FEBRUARY 2015

Private Equity (Global)

# **Private equity in India:** Once overestimated, now underserved

**General partners can use lessons from the past decade to build a new and better future.**

**Vivek Pandit**

In the early years of this century, private-equity (PE) firms and their investors were enthusiastic about India's potential. Fifty percent of the country's 1.1 billion people were younger than 30. From 2003 to 2007, GDP grew by 7.5 percent annually, 88 million middle-class households were formed (more than twice the number in Brazil), urban dwellers grew by 35 million to 330 million, and 60 percent of the population was in the labor force. Banks' nonperforming-asset ratios fell from 9.5 percent to 2.6 percent. Further, the PE-to-GDP ratio stood at 1.8 percent, reassuring investors that India had plenty of headroom when compared with developed markets such as the United Kingdom (4.2 percent) and the United States (4.4 percent).

Private investors poured about $93 billion into India between 2001 and 2013 (Exhibit 1). At first, returns were strong: 25 percent gross returns at exit for investments made from 1998 to 2005, considerably better than the 18 percent average return of public equity. But returns fell sharply in following vintages; funds that invested between 2006 and 2009 yielded 7 percent returns at exit, below public markets' average returns of 12 percent. In fact, India's PE funds in recent years have come up well short of benchmarks: with a 9 percent risk-free rate and a 9.5 percent equity risk premium (accounting for currency risk, country risk, and volatility), the climb for Indian PE investors is undisputedly steep. To be sure, returns are based on a small number of exits, but that in itself is a problem. Only $16 billion of the $51 billion of principal capital deployed between 2000 and 2008 has been exited and returned to investors.

This article will explore the reasons why expectations may have been overly rosy, the headwinds that few investors escaped, and the behaviors that firms fell into. As the industry matures and resets its sights more realistically, a new wave of growth seems within reach. Five factors can tilt the balance: an increase in a bias in favor of control investments, appreciation of the complexity of family-owned businesses, new supplies of mezzanine financing, greater scrutiny from limited partners over general-partner strategies and capabilities, and encouragement from regulators.

## Understanding what went wrong

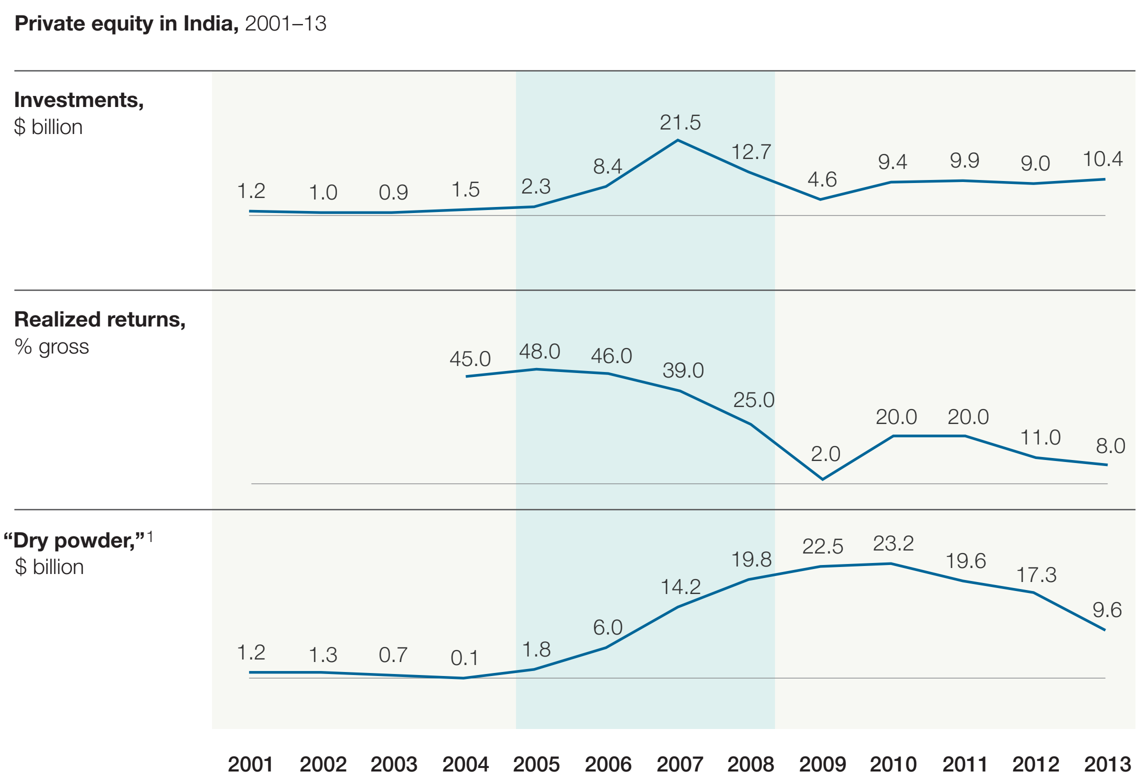
Where did PE firms go wrong? Many in the industry suggest that the management approach favored by North American buyout firms was ill suited to the Indian opportunity and was made worse by the inexperience of PE firms operating on the home turf of experienced promoters (a unique form of business owner and investment syndicator). However, there are better explanations, in two categories, which provide lessons for investors to explore.

### Estimates overshot the mark

Firms overestimated the market in several ways. Some misjudged the investable universe of private companies. The pull of public markets set the stage for some adverse selection of private

Exhibit 1

**Indian private equity peaked between 2005 and 2008 and has yet to regain its form.**




[1]Calculated as the difference between trailing 7-year funds raised and investments in India through local and Asia-focused funds.

Source: *Asian Venture Capital Journal*; Preqin; VCCEdge; McKinsey analysis companies and created unexpected competition from intermediaries. Overly optimistic GDP forecasts and a convenient interpretation of PE-to-GDP ratios also worked against some PE firms.

Indian general partners are fishing in a small pond (Exhibit 2). In 2013, India had 10,440 companies with between $25 million and $500 million in revenue, excluding state-owned entities and publicly listed companies; China had 41,150 and Russia had 16,700. And general partners can't step up in size and pursue larger companies; there are about 270 private companies with revenues over $125 million in India, compared with 1,295 in Brazil, 7,680 in China, and 3,430 in Russia. India has about 30 private companies with more than $500 million in revenues.

Indian general partners are in constant competition with stubbornly high capital-market valuations. India has around 2,600 publicly listed companies with less than $125 million in revenue, compared with 1,000 in China. As a result, many private companies went public before PE managers could access them.[1] This had two effects. First, it created pricing pressure on private buyers; indeed, India is one of the few markets where private valuations meet and often exceed public-market comparables. Second, some argue it created an adverse selection of private companies, as companies that could access public markets did.

With fewer investable private companies, competition from capital markets, and growing levels of "dry powder" among PE firms, the

Exhibit 2

## India offers fewer private companies than other emerging markets.

**Private companies by annual sales,**[1] number of companies, 2013

| | <$2 million | $2 million–$25 million | $25 million–$125 million | $125 million–$500 million | >$500 million |
|---|---|---|---|---|---|
| Brazil | 660,000 | 415,500 | 1,235 | 750 | 545 |
| Russia | 1,760,000 | 258,500 | 14,100 | 2,600 | 830 |
| China | 12,400,000 | 195,500 | 34,250 | 6,900 | 780 |
| India | 760,000 | 99,000 | 10,200 | 240 | 30 |
| | | Growth stages | | | |

[1]Does not include public-sector undertakings and other government-sponsored businesses, public companies, or businesses in the unorganized sector.

Source: OneSource; Russian Federation Federal State Statistics Service; McKinsey analysis environment became fertile for sell-side intermediaries, facilitating greater competition. Intermediaries push prices up via auctions, and, of course, public comps underpin the market. As a result, Indian general partners saw a highly intermediated, fully priced market with few proprietary deals.

Rewards for optimism persisted longer than they should have. In every year but one between 2002 and 2010, India's GDP exceeded all major analysts' predictions. However, from 2011 on, that trend reversed sharply as India's GDP came in either below or at the lower end of analysts' expectations. With so many models pegged to GDP growth estimates, volatility played havoc with returns.

India's general partners also had more capital on hand than could be reasonably invested. Many investors were bewitched by industry observers' claims that India's PE-to-GDP ratio was low relative to developed markets. However, a closer look reveals those numbers weren't so low. If cumulative PE investments from 2002 to 2005 relative to 2005 GDP are considered, India stood at 0.72 percent, similar to China (0.85 percent) and below Indonesia (1.08 percent) and Korea (1.15 percent). But as capital flowed in, India quickly hit and passed these benchmarks. The figures for 2006–09 stood at 3.5 percent for India, higher than China (1.2 percent), Korea (2.4 percent), and Indonesia (0.8 percent). True, between 2006 and 2009 private investors sunk nearly $60 billion into China, more than the $47 billion they invested in India. But then again, the Chinese opportunity is much larger—bear in mind the more than 40,000 companies that private investors might access in China, relative to India's 10,000, as shown in Exhibit 2. By the end of 2006, investors in India sat on more than four years of dry powder.

### Excess capital pressured discipline

With excess capital on hand, general partners increased transaction sizes and invested in a range of sectors, many of them capital intensive, relatively illiquid, and requiring longer times to exit. As a result, returns have been hurt, exits have been scarce, and secondary sales are becoming much more frequent.

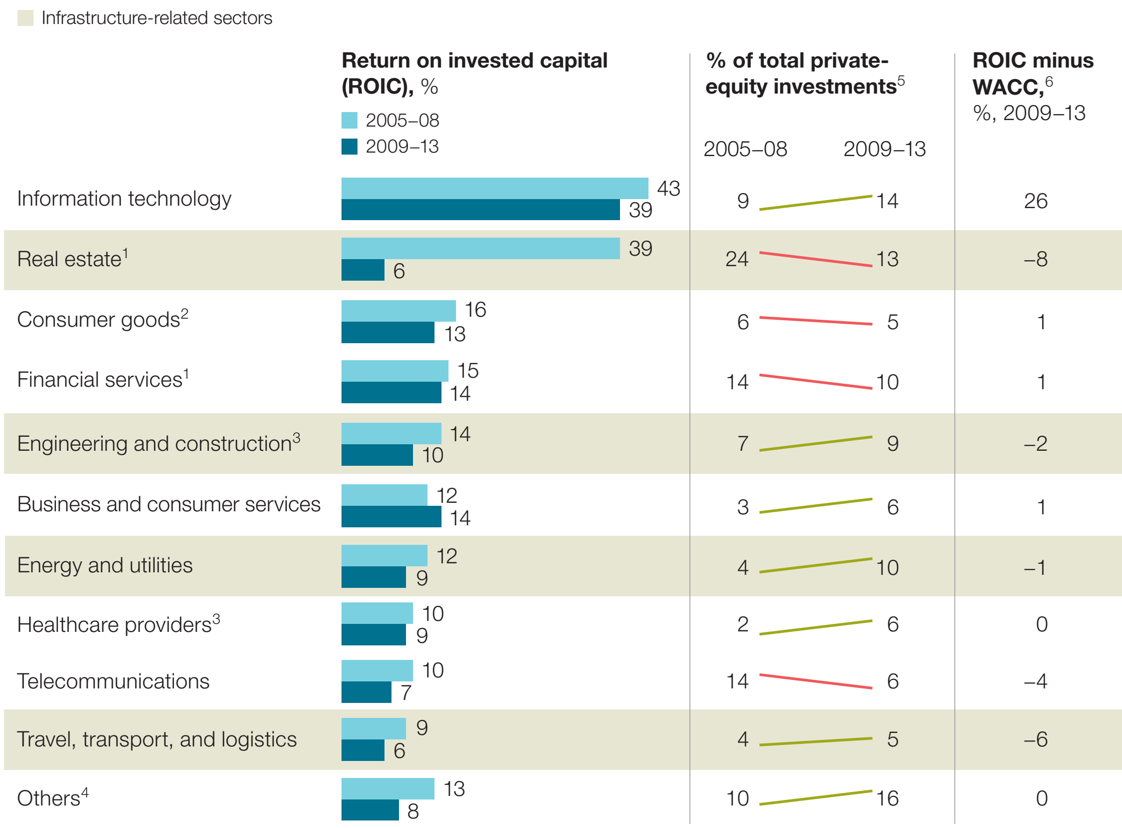
Between 2005 and 2008, firms deployed capital in several industries (Exhibit 3). In the next wave of investment, between 2009 and 2013, the investment mix shifted considerably, and not for the better. For one thing, more investments were directed to sectors that have longer gestation times and are more capital-expenditure intensive, such as engineering and construction, hospitals, power generation, and real estate—in other words, infrastructure plays. In India, such investments are often greenfield and take longer to bear fruit. By 2013, all of the 25 largest firms had at least one such investment in their portfolios, representing 43 percent of the $77 billion invested between 2007 and 2013. In several cases, as bank lending got tighter, inflation rose, and policies wavered, the returns in these sectors dropped, just as firms were committing more capital to them.

Second, many infrastructure investments were made by generalist firms whose capabilities to manage risk and projects with longer exit horizons varied significantly. By contrast, consumer goods accounted for a mere 6 percent of investments in 2005–08 and 5 percent in 2009–13. The expansion of investors' appetite for larger deals came at the same time that several capital-hungry sectors sought capital. But this increased risk, as these sectors were disproportionately affected by escalating input costs and policy-driven delays.

Exhibit 3

## Investors allocated more capital to several sectors whose subsequent performance lagged.

**Private-equity investments and returns in India, by sector**




[1]Return on equity and cost of equity have been used for these sectors in place of ROIC.
[2]Consumer goods includes all consumer products, food and beverage, leisure, retail, and textiles.
[3]Also includes related equipment suppliers.
[4]Includes automobiles, machinery and industrial goods, media and entertainment, metals and mining, and pharmaceuticals.
[5]Figures may not sum to 100%, because of rounding. Total investment in 2005–08 was $45 billion and in 2009–13 was $43 billion.
[6]Weighted average cost of capital.

Source: *Asian Venture Capital Journal*; PROWESS (India) Consulting Services; McKinsey analysis

The average investment holding period for exited deals rose from 3.5 years in 2004 to 5.2 years in 2013. Those entering these relatively illiquid long-gestation businesses found it even harder to exit: of the $51 billion in investments made between 2000 and 2008, only 14 percent (by value) of those in real estate exited, along with 29 percent in logistics plays, 21 percent in engineering and construction companies, and 9 percent in energy and utilities (Exhibit 4). Shareholders and promoters found themselves in a tough position as input costs soared, working-capital needs increased, and the IPO market lost its appetite for midmarket listings. In aggregate, only $16 billion

Exhibit 4

## Most sectors saw few exits, long holding periods, and low gross returns.

**Private-equity performance in India, by sector**

| | **Investments,** 2000–08, $ billion | **Exits,** % of total investments exited, 2000–13 | **Gross return of exits,**[1] % | **Holding period of deals exited,** years, 2000–08 |
|---|---|---|---|---|
| Real estate | 9.8 | 14 | 2 | 5.3 |
| Telecommunications | 7.2 | 25 | 5 | 4.2 |
| Financial services | 7.2 | 34 | 13 | 4.4 |
| Information technology | 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 |
| Energy and utilities | 1.9 | 9 | N/A[4] | 3.7 |
| Business and consumer services | 1.6 | 28 | 18 | 3.7 |
| Healthcare providers[2] | 1.0 | 39 | 19 | 4.9 |
| Others[5] | 8.2 | 69 | 0 | 4.3 |

Average

[1]Gross dollar internal rate of return estimated for ~610 exits, assuming all investments as 100% equity deals.
[2]Also includes related equipment suppliers.
[3]Consumer goods includes all consumer products, food and beverage, leisure, retail, and textiles.
[4]Fewer than 10 exits observed.
[5]Includes automobiles, machinery and industrial goods, media and entertainment, metals and mining, and pharmaceuticals.

Source: *Asian Venture Capital Journal*; PROWESS (India) Consulting Services; McKinsey analysis

(31 percent) of the $51 billion invested has exited, at a value of $27 billion (Exhibit 5). While several general partners have successfully renegotiated extensions with limited partners, these forces can be expected to have a material impact on returns.

Like many emerging markets, India is prone to momentum investing, with few contrarians to be found. More than 70 percent of private investments in the past ten years were made when the index traded above its ten-year median price-to-earnings multiple of 17.4 (Exhibit 6). By contrast, firms in China deployed less than 50 percent of their capital at times of high valuation. In India's volatile lending environment, promoters learned to raise capital when capital is plentiful. Discussions with general partners reveal a perception of unrealistic price expectations

Exhibit 5

**Of $51 billion invested from 2000 to 2008, $16 billion exited at 1.7x, or a value of $27 billion.**

| **Investment period** | **Investment,** $ billion | **Exits, cost basis,** $ billion | **Exits, value basis,** $ billion | **Exit to entry,** multiple |
|---|---|---|---|---|
| 2000–04 | 5.8 | 3.3 | 8.5 | 2.6 |
| 2005–08 | 45.1 | 13.0 | 18.7 | 1.4 |
| 2009–13 | 43.1 | 2.0 | 3.1 | 1.7[1] |

[1]Figures may not sum, because of rounding.
Source: *Asian Venture Capital Journal*; Preqin; VCCEdge; McKinsey analysis

and overpriced investments in others' portfolios. In a market that should prize liquidity, capturing liquidity premiums remains difficult.

With pressure to find an exit mounting, sales to other PE buyers are now the second-largest way out. Nearly 30 percent of all exits by value in 2012–13 were sponsor-to-sponsor sales, up from 10 percent in 2010–11 and 5 percent in 2006–07. The good news: PE-backed companies appear to be better governed and managed. However, they do not come with a buyback guarantee. One prominent recent sponsor-to-sponsor deal wound up a total loss, with lawsuits filed against the promoter and auditor.

### What might go right

For all these flaws, PE has grown to become a critical source of capital in the Indian economy. PE firms are responsible for 36 percent of the equity raised by companies in the past ten years and contribute even more when times are tough—47 percent in 2008 and 46 percent, on average, from 2011 to 2013. Further, our ongoing research suggests that PE-backed companies in India increased revenue and earnings faster than public companies across nearly all sectors and vintages, and these companies are, on balance, better governed, more compliant with respect to regulatory and fiduciary obligations, more likely to pursue M&A, and better at seizing export opportunities.

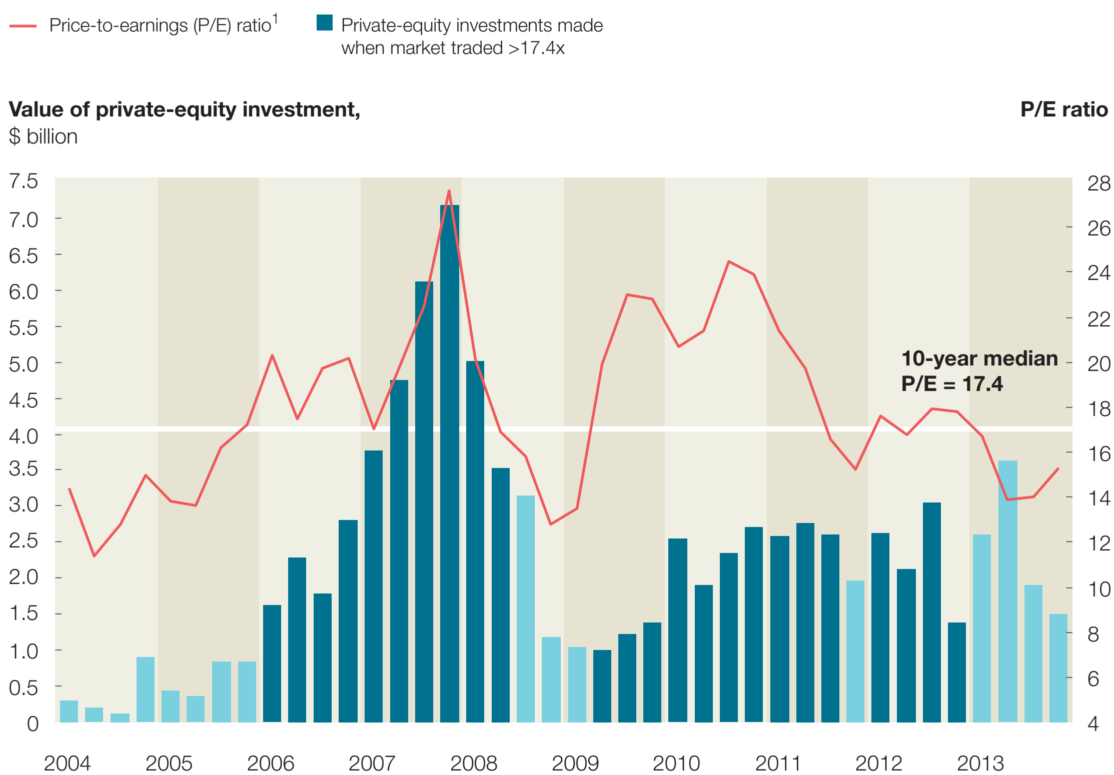
PE investors are clearly doing something right, and they can build on this. Once investors set their sights appropriately and govern behavioral excesses, they can begin to invest in an India that is paradoxically underserved. There are five supports that might emerge for a new wave of growth and returns: an increasing bias toward control deals, a recognition of the complex needs of family-owned businesses, new supply to meet a large and unaddressed need for mezzanine financing and capital restructuring, greater limited-partner scrutiny of general-partner strategies with track records, and support from regulators to boost the confidence of foreign and domestic investors.

As they look for new targets, PE firms can seek more opportunities to exercise control. In 2006–07, 13 percent of Indian PE investments by value were control investments. By 2013, this had increased to 29 percent—a favorable trend. Control investments allow firms to support an aging generation of entrepreneurs, ensure better capital discipline in portfolio companies across volatile cycles, and facilitate easier exits so that firms can renew maturing portfolios. A recent McKinsey survey of Indian general partners revealed capital discipline was the second most important focus after management capabilities.

Many of India's aging owners have succession problems, underscoring the need to address the issues of family-owned businesses. An estimated 70 percent by volume of PE investment from 2007 to 2013 (46 percent by value) went into family-owned businesses. Firms that build a deeper appreciation of the complex needs of these businesses, including the dynamics that affect succession,

Exhibit 6

## Seventy percent of investments (~$65 billion) were made during capital-market peaks.




[1] P/E is defined as current market capitalization divided by 12-month trailing earnings for top 200 Indian companies.

Source: *Asian Venture Capital Journal*; Datastream; McKinsey analysis

Our ongoing research suggests that PE-backed companies in India . . . are, on balance, better governed, more compliant with respect to regulatory and fiduciary obligations, more likely to pursue M&A, and better at seizing export opportunities.

talent attraction, family trusts, liquidity, and governance, can bring significant value to their investments and align the interests of promoters more easily. Investors confronted with issues in their family-owned-business investments need to act on early-warning signs and work through them in an orderly fashion to minimize impact on companies' health and performance. In the diligence phase, placing an equal emphasis on the business and on the promoter and management can help firms anticipate governance issues. In a recent McKinsey survey of portfolio-company promoters, general partners and portfolio companies identified the inability to recognize and navigate family issues as a weakness of general partners.

Private equity can also benefit from greater specialization—in particular, in mezzanine capital and distressed debt. The need for mezzanine and bridge financing can be estimated at between $18 billion and $24 billion by 2020; demand for distressed-debt services will likely be even higher. Given the rapid pace of expansion, including more cross-border acquisitions and the on-again, off-again nature of bank lending to companies, more mezzanine and bridge capital would serve promoters well.

With nonperforming corporate loans rising fast at India's banks and more corporate-debt-restructuring cases landing on the books of state banks (which do not always have strong work-out capabilities), there is a strong case for more distressed-debt funds. Many companies have problems in their capital structure, and PE players have the skills for efficient restructuring.

However, both mezzanine and distressed-debt funds need regulatory support. For this to take off, regulators would have to develop an appreciation of mezzanine debt, as they do equity risk capital. In doing so, they would need to expedite court receivership and delisting processes.

Some regulatory reform is needed to enable greater foreign and domestic PE participation. At the top of the list are providing clarity and parity on tax treatment for foreign and domestic funds (including issues such as pass-through status and capital gains), addressing restrictions on investment in certain sectors and on issuing convertible bonds, increasing the investable pool by simplifying the delisting process, encouraging distressed debt and mezzanine financing, simplifying fund-registration requirements, and recognizing the difference between traditional promoters and active investors. While these reforms have been on the table for a few years, many hold out hope that the new government will see some of them through.

Limited partners also have a role to play in seeing PE expand; they can do better at general-partner selection. Experience matters and is on the rise. Of the 113 funds that invested between 2000 and 2013, 33 are now inactive. The vast majority of these were first timers. The sector is slowly maturing; the number of funds investing from a third (or successive) fund increased from 5 in 2003 to 22 in 2013. As limited partners increase selectivity, further consolidation and increased discipline are anticipated.

• • •

The industry is well positioned for a new era of growth and returns if PE investors gain greater control, develop active-ownership capabilities, and can identify and align family and promoter interests, and if regulators recognize that investors can deliver more than money across the capital structure.

[1] In 2013, India had nearly 3,800 publicly listed companies; their median revenues were $20 million and mean revenues were $330 million. By contrast, China had 3,600 public companies, whose median revenues were $240 million and mean revenues were $1.6 billion. The figures for Brazil's 325 public companies were $490 million in median revenues and $2.5 billion in mean revenues.

The author wishes to thank Udit Anand, Souvik Chakraborty, and Yashashvi Takallapalli for their contributions to this article.

**Vivek Pandit** is a director in McKinsey's Mumbai office. 