



## INVESTING IN INDIA: A 20/20 PERSPECTIVE

### Second Annual South Asia Business Association India Business Conference Columbia Business School April 14, 2006

*As India's economy booms, financiers seek more vehicles, products and industries in which to diversify their holdings and capture new value. On April 14, 2006, Columbia Business School's South Asia Business Association held its second annual India Business Conference, "Investing in India: A 20/20 Perspective." The conference's "Private Equity Investing in India" panel featured four distinguished investors who discussed India's maturing private equity environment. Panelists addressed the challenges, both private equity-specific and countrywide, that must be addressed for the industry to be globally influential. They also explained why investors should be bullish on the Indian private equity sector.*

*The four panelists were*

- *Ajay Sharma, MBA '95, Director, Merrill Lynch Private Equity Group*
- *Anil Kumar, MBA '05, Managing Partner, Virtus Capital Partners*
- *Seth Freeman, CEO, EM Capital Management, LLC*
- *Mintoo Bhandari, Managing Director, The View Group*

*Paul Tierney, adjunct professor at Columbia Business School and general partner at Aperture Venture Partners, moderated the panel and gave opening remarks.*

### **Summary of Discussions**

In 2005, investors allocated \$250 billion in private equity (PE) funds in the United States, while sending a meager \$2.7 billion to India. Although India's share amounts to just 1.1 percent of that in the United States, a closer inspection reveals a growing and evolving industry positioned to play a prominent role in the Indian economy.

Just as the private equity and hedge fund industries have begun an apparent convergence in the United States, so too have private equity and joint venture projects come together in India. Three-way deals, pairing a financial firm, an Indian company and a non-Indian operating company, are becoming commonplace. Based on these crossovers, it is hard to determine exact industry statistics. But what is certain, according to Adjunct Professor Paul Tierney, is that “India is at the very beginning of a large deluge of capital.”

### **PE-Specific Challenges**

Despite this deluge, Indian private equity firms face strong disadvantages. When investors are shopping for private equity firms with which to invest, they generally look for three qualifications: the team, the investment strategy and the track record. While Indian firms can offer the first two items, there is simply not enough history to assuage investors about the third. In a typical PE fund, investors are asked to make 8- to 10-year commitments of cash: four to five years for the PE firm’s principals to find deals, and an additional four to five years to harvest those deals. Investors with enough capital to make such a long-term and high-risk investment will often feel more comfortable investing with major firms like Carlyle, Blackstone and KKR. While some of these firms have opened offices in Mumbai, this is a very recent phenomenon, and the investments are still on a relatively small scale. Many foreign investors prefer Indian index and hedge funds, which do not require any long-term commitment, giving PE firms an even greater challenge in their marketing. Another challenge is that 50 percent of private equity dollars come from pension funds, which are famously conservative with their money given the nature of their business. As a result, Indian firms have a difficult task at hand.

There are a number of other challenges that confront the Indian PE industry. First, Western investors find comfort in large-scale deals, which are scarce in India. Most Indian PE opportunities are middle market and deemed not large enough. Additionally, many of the Indian deals are private investments in publicly traded entities, or PIPES. Western investors tend not to like PIPES because they feel that high management fees should reward management for finding deals that investors could not find themselves. PIPES deals, however, are publicly available. Investors are also concerned about making accurate valuations in the face of India’s fast-growing economy and the rapid growth of index funds. Further, due diligence and information gathering are difficult, as deals are very relationship driven. Finally, as investors inevitably compare India to China, they may be attracted to the larger deal flow in China. A growing consensus concludes that China is a more mature market with which more foreign investors have experience.

### **Opportunities in the Current Marketplace**

Concerns are slowly fading as Western PE funds seek untapped sources of returns away from the saturated markets of the United States and Europe. The preexisting Indian presence of major U.S. firms like Microsoft, Dell, and Honeywell provide what Ajay Sharma, director at Merrill Lynch Private Equity Group, describes as “an economic ecosystem” that instills further confidence. U.S. university endowments and Swiss insurance companies have been among the first to invest in large-scale private equity deals in India. There is some concern that there is already too much money following too few deals.

Another promising attribute, pointed out by Anil Kumar, managing partner at Virtus Capital Partners, is the focus on early- and late-stage investments, which add depth to the overall PE market. Domestic firms tend more toward venture capital, while foreign firms are attracted to maturing companies. There are mutual benefits to this, as early-stage investors take comfort in knowing the portfolio company will have long-term assistance. Late-stage investors like to know that a company has had prior outside help. However, there is much progress to be made. While Indian funds have succeeded for firms based in New York and London, there is still yet to be large-scale PE activity where the money is purely Indian and the investment decisions are made in Mumbai. Notable exceptions include Westbridge and ICICI Capital.

### **Where to Invest**

Favorable growth is occurring in many sectors, and targeting the most promising one is a challenge to investors. Mintoo Bhandari, managing director at the View Group, recommends sectors and companies with dollar revenues and rupee costs, such as financial services, health care and engineering, particularly in cross-border deals. Seth Freeman, CEO of EM Capital Management, quipped about the hidden value in small- and midcap market opportunities, even zipper companies. “It doesn’t take an MBA to figure out that there are 1.2 billion people and they need zippers.”

Kumar urged a redirection of cash toward product-development companies rather than service-oriented companies. Product-development companies permit easier withdrawal of capital, and India has more skills and potential as a product developer, not just as a place to execute U.S.-made designs. Real estate is another sector that panelists deemed promising because land is the most efficiently priced asset in the market. Foreigners should invest only if they build something and add value. Finally, the panelists encouraged—but also cautioned—investors in the public goods sector, including food, roads, housing and infrastructure.

### **Attributes of India at Large**

Bhandari discussed private equity through a framework of India's biggest challenges, coupled with the country's most promising trends. The three biggest challenges are tension between old and new generations, infrastructure and corporate governance. According to Bhandari, India's three greatest attributes are that it is undervalued, it has favorable demographics and entrepreneurialism is ingrained in the culture. He argued that as India goes, so will go the PE sector.

The Indian old guard still favors a socialist and regulated business environment, in contrast to the energetic and dynamic culture of the country's young people. This chasm manifests itself in many ways, and Bhandari argued that it must be reconciled in order for the private equity industry, and India as a whole, to reach its fullest potential. Old-economy sectors such as agriculture and state-owned enterprises are growing at 2 percent a year, in contrast to technology and outsourcing, which grow by 7–8 percent. Economists believe India can and should be growing at 10 percent, so structural changes may need to occur. The administration of Prime Minister Singh represents the more socialist past. Bhandari adamantly believes that more privatization and liberalization must occur.

India could compete with China in supply-chain-intensive manufacturing, were the physical infrastructure in stronger condition. Heavy manufacturing also creates jobs for lower-skilled people, a subset of the population with higher unemployment. Infrastructure improvement is a major challenge that affects all sectors of the Indian economy and is a top priority of the current government.

Finally, Bhandari highlighted corporate governance difficulties. There are fundamental differences in Indian governance compared to Western norms. One must know the people with whom one is dealing because business culture is relationship-driven, and there are no easy exits. There is also a perception that the value of an Indian company is in the entrepreneur or family who founded it and that an outside entity cannot control a company and keep the value as a result.

As for India's positive attributes, first, many assets are undervalued. Beyond the SENSEX index of the Bombay Stock Exchange, PE ratios are low, and the country is doing far better than GDP and other statistics portray to the outside world. There is much room for growth, in private equity and otherwise. Second, 54 percent of India's population is under 25, well educated and English-speaking. Bhandari believes that this generation

could drive the world's economy and that at some point in the future, one in two white-collar workers will be Indian. China's next generation, in contrast, is depleted from the one-child policy and speaks far less English. Finally, Bhandari extolled the culture of innovation and entrepreneurialism and said that the PE industry will grow and succeed so long as India's entrepreneurial values stay in place.

### **Conclusion**

The outlook on Indian private equity is positive, mirroring the advantages and drawbacks of the overall economy. Large firms are just beginning to take India seriously. Blackstone will soon have an all-India fund, no longer just an emerging market fund in which Indian assets compose a small part; Warburg Pincus and Carlyle have new Mumbai offices. Currency risk is no longer of significant concern, according to Professor Tierney, who valued a political risk premium at 500–700 basis points. Most important, the panelists agreed, Indian returns must be comparable to those in the West. After a full cycle of fund-raising, execution and profit realization has taken place, Indian private equity should be in a much stronger position to accomplish this.

For these returns to be realized, India as a whole will have to undergo various changes. Some challenges are specific to the private equity industry—lack of track records, difficult due diligence and PIPES investments; others affect the whole country. Meeting these challenges will be important for India's private equity industry, and the economy as a whole, to maintain upward growth and exert continued influence on the global economy.

Jay Hallen MBA '07  
Columbia Business School

*For more information on the SABA Indian Business Conference, visit*  
[www.gsb.columbia.edu/students/organizations/saba/ibc](http://www.gsb.columbia.edu/students/organizations/saba/ibc).