs"* |
| Invest in specific thesis | 68% | ▪ *"Avoid growth capital investing in India"*<br>▪ *"Deep sector expertise is very important"* |
| Invest for longer horizon | 45% | ▪ *"Growth in Indian PE market is steady, but slow"* |
| Factor in currency exposure | 32% | ▪ *"Base your return expectation with a 15-20% currency diminution"* |
| Invest in smaller funds by size | 32% | ▪ *"Fund size has been the enemy of performance"* |
| Others | 9% | ▪ *Other reasons mentioned: "High entry valuations", "Cyclical market conditions", "India doesn't yet have large cap exits" etc.* |

SOURCE: McKinsey-IVCA Limited Partner Survey; McKinsey analysis

Armed with co-investment rights, investors are also developing individual investment theses, which guide their fund allocation decisions and manager selection. Amongst the various themes expressed were preferences for dollar-denominated funds, smaller funds and sector-focused funds. Conversely, there is hesitation towards certain sectors, such as civil construction, because of issues like high frictional cost of dealing with clearances, uncertainty arising from shifting regulations, delays in project timing or availability of concessions and an inability to protect underlying project cash flows.

However, despite the underperformance of the past, most foreign investors said they remained committed to investing in India, with the vast majority saying they would retain or increase their funding allocation to India (Exhibit 3.4). About two-fifths of the investors we interviewed have been active in India for at least a decade and continue to take a longer-term view of India's potential.

**Exhibit 3.4:** LPs expect to maintain or increase allocation to India despite unmet expectations




1 4 of the 22 LP respondents don't have a country specific allocation
2 Includes 'Increase allocation to India as percentage of our overall fund' and 'increase allocation to India in proportion to growth of our overall fund'

SOURCE: McKinsey-IVCA Limited Partner Survey; McKinsey analysis

### Portfolio executives seek more operational help

Survey responses of more than 40 executives at portfolio companies suggest that they welcome contributions from private equity firms in board governance, business strategy, talent management, succession planning and enabling inorganic expansion. Interestingly, they added that they would like significantly more help in improving operational efficiency and customer acquisition, leveraging the experience of private equity firms.

## Need for a supportive regulatory framework

The regulatory framework that governs the broader financial services and securities industry in India has a direct impact on private equity investors. This framework, amongst other objectives, is designed to protect the interests of minority shareholders and to discourage the use of offshore tax treaties to prevent tax evasion. There are however instances in which these regulations have had unintended, potentially adverse consequences for private equity, which is a distinct asset class.

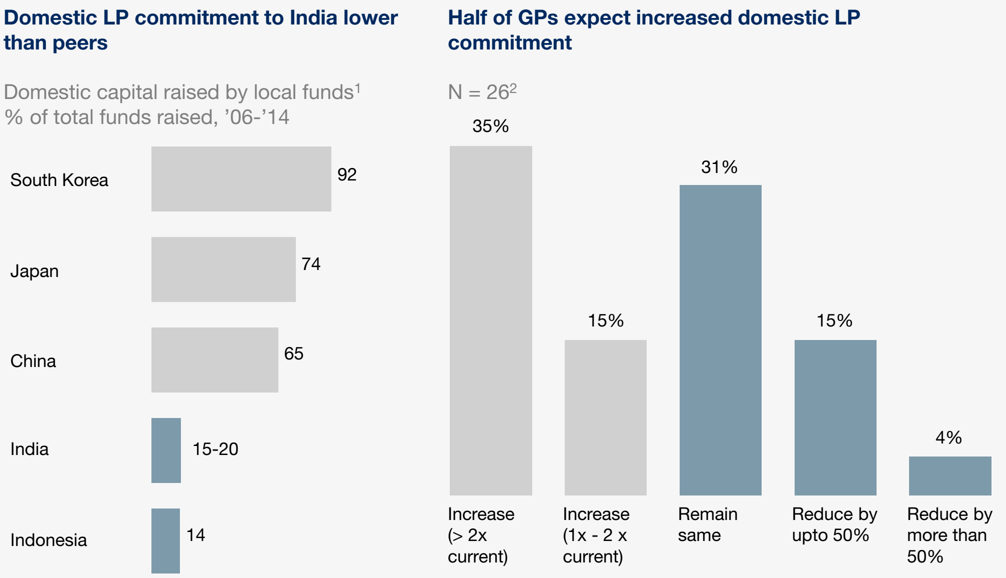
Industry leaders have been in conversations with regulators to address some of these concerns and progress has been made recently, including in the Union Budget (Finance Bill 2015) presented by the finance minister in parliament, which contained positive overtures to private equity investors. Specifically, the government has proposed to defer the introduction of GAAR provisions to the Income Tax Act until April 1, 2017, allow pass-through status to all Category I and II AIF vehicles and introduce safe harbour norms for offshore funds.

The external environment now provides a unique opportunity: analogous to the government's "Make in India" campaign, a similar "Manage Indian investments from India" campaign could support increasing capital investment from domestic and foreign sources. With private equity contributing more than 40 per cent of equity financing today, stakeholders have told us that a set of cohesive and cogent policies specifically aimed at encouraging the flow of private equity would be welcome. Several priorities have been identified by industry leaders and other stakeholders, including foreign and domestic private equity managers, foreign and domestic limited partners, legal counsels and advisors. Acting on these suggestions could help the industry blaze a resurgent path forward. They include:

## Mobilising additional domestic capital

In India, about 15 per cent of domestic capital is committed to private equity funds for investment in India, which is well behind 65 per cent committed in China to domestic-focused funds and 75 per cent in Japan[20] (Exhibit 3.5). While part of this difference is attributed to risk aversion amongst domestic investors, part is likely linked to regulatory restrictions.  For example, some domestic institutional investors like banks are allowed an allocation of up to 10 per cent of their total funds in private equity, while provident and pension funds, which are among the common pools of capital in most countries for private equity, are not allowed to invest in private equity at all.[21] As a result, of the $412 billion of capital with insurance, provident and pension funds, only $9.9 billion is made available, of which $7.4 billion is invested (Exhibit 3.6).

**Exhibit 3.5:** Expectations to mobilize domestic capital are high




1 Contribution calculated based on known fund commitments by domestic LPs to total known fund commitments attributable to all LPs for each country
2 Of the 40 survey responses, 14 responses excluded as those GPs do not raise country specific funds/cannot access domestic LPs

SOURCE: McKinsey-IVCA General Partner Survey; McKinsey analysis

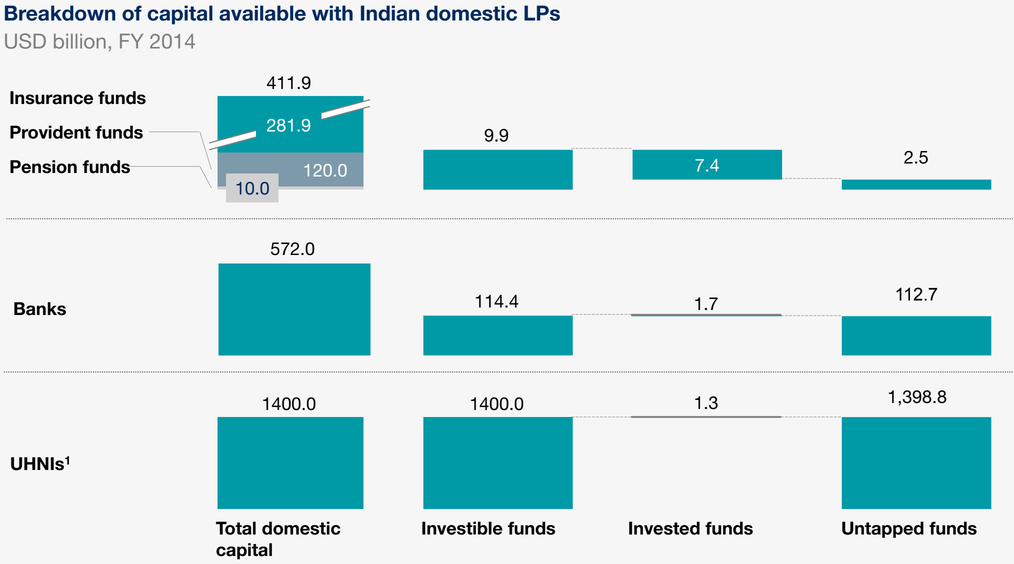
Further, there are additional restrictions on how much most domestic institutions can commit to any single alternative investment fund vehicle based on the size of assets being managed. While some of these restrictions may have once been appropriate given the inherent risks in the asset class and lack of understanding, today there are domestic

20 Fundraising statistics, AVCJ Research, Preqin database.

21 The 2015 G.N. Bajpai Committee report for investment guidelines for National Pension System (NPS) has recommended that pension funds be allowed to invest in alternate asset classes such as alternate investment funds (AIFs).

institutions that understand the nature of this relatively illiquid asset class and would like to enhance their exposure to it.

**Exhibit 3.6:** Typical sources of capital for private equity are marginally tapped in India




1 Ultra high net worth individuals, defined as persons with assets greater than INR 25 crore

SOURCE: Kotak wealth management; McKinsey analysis

The recent amendments to the Income Tax Act that allow for pass-through on all income other than business income for Category I and II AIFs have removed some of the structural challenges that collective investment vehicles have had in raising domestic capital efficiently. However the characterisation of income for AIFs as business income and capital gains introduces the potential for litigation in the future.

Domestic investors currently also have limited access to accurate information about the performance of the private equity industry, which limits their ability to objectively assess its attractiveness as part of their portfolio allocation process. Making information about the industry's performance more easily available through neutral gatekeepers will help resolve this gap.

## Enabling environment for offshore funds

The foundation of the regulatory framework for overseas investors rests on favourable tax treaties with jurisdictions like Mauritius and Singapore. Private equity investors were encouraged by clarification provided in the Union Budget 2015 on deferring the introduction of GAAR provisions to the Income Tax Act until 2018 and on noting that these provisions would not be retroactive.

However, a few aspects of the overall framework continue to limit its effectiveness. For example, the introduction of safe harbour norms for offshore funds establishes the intent to allow professionals to work effectively from India, but once the qualifying conditions are considered, most funds operating in India would be ineligible to benefit from such norms. Similarly, while the pass-through benefit has been given to investors in collective fund vehicles, the withholding tax of 10 per cent makes it cumbersome for global pension funds, which are major investors into private equity, since they enjoy tax-free status in most countries.

### Simplifying delisting norms and the court receivership process

The narrow investment universe in India can be expanded by simplifying the delisting process for the large number of listed companies that are closely held and thinly traded. The pricing norms set as a reverse book building method coupled with a high threshold level for shareholder approvals makes it impractical for private equity firms to delist these companies, take them private, and then start various performance enhancement programs. Accelerating the delisting process will help these companies get access to alternative funding, while at the same time expand the investment options available to private equity investors in India.

A similar opportunity exists in distressed situations. A constructive bankruptcy regulation and receivership process would enable private equity investors to provide a capital infusion and restore the health of companies, supporting continued job creation and limiting bank write-downs.

### Facilitating exits from investments within a reasonable horizon

Successful exits are a key factor that investors consider in allocating capital in subsequent rounds of fund raising. However, there are two constraints that impede the exit process. Firstly, classification of private equity investors as "promoters" in portfolio companies locks them in for up to three years after an IPO before they can completely exit the company. Secondly, challenges to transactions by tax authorities after a private equity fund has been dissolved and its assets returned to investors raises natural concerns, and investors are often required to offer potential buyers additional indemnities and insurance, which adds to the costs and timelines of exiting investments.

Undoubtedly, public and private stakeholders recognise, understand and appreciate these issues, and many efforts are underway to resolve them appropriately. Accelerating these efforts amid an improving external environment will provide a major boost to the industry just as it rejoins its journey towards a long-term sustainable model.

□ □ □

After several challenging years, the private equity industry in India can take advantage of the newfound economic optimism, a record of impact on portfolio companies and chart a route to resurgence. Changes in the strategies and mindset of private equity firms and their investors, as well as those of entrepreneurs and executives at portfolio companies, point towards a stronger industry that can again offer significant contributions to the Indian economy. To reach this potential, challenges must be overcome through cooperation and continued dialogue amongst investors, regulators and industry associations.

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